Exhibit No.:	
Issues:	Revenue Requirement
Witness:	Michael P. Gorman
Type of Exhibit:	Surrebuttal Testimony
Sponsoring Party:	Midwest Energy Users' Association
Case No.:	ER-2012-0345
Date Testimony Prepared:	February 4, 2013

BEFORE THE PUBLIC SERVICE COMMISSION OF THE STATE OF MISSOURI

In the Matter of The Empire District Electric Company of Joplin, Missouri Tariffs Increasing Rates for Electric Service Provided to Customers in the Missouri Service Area of the Company	**Case No. ER-2012-0345**

Surrebuttal Testimony of

Michael P. Gorman

On behalf of

Midwest Energy Users' Association

February 4, 2013

BRUBAKER & ASSOCIATES, INC.

Project 9669

BEFORE THE PUBLIC SERVICE COMMISSION OF THE STATE OF MISSOURI

In the Matter of The Empire District Electric Company of Joplin, Missouri Tariffs Increasing Rates for Electric Service Provided to Customers in the Missouri Service Area of the Company	**Case No. ER-2012-0345**

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 Midwest Energy Users' Association in this proceeding on their behalf.

2. Attached hereto and made a part hereof for all purposes is my surrebuttal testimony which was prepared in written form for introduction into evidence in the Missouri Public Commission Case No. ER-2012-0345.

3. I hereby swear and affirm that the testimony is true and correct and that it shows the matters and things that it purports to show.

Michael P. Gorman

Subscribed and sworn to before me this 4th day of February, 2013.

MARIA E. DECKER
Notary Public - Notary Seal
STATE OF MISSOURI
St. Louis City
My Commission Expires: May 5, 2013
Commission # 09706793

Maria E. Decker
Notary Public

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Surrebuttal Testimony of Michael P. Gorman

Q PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

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

Q WHAT IS YOUR OCCUPATION?

A I am a consultant in the field of public utility regulation and a Managing Principal with Brubaker & Associates, Inc., energy, economic and regulatory consultants.

Q ARE YOU THE SAME MICHAEL P. GORMAN WHO FILED TESTIMONY EARLIER IN THIS PROCEEDING?

A Yes.

Q WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?

A I respond to the rebuttal testimony of The Empire District Electric Company ("Empire" or "Company") witnesses Robert W. Sager, and Dr. James H. Vander Weide.

Response to Mr. Sager

Q DOES MR. SAGER TAKE ISSUE WITH YOUR DIRECT TESTIMONY?

A Yes. Mr. Sager took issue with my proposal to adjust the ratemaking capital structure to remove the common equity supporting Empire's goodwill asset. The reasons Mr. Sager disagrees with my proposed adjustment includes the following:

- He states it is unclear to him why the common equity supporting goodwill should be removed from a capital structure used to set rates.
- He states that Empire's acquisition of the Aquila gas assets was financed by both debt and equity. Therefore, he believes that the Company's consolidated capital structure is the most reasonable to use for ratemaking purposes in this case.

Q PLEASE EXPLAIN WHY IT IS NOT APPROPRIATE TO INCLUDE THE COMMON EQUITY SUPPORTING A GOODWILL ASSET IN A RATEMAKING CAPITAL STRUCTURE.

A The objective of setting rates is to identify Empire's cost of providing utility service. This includes the identification of the capital costs related to Empire's investment in utility plant and equipment. A goodwill asset is not used to provide utility service, and the capital supporting Empire's goodwill asset is not a capital cost related to providing utility service. Therefore, the capital supporting the goodwill asset should be removed from Empire's ratemaking capital structure.

Q WHAT IS A GOODWILL ASSET?

A A goodwill asset represents the acquisition premium price or amount Empire paid to Missouri Gas above the book value of the gas utility plant and equipment for acquiring the assets. Empire disclosed the creation of this goodwill asset as follows:

Goodwill

> We recorded goodwill upon the completion of the Missouri Gas acquisition of $39.3 million. Goodwill represents the excess of the cost of the acquisition over the fair value of the related net assets at the date of acquisition. In accordance with Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets," goodwill is required to be tested for impairment on an annual basis or whenever events or circumstances indicate possible impairment.[1]

As described by Empire in its disclosure to shareholders above, its acquisition of the Missouri Gas operations included an acquisition price that was set equal to the fair value (i.e., book value) of its utility assets plus a premium paid to Missouri Gas investors to take ownership of the assets. The premium was recorded as a goodwill asset. The total acquisition price was further described by Empire below.

> The components of the purchase price allocation for the Missouri Gas acquisition are shown below. (See Note 7 – "Long-Term Debt," for the information on the purchase price financing). Assets and liabilities are valued at fair value. In the case of property, plant and equipment, fair value is calculated in a manner consistent with the amount recoverable for regulatory treatment.

(In thousands)	Missouri Gas
Purchase Price:	
Cash paid	$102,502
Acquisition costs	2,277
Total	$104,779
Allocation:	
Property, plant and equipment	$52,226
Current assets	15,515
Goodwill	**39,323**
Other assets	11,106
Other liabilities	(13,391)
Total	$104,779[2]

As shown in the disclosure made by Empire above, the amount of the goodwill asset represents the difference between the net book value of the Missouri Gas assets and the acquisition price paid to Missouri Gas investors from Empire.

[1] 2008 SEC 10-K at 75, emphasis added.
[2] 2008 SEC 10-K at 81, emphasis added

Therefore, the goodwill asset represents the amount of acquisition price above the prevailing book value of the Missouri Gas utility assets.

Q IS THE BOOK VALUE OF MISSOURI GAS OPERATIONS' ACQUISITION INCLUDED IN REGULATED COST OF SERVICE?

A Yes. The costs associated with the book value of the Missouri Gas utility plant and equipment, and working capital are included in Empire's regulated cost of service. However, because the goodwill asset amount of the acquisition costs represents a premium payment made to Missouri Gas Operations' shareholders it should not be included in Empire's cost of service. Neither the goodwill asset nor the capital supporting this asset should be included in Empire's regulated cost of service used to set rates.

Q IS IT GENERALLY RECOGNIZED THAT THE CAPITAL STRUCTURE SHOULD BE ADJUSTED TO REMOVE THE EFFECTS OF GOODWILL AND ANY OTHER ACQUISITION-RELATED COST?

A Yes. This is generally accepted ratemaking practices in many jurisdictions. Those jurisdictions include at a minimum the following:

1. In setting rates for Commonwealth Edison Company ("ComEd") for approximately the last 10 years, the Illinois Commerce Commission consistently adjusted ComEd's common equity component of its capital structure to remove the amount of equity capital supporting ComEd's goodwill asset recorded on its balance sheet.

2. Illinois recently passed a Formula Rate Plan ("FRP") law entitled "Infrastructure Investment and Modernization; Regulatory Reform" ("IIMR"). The FRP requires an adjustment to the common equity component of the capital structure to remove the amount of common equity in the actual capital structure by the amount of goodwill recorded on the utility's balance sheet. The Illinois IIMR law states as follows:

> The performance-based formula rate approved by the Commission shall do the following:
>
> (1) Provide for the recovery of the utility's actual costs of delivery services that are prudently incurred and reasonable in amount consistent with Commission practice and law. The sole fact that a cost differs from that incurred in a prior calendar year or that an investment is different from that made in a prior calendar year shall not imply the imprudence or unreasonableness of that cost or investment.
>
> (2) Reflect the utility's actual capital structure for the applicable calendar year, excluding goodwill, subject to a determination of prudence and reasonableness consistent with Commission practice and law.[3]

3. Further, in New York state, Niagara Mohawk has been adjusting its capital structure to remove the effects of goodwill for ratemaking purposes in its last several rate cases. In a recent case, in Case No. 08-G-0609, Niagara Mohawk Company witness Andrew E. Dinkel III testified that the company's capital structure weights were calculated after excluding goodwill from the common equity component of capital.

Q THE COMPANY ARGUES THAT IT FINANCED THE ACQUISITION OF THE MISSOURI GAS ASSETS USING BOTH DEBT AND EQUITY. PLEASE RESPOND.

A I do not dispute that the Company relied on both debt and equity financing for its acquisition of the Missouri Gas assets. Indeed, the acquisition included predominantly purchase of utility plant and equipment which is properly reflected as utility cost of service items. The acquisition of the book value of the Missouri Gas assets is properly financed with both debt and equity capital. Therefore, it is not surprising, and I do not dispute, that Empire relied on debt as a source of capital to fund the Missouri Gas acquisition.

[3] 220 Illinois Compiled Statutes 5/) Public Utilities Act, Section 16-108.5, page 30 of 139, emphasis added.

However, the payment of an acquisition premium above the book value of those assets that was paid to Missouri Gas shareholders causes a recording of a goodwill asset and a corresponding write-up of common equity on Empire's books. The acquisition premium above the book value of the Missouri Gas assets (i.e., goodwill) was an equity transaction between shareholders, and is unrelated to Empire's cost of directly investing in utility plant and equipment.

Q ON PAGE 30 OF DR. VANDER WEIDE'S TESTIMONY, HE ASSERTS THAT THE CREATION OF A GOODWILL ASSET DID NOT INCREASE EMPIRE'S COMMON EQUITY BALANCE. PLEASE RESPOND.

A Dr. Vander Weide's position is simply inconsistent with well-established purchase accounting practices. Indeed, had Empire recorded the purchase of the Missouri Gas operations at book value, rather than at the acquisition price, a goodwill asset would not have been recorded on Empire's books, and its common equity balance would be reduced by the elimination of the goodwill asset. The financing structure for the actual purchase of the book value of the gas assets would not have changed. Hence, Dr. Vander Weide's belief that recording of a goodwill asset does not simultaneously create a write-up of common equity is simply inconsistent with purchase accounting practices.

Q DO CREDIT RATING ANALYSTS TYPICALLY RECOGNIZE THAT AMOUNTS OF GOODWILL RECORDED ON THE BALANCE SHEET REFLECT A WRITE-UP OF EQUITY?

A Yes. Credit analysts recognize that goodwill simply reflects purchase accounting which creates an asset and additional equity on the balance sheet when a company pays a premium to fair value for the acquisition of assets.

Standard & Poor's ("S&P") states as follows:

> Accounting standards allow the acquired company's assets and equity to be <u>written up</u> to reflect the <u>acquisition price</u>, 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. . . .
>
> Presence of a material <u>goodwill</u> account indicates the impact of acquisitions and purchase accounting on a company's <u>equity base</u>. 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. <u>This alone requires some analytical adjustment when measuring leverage</u>.[4]

In determining a company's credit metrics and ability to support its outstanding debt, S&P and other credit rating agencies recognize purchase accounting impacts on a balance sheet and adjust to assess a company's ability to support its outstanding debt. This type of adjustment is also done in regulatory proceedings in order to accurately estimate the utility's capital cost in supporting its investment in utility plant and equipment.

[4] *Standard & Poor's Corporate Ratings Criteria 2008* at 45, emphasis added.

Q DR. VANDER WEIDE ASSERTS THAT IT IS NOT APPROPRIATE TO TRACE CAPITAL FROM ITS SOURCES TO THE SPECIFIC LONG-TERM ASSET WHICH WAS FINANCED. PLEASE RESPOND.

A A goodwill asset is a very specific asset created as a result of purchase accounting, and when the goodwill asset is recorded, the company also writes up the amount of common equity on its books and records. Hence, since these are an asset and common equity that are created by purchase accounting, the goodwill asset and associated common equity are not used in providing utility service.

DCF Model

Q DOES DR. VANDER WEIDE MAKE ANY COMMENTS CONCERNING YOUR DCF STUDIES?

A Yes. Dr. Vander Weide suggests that the use of investor analyst growth rate projections are always appropriate for estimating a fair return in a DCF study. This proposition would suggest that investors do not make rational investment decisions, the market is not efficient, and investors are not capable of understanding that a three- to five-year analysts' growth rate projection may not be appropriate to use as a long-term growth rate projection (i.e., reflecting growth into perpetuity).

I disagree. Without reviewing the reasonableness of the inputs into any return on equity model, the outputs of the model would not be reliable. The most critical elements of measuring a fair return on common equity whether that be from a DCF, risk premium or CAPM study, is to use reasonable and informed judgment. Without use of informed judgment and the expectation of rational investor decisions, the ability to accurately measure a fair return on equity is at very best problematic.

For all these reasons, I reject Dr. Vander Weide's proposition that a three- to five-year growth rate estimate will always be accepted by investors as a reasonable long-term growth rate projection.

Q DR. VANDER WEIDE SUGGESTS THAT IF YOU ARE GOING TO ADJUST THE GROWTH COMPONENT IN A DCF STUDY, YOU SHOULD ALSO ADJUST THE STOCK COMPONENT. PLEASE RESPOND.

A Again, I disagree. A DCF model should reflect rational investor outlooks. The objective of a DCF model is to capture investor outlooks that were relied on to arrive at the observable stock price. Because it is reasonable to conclude that investors make rational investment decisions, the growth rate that properly reflects a rational and achievable long-term sustainable growth rate is the best estimate of the investor expectations that have been used by investors to set the observable stock price. Dr. Vander Weide's proposal to substitute his judgment for that of rational investors simply results in a biased return on equity estimate.

Q DOES DR. VANDER WEIDE TAKE ISSUE WITH A SUSTAINABLE GROWTH RATE MODEL?

A Yes. He believes that a sustainable growth model is not as reliable as growth rates derived from public security analysts' growth forecasts. If he is referring to the period over which the growth rates are intended to represent, then I would agree.

However, a constant DCF model requires a perpetual growth rate. Therefore, more information is necessary to provide a better estimate of the long-term sustainable growth rate for a DCF model. He also asserts that a sustainable growth rate model is logically circular because the Company's projected rate of return on equity is a component to the model.

Q PLEASE RESPOND.

A I generally agree that there are some circularities with this model. However, all financial models have strengths and weaknesses. There are weaknesses in the sustainable growth DCF model, but there are also weaknesses in the constant growth DCF model using analysts' growth rate estimates, there are weaknesses in the risk premium model and there are weaknesses in the CAPM model. These models should not be relied upon on a stand-alone basis. Even though the sustainable growth DCF model, like all the other models, has weaknesses, if used with other balanced methodologies, it provides meaningful information from which to estimate a fair return.

Q DOES DR. VANDER WEIDE COMMENT ON YOUR MULTI-GROWTH MODEL?

A Yes. He takes issue with whether the Company can grow at a rate faster than the GDP growth rate. In effect, Dr. Vander Weide questions whether or not it is rational to expect that a company can grow faster than the economy in which it sells its good and services over an indefinite length of time. Dr. Vander Weide's position is in stark contrast to academic literature and industry practitioner data. A company's growth is limited to the market for the service. Therefore, Dr. Vander Weide's approach of not assuming rational growth outlooks or common sense limited to assess investment growth outlooks is not reliable.

Risk Premium

Q DOES DR. VANDER WEIDE TAKE ISSUE WITH YOUR RISK PREMIUM STUDY?

A Dr. Vander Weide was critical of me not making the assumption that equity risk premiums are inversely related to interest rates.

Q IS IT REASONABLE TO ASSUME THAT INTEREST RATES ARE INVERSELY RELATED TO INTEREST RATES IN A RISK PREMIUM STUDY?

A No. Dr. Vander Weide's simplistic assumption for an inverse relationship does not produce a reliable risk premium estimate for Empire. Academic literature and actual market participant statements clearly indicate that equity risk premiums change with perceived levels of risk of debt securities compared to those of equity securities. The equity risk premium does not simply change with changes in nominal interest rates as Dr. Vander Weide erroneously asserts.

Dr. Vander Weide's simple regression analysis simply reflects historical practices of regulatory commissions to conservatively reduce authorized returns on equity more slowly than the debt market drives down bond yields. There is simply no cost-causation or risk-return relationship captured by Dr. Vander Weide's regression study. While market research has indicated that market risk premiums can be correlated with interest rates, that correlation can be either positive, negative, or non-existent depending on market conditions. Dr. Vander Weide's analysis is simply an opportunistic extrapolation that is not based on risk and return interrelationships.

Q DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?

A Yes, it does.

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