Exhibit No.:
Issue: Revenue Requirement
Witness: Michael P. Gorman
Type of Exhibit: Rebuttal Testimony
Sponsoring Party: Office of the Public Counsel
Case No.: GR-2014-0007
Date Testimony Prepared: March 4, 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**

Rebuttal Testimony and Schedule of

Michael P. Gorman

On behalf of

The Office of the Public Counsel

March 4, 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 rebuttal testimony and schedule 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 schedule 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 4th 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
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**

Rebuttal 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?

A Yes. On January 29, 2014, I filed direct testimony and schedules on behalf of the Office of the Public Counsel ("OPC").

Q WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

A I will respond to Missouri Gas Energy, Inc. ("MGE" or "Company") witness Pauline Ahern. I will also respond to the Staff Report filed on January 29, 2014.

Response to MGE Witness Ms. Pauline Ahern

Q WHAT RETURN ON COMMON EQUITY IS MGE PROPOSING FOR THIS PROCEEDING?

A Ms. Ahern recommends a return on equity of 10.25%.

However, MGE proposes a lower return on equity to be consistent with its commitment in the MGE/Laclede merger/acquisition agreement. In order to accomplish this overall rate of return agreement, MGE reduced its proposed return on equity from the 10.25% recommended by Ms. Ahern down to 9.70%.[1]

Q IS MS. AHERN'S ESTIMATED RETURN ON EQUITY REASONABLE?

A No. For the reasons outlined below, Ms. Ahern's estimated return on equity of 10.25% significantly exceeds current capital market costs for MGE. MGE's current market cost of equity is also lower than the 9.70% proposed concession MGE is making as part of the merger agreement. As described below, a fair return on equity for MGE in this case is approximately 9.35%.

Q PLEASE DESCRIBE MS. AHERN'S METHODOLOGY SUPPORTING HER RETURN ON COMMON EQUITY.

A Ms. Ahern estimates a return on equity for MGE based on the Discounted Cash Flow ("DCF") model, the Risk Premium ("RP") model and the Capital Asset Pricing Model ("CAPM"). Ms. Ahern then attempts to corroborate her results by applying the same models to a proxy group of non-price regulated companies.

Q PLEASE SUMMARIZE MS. AHERN'S RESULTS.

A Ms. Ahern's results are summarized in Table 1 below.

[1]Direct Testimony of Glenn W. Buck at 5.

TABLE 1

Summary of Ms. Ahern's Return on Equity Estimates

Model	Proposed Return on Equity[1]	Adjusted
DCF	8.66%	8.66%
RP	11.60%	9.49%
CAPM	10.16%	9.03%
Non-Price Regulated Companies	10.31%	Reject
Recommended Return on Equity	10.25%	9.06%

Sources:
[1]Ahern Direct Testimony at 44, Table 3.

For the reasons outlined below, reasonable adjustments to Ms. Ahern's return on equity estimates reduce her findings from 10.25% down to approximately 9.00%. A reasonable range of return on equity estimates, based on reasonable adjustments to Ms. Ahern's model, suggests MGE's current market cost of equity falls in the range of 8.66% to 9.49%. All of this shows that my recommended return of 9.35% is reasonable and conservative.

Q PLEASE DESCRIBE MS. AHERN'S DCF ANALYSIS.

A Ms. Ahern estimates a dividend yield for each company included in her proxy group based on the average dividend yield for the 60 days ending September 6, 2013. Then, the dividend yield component is adjusted to reflect one-half the annual dividend growth rate.

Ms. Ahern used analysts' projected earnings per share growth estimates from *Value Line*, Reuters, Zacks and Yahoo Finance. The average projected three- to five-year growth rate for the proxy group was 4.98%.

Ms. Ahern determined her DCF return on equity estimate relying on her group's median results. (Schedule PMA-4).

Q DO YOU HAVE ANY ISSUES WITH MS. AHERN'S DCF ANALYSIS.

A No. Ms. Ahern's three- to five-year analysts' growth rate projections used in her study were 4.98% and 4.72% for the proxy group average and median, respectively. These growth rates are in line with reasonable estimates of long-term sustainable growth. A reasonable estimate of long-term sustainable growth is 4.80%, which is the projected long-term growth rate of the U.S. GDP.

Q DOES MS. AHERN CAST DOUBT AS TO THE REASONABLENESS OF THE DCF RESULTS FOR USE IN ESTIMATING MGE'S CURRENT MARKET RETURN ON EQUITY IN THIS PROCEEDING?

A Yes. Ms. Ahern opines that the DCF analysis understates MGE's cost of equity because the proxy group's market-to-book value ratio is greater than 1. She believes that when the market-to-book value ratio is greater than 1, a DCF derived on market value stock, understates a fair return on equity applied to book value.

Q DO YOU AGREE WITH MS. AHERN'S CONCLUSION WITH RESPECT TO THE MARKET-TO-BOOK RATIO AND THE REASONABLENESS OF THE DCF RESULTS?

A No. This argument is without merit. Ms. Ahern fails to observe that the DCF model measures the incremental cost of capital for a utility. That is, it estimates the market-required rate of return based on the last stock purchased. If this rate of return is applied to incremental investments in utility plant and equipment, then the utility would be presented with the economically balanced investment position of earning the same rate of return on incremental plant investments as it could receive by making an alternative investment in a comparable risk stock. As such, on the margin, or on an incremental basis, the book value and market value of a utility's equity investments are always equal to 1.

For all these reasons, Ms. Ahern's market-to-book ratio criticisms are without merit, and should be disregarded. Because the DCF result is based on a reasonable sustainable long-term growth rate, and the proxy group reasonably approximates the investment risk of MGE, the results of my DCF analysis and Ms. Ahern's DCF analysis provide a reasonable estimate of the current market cost of equity for MGE, which is a fair return on equity to use for ratemaking purposes.

Q PLEASE DESCRIBE MS. AHERN'S RISK PREMIUM ANALYSIS.

A Ms. Ahern estimated a risk premium return of 11.6% based on the results of two different risk premium studies. First, she derived an equity risk premium using a Predictive Risk Premium Model ("PRPM™"). The PRPM™ model estimated a proxy group average equity risk premium of 7.83%. She then added a forecasted risk-free rate of 4.31%, to produce a median cost of equity of 12.08%. (Schedule PMA-6).

Ms. Ahern's second risk premium return was based on a projected "A" rated utility bond yield of 5.35% and an average equity risk premium of 4.8%. The 4.8% risk premium used in this was the result of two separate risk premium studies. The first was a 4.89% risk premium study as developed on page 8 of Schedule PMA-6. This risk premium was based on an Ibbotson equity risk premium estimate and a PRPM™ risk premium derived using Ibbotson data. The second risk premium was a 4.7% risk premium estimate derived from a holding period return on the S&P Utility Index and "A" rated utility bonds, and again the use of a PRPM™ risk premium estimate based on the S&P Utility Index and corporate bond yields. This model produces an estimated return of 10.15%. (*Id*.).

Based on these two models, Ms. Ahern recommends a return on equity using the risk premium of 11.6% based on her belief that the two risk premium results of 12.08% and 10.15% produce an average return of 11.60%. (Schedule PMA-6, page 1). The actual arithmetic average result of this range however is 11.12%.

Q DO YOU HAVE ANY ISSUES WITH MS. AHERN'S RISK PREMIUM STUDIES?

A Yes. The primary issue I have in this case is her reliance on the PRPM™ analysis which she included in each risk premium estimate. The PRPM™ analysis produced inflated risk premium estimates. The risk premiums produced with the PRPM™ analysis were significantly higher than the risk premiums produced through independent sources.

As shown below in Table 2, her use of the PRPM™ analysis for producing a risk premium of Treasury bond yields indicated a risk premium in the range of 7.83% to 7.77%. This is much higher than Morningstar's estimated risk premium relative to the S&P 500 of around 6.7%. Ms. Ahern's estimated risk premium over Treasury

bonds applicable to her proxy group is considerably higher than Ibbotson found appropriate for the overall market. Clearly, Ms. Ahern's Treasury bond risk premiums are suspect.

Further, Ms. Ahern used the PRPM™ analysis to produce risk premiums over "A" rated utility bond yields. As shown under Column 4, her first utility bond risk premium of 4.89% was based on three risk premium estimates. The PRPM™ analysis was more than 3 percentage points higher than the highest of the two independent publication risk premium sources. This significant spread raises questions about the validity and accuracy of the risk premium.

Finally, her second risk premium estimate over "A" rated utility bond yields suggested a risk premium of 5.24% using the PRPM™ analysis. That was over 100 basis points higher than the actual historical achieved return of utility stocks versus "A" rated utility bonds estimated by Morningstar. Again, the accuracy and legitimacy of the PRPM™ estimate is highly questionable.

TABLE 2

Ahern's Risk Premium Studies

Source (1)	Treasury Bond Risk Premium (2)	Treasury Bond Risk Premium (3)	"A" Utility Bond Risk Premium (4)	"A" Utility Bond Risk Premium (5)
Recommended	7.83%	7.77%	4.89%	4.70%
Average			4.80%	
PRPM™				
Proxy Average	**7.83%**			
Proxy Median		**7.77%**		
Ibbotson			5.60%	
Value Line			6.16%	
PRPM™			**9.20%**	
Average			6.99%	
Beta			0.70	
Risk Premium			**4.89%**	
Historical				4.16%
PRPM™				**5.24%**
Average				**4.70%**

Sources:

Ahern Schedule PMA-6, pages 2, 6, 8 and 11.

Q ARE THE RESULTS OF MS. AHERN'S PRPM™ RISK PREMIUM STUDY REASONABLE?

A No. Ms. Ahern's PRPM™ risk premium study is not reasonable. Her risk premium is biased because she does not reflect actual investment characteristics of Treasury bonds and corporate bonds in her development of a risk premium. Rather, Ms. Ahern developed her risk premiums based on differences in volatility between the monthly

holding period returns on bond income returns (yield), relative to the monthly total investment returns on common stock (capital appreciation and dividend yield).

Her methodology substantially biases the measure of relative volatility (and hence risk premiums) between alternative investment options because she does not recognize the return volatility realized by changes in bond prices. As a result, she significantly skews the measure of relative volatility and inflates the risk premium because she understates the risk of making bond investments.

Her PRPM™ methodology also inflated the risk premium because her bond income returns were much lower than the actual realized bond total investment returns. Therefore, the indicated risk premium was much larger.

Q CAN YOU ILLUSTRATE THE DIFFERENCE BETWEEN REFLECTING BOND INVESTMENT RETURN VOLATILITY BY CONSIDERING ONLY THE INCOME COMPONENT OF BONDS, COMPARED TO TOTAL INVESTMENT RETURNS ON BONDS?

A Yes. This is illustrated on Schedule MPG-R-1, page 1. As shown on that schedule, I have shown graphically the monthly total returns on stocks, the monthly income return on Treasury bonds, and the monthly total returns on Treasury bonds. As shown on this graph, the variation in monthly total returns on Treasury bonds is more similar to the variation in monthly total returns on stock. However, the monthly income return on bonds is skewed because it does not reflect any variation in the monthly return caused by capital appreciation or capital loss on Treasury bonds market prices.

The impact in standard deviation (a variability measure) of the monthly returns makes this illustration quite clear. The standard deviations on total returns on the

stock market and total returns on the bonds are 4.27% and 3.47%, respectively. Variations are very similar to one another. However, the standard deviation of monthly returns on income bonds is only 0.07%. Hence, income returns are quite stable because they do not reflect any changes in the market value of the bond price.

On Schedule MPG-R-1, page 2, I show the same information related to the Standard & Poor's ("S&P") Utility Index and "A" rated utility bonds. Again, including the change in market value of the bonds as interest rates change significantly increases the monthly variability of the total return on the bonds. The standard deviations on the S&P Utility Index and "A" rated utility bonds are 3.86% and 3.02%, respectively, illustrating risk characteristics not significantly different from one another. However, reflecting only the income return on the bonds, and ignoring capital appreciation and losses on the face value of the bonds, suggests monthly variation of return of only 0.06%.

Schedule MPG-R-1 also illustrates how Ms. Ahern's methodology inflated the risk premium. Her risk premium is based on the difference in monthly returns of the stock index less the income return on the bonds. As shown in the attached schedule, this inflated the risk premium implied by her study. However, had Ms. Ahern measured the real investment return differences between having made an investment in common stock, or an investment in the bonds, the risk premium (or increased return produced through an equity investment versus a bond investment) would have been far narrower than that measured by Ms. Ahern in her analysis.

As such, Ms. Ahern's PRPM™ study misstates relative differences in volatility and hence investment risk, and overstates the risk premium because she failed to consider the relative real difference between returns earned by investing in a stock or investing in a bond.

Q WHY IS THIS ILLUSTRATION OF THE COMPARISON OF THE TOTAL RETURN ON THE MARKET, TO THE TOTAL RETURN ON TREASURY AND UTILITY BONDS, AND INCOME RETURN ON TREASURY AND UTILITY BONDS RELEVANT HERE?

A Ms. Ahern in her PRPM™ study measured the variability of investing in Treasury and utility bonds by only considering the changes to the income return on the bonds. Hence, she did not reflect the true investment risk of investing in Treasury or utility bonds. Stated differently, an investor that was deciding to make an investment in either stocks or bonds would recognize that the price of the stock and the price of the bonds will change based on changes in interest rates, and other market factors. Ms. Ahern's study assumes that the price of the bonds will never change, but stock prices will change based on market factors. Her analysis simply does not reflect real investment alternatives, and does not consider the full risk of bond monthly returns.

Q CAN AN INVESTOR MITIGATE THE PRICE RISK OF OWNING A TREASURY OR CORPORATE BOND BY HOLDING THE BOND TO MATURITY?

A Yes. Holding an investment over time can mitigate the volatility of capital appreciation and capital loss realized on monthly returns. However, holding a common stock over time can also mitigate the volatility of monthly capital appreciation and losses on stock prices. Hence, a holding period can mitigate short-term variations on capital gains/losses on both stocks and bond investments. It is inappropriate and skews the analysis, to simply assume that the capital gains/losses on bonds can be mitigated by holding to maturity, but making no comparable assumptions on mitigating the volatility of stock price changes over longer holding periods.

Q DO YOU HAVE ANY ISSUES WITH HOW MS. AHERN DEVELOPED HER EQUITY RISK PREMIUM OVER UTILITY BOND YIELDS?

A Yes. Ms. Ahern's second risk premium uses an estimated equity risk premium over "A" rated utility bond yields, with a projected yield on an "A" rated utility bond. Ms. Ahern projects "A" rated utility bond yields to be 5.35%, and adds an equity risk premium of 4.8% to that projected bond yield to produce a return of 10.15%.[2]

Ms. Ahern's equity risk premium of 4.80% applied to a projected "A" rated utility bond yield was developed on her Schedule PMA-6, pages 7-11. There, she produces a 4.8% average risk premium based on a calculated equity risk premium using a beta approach of 4.89% and a mean equity risk premium based on holding period returns of 4.70%. Her calculated equity risk premium was based on her Schedule PMA-6, page 8. There, she includes an Ibbotson risk premium of 5.6%, and an Ibbotson equity risk premium based on her PRPM™ analysis of 9.2%. She also includes a risk premium based on *Value Line* data of 6.16%. The average of these three risk premiums is 6.99%. She then applies a beta factor for the proxy group of .7 to produce a beta-adjusted equity risk premium of 4.89%.

Her second equity risk premium was based on page 11 of her Schedule PMA-6. There, she uses Ibbotson Associates data to produce a historical equity risk premium of 4.16%. She averages this with an additional forecasted risk premium based on her PRPM™ analysis of 5.24%, to produce an average historical risk premium of 4.70%.

[2]Schedule PMA-6, page 3.

Q DO YOU AGREE THAT MS. AHERN'S EQUITY RISK PREMIUM OVER "A" RATED UTILITY BONDS IS REASONABLE?

A No. Her utility bond risk premium estimate is unreasonable for several reasons. First, her projected yield on "A" rated utility bonds of 5.35% significantly exceeds current observable utility bond yields of 4.75%. (See my Direct Testimony Schedule MPG-11, page 1).

Ms. Ahern's "A" rated utility bond yield projections reflect a historical spread between "AAA" corporates and "A" rated utility bond yields of 0.27%. Ms. Ahern has not provided any evidence that the market believes that this yield spread will hold over time. As such, her projected yield on "A" rated utility bond yields has not been shown to be reflective of consensus market outlooks.

Second, her equity risk premium methodology is unreliable. Her reliance on the PRPM™ equity risk premium in the market is flawed for the same reasons discussed above in relationship to her projections for utility stocks alone. Ms. Ahern mismatches volatility from the past with projected bond yields in the future. This creates a mismatch between the equity risk premium and the bond yield.

Indeed, Ms. Ahern's PRPM™ market equity risk premium is a clear outlier shown on the other data on her Schedule PMA-6, page 8. There, independent sources by Ibbotson and *Value Line* project market risk premiums of 5.6% and 6.16%, respectively. Ms. Ahern's market risk premium projection based on her PRPM™ analysis is 9.2%. This is a substantial outlier compared to the independent market participant market risk premium estimates.

For all these reasons, Ms. Ahern's market risk premium estimates are simply unreliable and erroneous.

Q CAN MS. AHERN'S RISK PREMIUM MODEL BE MODIFIED TO PRODUCE A REASONABLE ESTIMATE OF COST OF EQUITY FOR MGE?

A Yes. Again removing the severely flawed and biased PRPM™ risk premium adjustments Ms. Ahern makes to her Schedule PMA-6, the risk premium over her projected utility bond yield would decline from 4.89% to 4.70% with a midpoint of 4.80%, to 4.12% to 4.16% with a midpoint estimate of 4.14%. Again, this simply removes the highly biased, flawed and unreliable PRPM™ analysis risk premium estimate captured on Schedule PMA-6 at pages 8 and 11. This revised equity risk premium of 4.14%, even with Ms. Ahern's projected "A" rated utility bond yield of 5.35%, would suggest a fair return on equity of 9.49%.

Q HOW DID MS. AHERN DERIVE HER CAPM RETURN ESTIMATE FOR MGE?

A Ms. Ahern developed her CAPM return estimate as shown on her Schedule PMA-7. As shown on that schedule, she relied on *Value Line* beta estimates for her proxy companies, a market risk premium of 7.93%, a risk-free rate of 4.3%, and proxy group average beta of 0.70.

Q DO YOU HAVE ANY ISSUES WITH MS. AHERN'S CAPM STUDY?

A Yes. I believe her market risk premium of 7.93% is excessive and unreliable.

Q WHY DO YOU BELIEVE MS. AHERN'S MARKET RISK PREMIUM IS EXCESSIVE AND UNRELIABLE?

A Ms. Ahern averages three market risk premium estimates to develop her recommended market risk premium of 7.93%.

Her first market risk premium is based on *Value Line* projected data from which she derived an expected return on the *Value Line* index of 11.24%. From that, she subtracts her risk-free rate of 4.31% to produce a market risk premium of 6.93%.

Her second market risk premium is based on her PRPM™ method. With this methodology, she estimates a market risk premium of 10.3%.

Finally, she uses Ibbotson's market risk premium estimate of 6.55%.

Her recommended market risk premium of 7.93% then is the average of these three market risk premium estimates ((6.93 + 10.3 + 6.55) ÷ 3).

Q ARE THE RESULTS OF MS. AHERN'S CAPM ESTIMATE REASONABLE?

A No. The market risk premium based on her PRPM™ analysis is unreliable, non-transparent, and flawed for the reasons described above. Further, the PRPM™ risk premium is significantly higher than the risk premium derived from independent market participants. Removing the results of that PRPM™ analysis, Ms. Ahern's studies would indicate a market risk premium in the range of 6.55% up to 6.93%, with a midpoint of 6.74%.

Adjusting Ms. Ahern's CAPM return estimate using her risk-free rate of 4.31%, a market risk premium of 6.74%, and beta estimate of 0.70 would produce a CAPM return estimate of 9.03%.

Q DO YOU HAVE ANY CONCERNS WITH MS. AHERN'S EMPIRICAL CAPM ("ECAPM") ANALYSIS?

A Yes. The proposed ECAPM analysis should be rejected. The ECAPM increases the beta estimate to reflect a more gradual increase in security risk across the risk

spectrum. In other words, the ECAPM will reduce a CAPM estimate for a beta estimate greater than 1, and increase the CAPM estimate for a beta less than 1.

This flattening of the security market line, or the CAPM return estimate, is redundant with the use of *Value Line*'s adjusted betas and, therefore, is unreasonable. The *Value Line* beta Ms. Ahern relied on to estimate a utility beta is already adjusted for the tendencies of betas lower than 1 to increase toward the market beta of 1 over time. That is, an adjusted beta will increase a CAPM return estimate for companies with raw betas less than 1, and decrease CAPM return estimates for companies with raw betas greater than 1. A raw beta is an unadjusted beta. *Value Line* adjusts its raw beta by weighting the raw beta with a market beta of 1. Specifically, *Value Line*'s adjusted beta formula is to apply a weight as follows:

Adjusted Beta = Raw Beta x 67% + Market Beta x 35%.

The practical effect of *Value Line*'s beta adjustment is that it flattens the security market line in the same way that the ECAPM does. Consequently, *Value Line*'s beta adjustment formula accomplishes the same thing as the ECAPM analysis. Hence, the use of *Value Line* adjusted betas in an ECAPM double-counts this return adjustment.

Ms. Ahern's use of an adjusted beta in an ECAPM analysis double-counts the increase to a CAPM return estimate for utility betas less than 1. I am not aware of any academic support for use of an adjusted beta in an ECAPM analysis. Consequently, Ms. Ahern's application of an ECAPM analysis with an adjusted beta distorts and erroneously increases the CAPM return estimate for her utility proxy group.

Second, capturing investors' expectations is the primary objective, not manipulating data to increase the return estimate. This is the significant deficiency in

Ms. Ahern's ECAPM study. Specifically, *Value Line* publishes beta estimates that are widely followed by the investment market. These beta estimates reflect stock return estimates and are used by investors to make stock purchase and sale decisions. In significant contrast, Ms. Ahern's manipulation of the beta estimate in a CAPM analysis is not reflective of market information used by investors to value stock. Therefore, Ms. Ahern's ECAPM should be rejected.

Q IS MS. AHERN'S NON-PRICE REGULATED COMPANIES' EARNED RETURN ON EQUITY ESTIMATE OF 10.31% A REASONABLE METHODOLOGY OF ESTIMATING MGE'S CURRENT MARKET COST OF EQUITY?

A No. Ms. Ahern's non-price regulated return on equity estimate is based on the results from DCF, Risk Premium and CAPM studies on a proxy group of nine non-price regulated companies. The average result of her market-based study on her non-price regulated companies produced her estimated return on equity from this methodology of 10.31% ((11.21% + 9.92% + 9.81%) ÷ 3).

Q ARE THERE OTHER REASONS TO DISREGARD THE NON-PRICE REGULATED RISK PROXY GROUP ESTIMATE OF MGE'S CURRENT RETURN ON EQUITY?

A Yes. Ms. Ahern has not proved that these companies are risk comparable to MGE. While these companies may have comparable beta estimates, she has not shown that they have comparable business and operating risk to a low-risk regulated utility company. Therefore, it is necessary to show that these companies have comparable risk factors that are commonly used by investment professionals to compare investment risk between different investment alternatives. Because she has not

shown that these companies are indeed risk comparable to MGE, her estimated return on this proxy group is not reliable and should be disregarded.

Response to Staff

Q DID YOU REVIEW STAFF'S REPORT FILED ON JANUARY 29, 2014?

A Yes.

Q DO YOU TAKE ISSUE WITH ANYTHING IN THAT REPORT?

A Yes. I specifically take issue with Staff's recommended capital structure. Staff is proposing an unadjusted consolidated capital structure consisting of approximately 53.1% common equity and 46.9% long-term debt.

Q DID STAFF MAKE A GOODWILL ADJUSTMENT TO MGE'S CAPITAL STRUCTURE?

A No.

Q DID STAFF PROVIDE AN EXPLANATION AS TO WHY IT DID NOT ADJUST MGE'S CAPITAL STRUCTURE FOR GOODWILL?

A Yes. On page 18 of Staff's Report, Staff explains as follows:

> Staff established, by corresponding with rating agency analysts and reviewing reports published by credit rating agencies, that rating agencies use an unadjusted consolidated capital structure for purposes of reporting leverage ratios of a company except in cases where the agencies believe that the goodwill amount recorded on the books is highly likely to be impaired in the immediate future.
>
> Staff also believes the use of an unadjusted consolidated capital structure is consistent with its general approach, discussed in several

parts of this testimony, of attempting to emulate the investor decision-making processes.[3]

Staff provided, in response to OPC's data request 5030, the previously mentioned correspondence and published credit reports it relied on in reaching its position.

Q DO YOU AGREE THAT STAFF HAS JUSTIFIED ITS REASON TO NOT ADJUST MGE'S CAPITAL STRUCTURE FOR THE GOODWILL ASSET?

A No. I believe Staff has misinterpreted the S&P analyst explanations as provided in the e-mail correspondence and in the published material provided by S&P.

An S&P analyst, Todd Shipman, corresponded with Staff witness Zephania Marevangepo in an e-mail dated October 11, 2013. The S&P analyst stated that simply because S&P does not adjust for something does not mean that S&P ignores it in its analysis. He provided specific guidance on how goodwill would be treated by S&P and referred Mr. Marevangepo to page 46 of S&P's "Corporate Ratings Criteria." There, S&P describes its asset valuation adjustments used in its review of a utility's credit rating and financial leverage. The Report states as follows:

> **Asset valuation**
>
> Knowing appropriate values to assign a company's assets is key to our analysis. Leverage as reported in the financial statements is meaningless if the assets' book values are materially undervalued or overvalued relative to economic value.
>
> We consider the profitability of an asset as an appropriate basis for determining its economic value. Market values of a company's assets or independent asset appraisals can offer additional insights. However, there are shortcomings in these methods of valuation--just as there are with historical cost accounting--that prevent reliance on any single measure. (Similarly, using the market value of a company's equity in calculations of leverage has its drawbacks. The stock market

[3]Missouri Public Service Commission Staff Report regarding Revenue Requirement and Cost of Service, January 29, 2014.

emphasizes growth prospects and has a short time horizon; it is influenced by changes in alternative investment opportunities and can be very volatile. A company's ability to service its debt is not affected directly by such factors.)

The analytical challenge of which values to use is especially evident in the case of merged and acquired companies. Accounting standards allow the acquired company's assets and equity to be written up to reflect the acquisition price, but the revalued assets have the same earning power as before; they cannot support more debt just because a different number is used to record their value. Right after the transaction, the analysis can take these factors into account, but down the road the picture becomes muddied. We attempt to normalize for purchase accounting, but the ability to relate to preacquisition financial statements and to make comparisons with peer companies is limited.

Presence of a material goodwill account indicates the impact of acquisitions and purchase accounting on a company's equity base. Intangible assets are no less "valuable" than tangible ones, but comparisons are still distorted, because other companies cannot record their own valuable business intangibles, i.e., those that have been developed, rather than acquired. This alone requires some analytical adjustment when measuring leverage. In addition, analysts are entitled to be more skeptical about earning prospects of an acquisitive company when these rely on turnaround strategies or "synergistic" mergers.[4]

Q WHY DO YOU BELIEVE THAT THIS PASSAGE FROM S&P IN ITS CORPORATE RATING CRITERIA SUPPORTS YOUR RECOMMENDATION TO ADJUST COMMON EQUITY CAPITAL TO REMOVE THE EQUITY CAPITAL SUPPORTING GOODWILL?

A This passage supports my adjustments for several reasons including the following:

1. S&P makes it clear that in measuring a company's leverage, it adjusts the value of the assets on the books to reflect economic value. The goodwill asset recorded on Laclede Gas's balance sheet produces no cash flows, is not used to provide utility service nor unregulated service and therefore has no economic

[4] *Standard & Poor's Ratings Direct*: "Criteria/Corporates/General: Corporate Ratings Criteria 2008 at 46, emphasis added.

value. Rather, it is an asset that was recorded simply because of the acquisition accounting chosen by Laclede, and has no bearing on the pre-acquisition original cost accounting of utility plant and equipment that now comprises Laclede Gas.

2. The amount of original cost rate base assets did not change simply by the consolidation of Laclede Gas and MGE. As a result, the amount of financial leverage relative to net utility plant increased due to the acquisition financial structure. This caused Laclede Gas's financial risk to increase. If the debt in relationship to regulated rate base increases, then the debt leverage of the Company increases. This will put stress on the credit rating. Stated differently, the cash flows available to support Laclede Gas's debt obligations after the acquisition are directly related to the cash flows produced from its regulated utility operations. To the extent Laclede increases its debt obligations due to the financing structure of the acquisition, its cash flows will provide a weaker coverage of the post-acquisition debt, and Laclede Gas's financial leverage and financial risk will increase.

3. As noted in my direct testimony, the amount of goodwill recorded by Laclede as a result of its acquisition of MGE is material. Therefore, it is reasonable to conclude that credit rating agencies will make an adjustment to Laclede's common equity balance in measuring its leverage or financial risk comparing the amount of total debt and the cash flow available to support that debt. The existence of goodwill and the common equity supporting goodwill bear no relationship in describing the level of cash flows available to support Laclede Group's total financial obligations.

Q DO OTHER DOCUMENTS FROM STAFF SUPPORT YOUR CONCLUSION THAT LACLEDE GAS COMPANY IS A HIGHER LEVERAGED COMPANY AS A RESULT OF THE MGE ACQUISITION?

A Yes. Despite the proposed financing mix being reasonably consistent with the capital structure mix that existed prior to the transaction, credit rating reports have now found that Laclede Gas has higher leverage due to the acquisition. For example, S&P stated the following as Rating Action for Laclede Gas:

> The rating action reflects our expectation that LG's financial measures will weaken primarily due to the incremental debt needed to fund the MGE acquisition. As a result, we have revised the company's financial risk profile to significant from intermediate. We are maintaining our designation of LG's business risk profile as excellent because the company will derive the bulk of its EBITDA from relatively low-risk regulated natural gas operations following the acquisition. However, if the riskier unregulated activities become a more meaningful percentage of the overall company, we would likely revise the business risk profile to strong.[5]

Moody's Investors Service issued a recent report that described its credit rating upgrade for Laclede Gas, and many other companies in the industry. While Moody's upgraded Laclede Gas's bond rating, it nevertheless recognized its increased financial risk as a result of the financing structure of MGE. Moody's stated as follows:

> Laclede's (P) A3 rating reflects the company's low-risk local gas distribution (LDC) business and the supportive regulatory framework in Missouri which has allowed Laclede several credit-supportive rate adjustment mechanisms. The rating also considers the <u>increased leverage</u> and integration risks associated with the MGE acquisition but the financial metrics should remain appropriate for the rating category.[6]

[5] *Standard & Poor's RatingsDirect*: "Research Update: The Laclede Group Inc. And Laclede Gas Co. Corporate Credit Ratings Lowered To 'A-' On Acquisition Approval, July 19, 2013 at 2, provided by MGE in response to OPC DR 5007. This quote also appears in Gorman Direct Testimony at 6 and 7.

[6] Moody's Investors Service, "Rating Action: Moody's upgrades The Laclede Group to (P) Baa1 from (P) Baa2 and Laclede Gas Company to (P) A3 from (P) Baa1; rating outlooks stable," January 31, 2014, emphasis

Staff's proposed capital structure is not reasonable because it includes common equity that funds a goodwill asset.

Q DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?

A Yes, it does.

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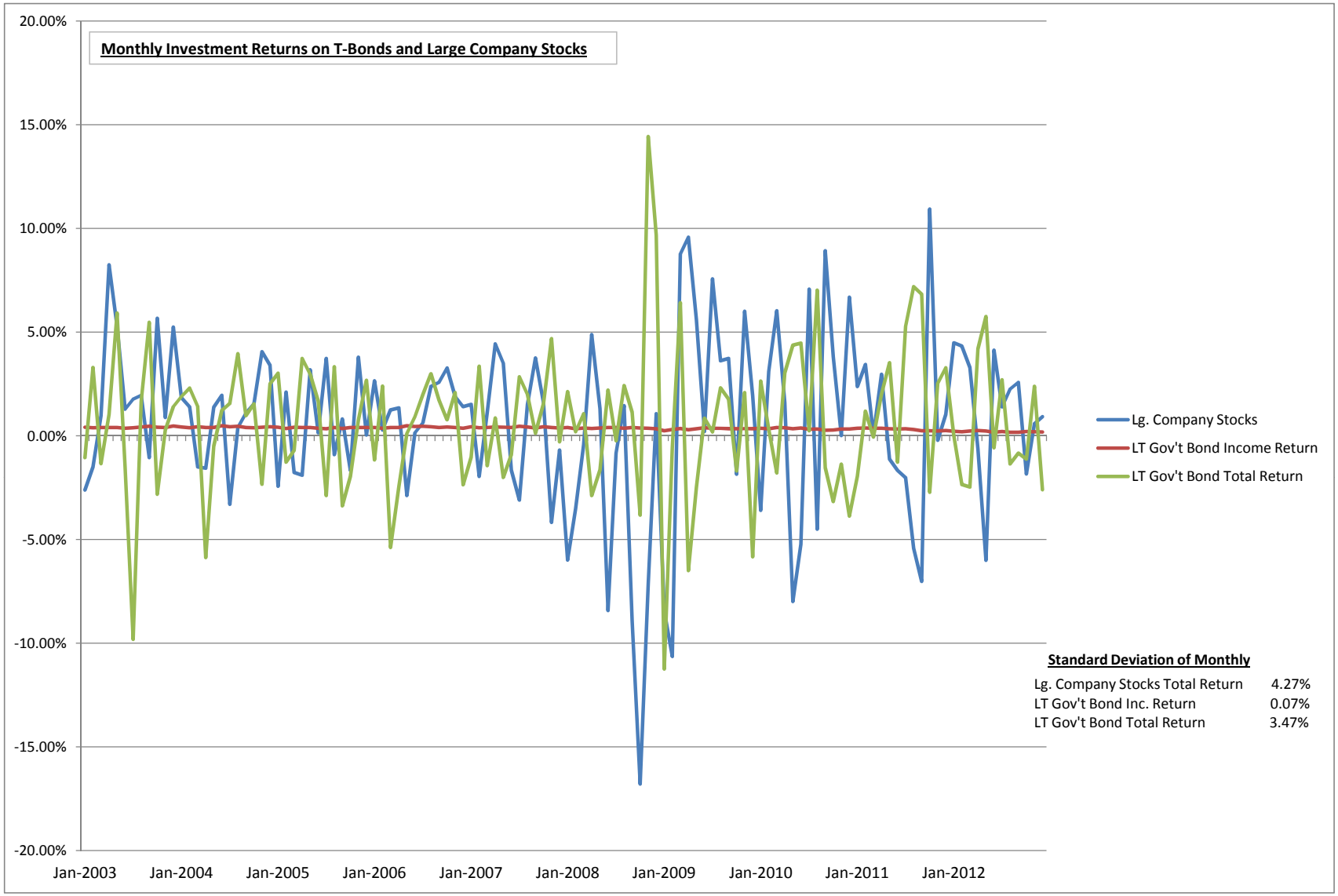
Missouri Gas Energy

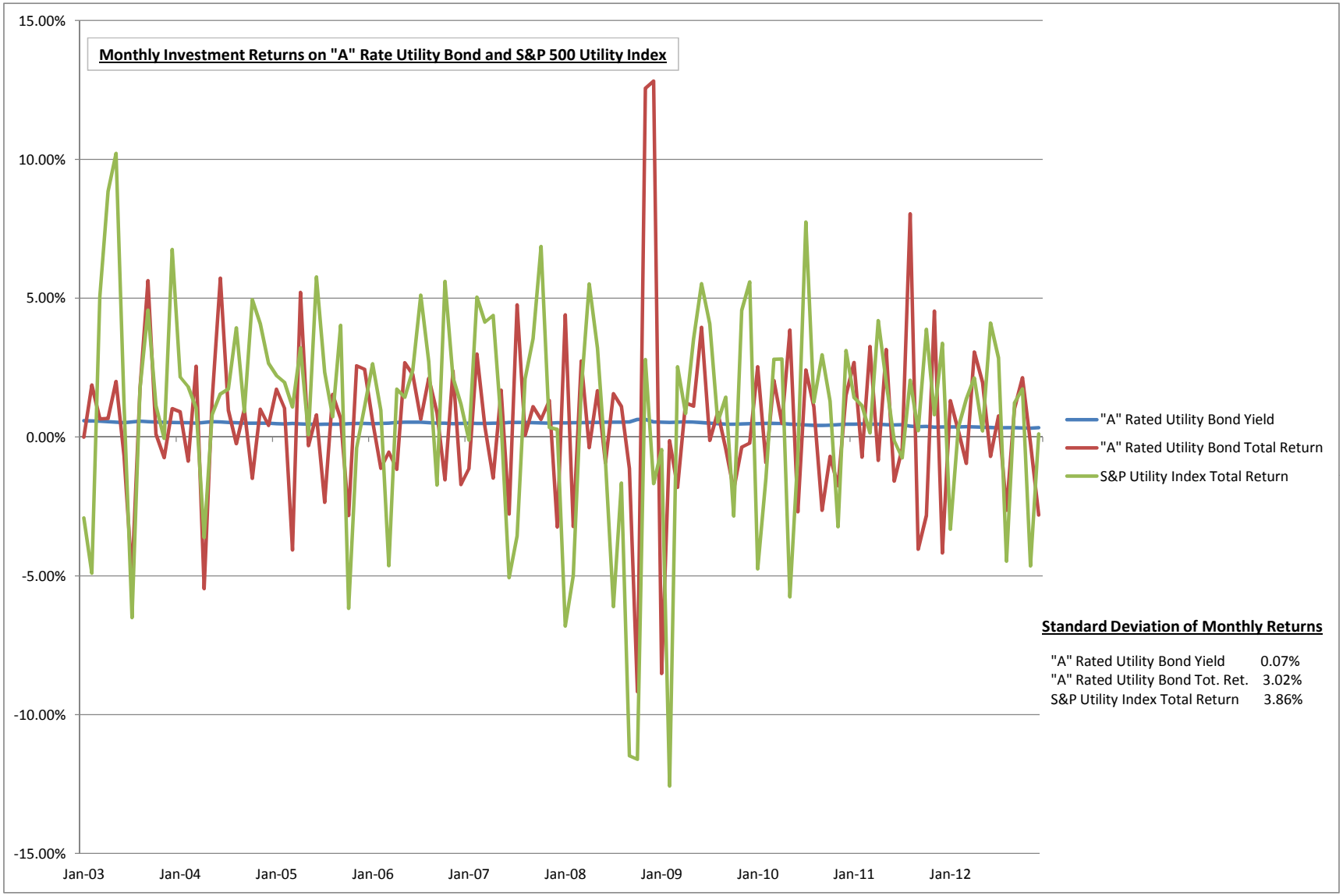
Predictive Risk Premium Model



Sources:
Ahern's 'PRPM wp1'.
Ibbotson SBBI 2013 Classic Yearbook, pages 194-199

Missouri Gas Energy

Predictive Risk Premium Model



Sources:
Ahern's 'PRPM wp1'.