Exhibit No.:	**_______________**
Issue:	**Accounting Authority Order**
Witness:	**Frank J. Hanley**
Sponsoring Party:	**Missouri Gas Energy**
Case No.:	**GU-2011-0392**
Date:	**November 15, 2011**

MISSOURI PUBLIC SERVICE COMMISSION

MISSOURI GAS ENERGY

CASE NO. GU-2011-0392

SURREBUTTAL TESTIMONY OF

FRANK J. HANLEY, PRINCIPAL & DIRECTOR
AUS CONSULTANTS

NOVEMBER 2011

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INTRODUCTION AND PURPOSE

Q. PLEASE STATE YOUR NAME, OCCUPATION AND BUSINESS ADDRESS.

A. My name is Frank J. Hanley and I am a Principal and Director of AUS Consultants. My business address is 155 Gaither Drive, Suite A, Mt. Laurel, New Jersey, 08054.

Q. PLEASE SUMMARIZE YOUR EDUCATIONAL BACKGROUND AND PROFESSIONAL EXPERIENCE.

A. I have testified as an expert witness on rate of return and related financial issues before 33 state public utility commissions including the Missouri Public Service Commission, the District of Columbia Public Service Commission, the Public Services Commission of the Territory of the U.S. Virgin Islands, and the Federal Energy Regulatory Commission. I have also testified before local and county regulatory bodies, an arbitration panel, a U.S. Bankruptcy Court, the U.S. Tax Court and a state district court. I have appeared on behalf of investor-owned companies, municipalities, and state public utility commissions. The details of these appearances, as well as my educational background, are shown in Appendix A supplementing this testimony.

Q. WHAT IS THE PURPOSE OF THIS TESTIMONY?

A. The purpose of this testimony is to provide surrebuttal to the portion of the prepared rebuttal testimony of Office of the Public Counsel Witness Shawn Lafferty which relates to his discussion of risk and its implication on the investor-required return on equity and the relevance of MGE's present or future ownership on the potential for adverse effect resulting from the May 22, 2011 tornado which struck Joplin, Missouri (Joplin).

RISK

Q. AT PAGES 13-14 OF HIS REBUTTAL TESTIMONY, MR. LAFFERTY DISCUSSES RISK WHICH INVESTORS INCUR WHEN INVESTED IN A REGULATED UTILITY. PLEASE COMMENT.

A. It is true that investors are compensated for risks which they perceive as the normal and ordinary risks facing an enterprise. The risks enumerated by Mr. Lafferty at the bottom of page 14 of his rebuttal testimony are indeed risks which investors expect to face including severe weather. Such events can affect utilities' earnings and thus the investors' return as indicated by Mr. Lafferty. However, I totally disagree with Mr. Lafferty's assumption that an event as extraordinary as the May 22, 2011 tornado which struck Joplin was the type of "severe weather" anticipated and reflected in the market prices paid by proxy gas distribution companies which were utilized to establish the most recently allowed rate of return on common equity capital for Missouri Gas Energy (MGE). Indeed, the event was, as seemingly acknowledged by all parties, an extraordinary event.

Schedule FJH-1, which consists of three pages, contains the Merriam Webster definition of the term "extraordinary". As can be seen on page 1, the definition is that of which is "going beyond what is usual, regular, or customary; exceptional to a very marked extent; and non-recurring." Moreover, synonyms for extraordinary are shown at the top of page 2 of Schedule FJH-1. Several synonyms are aberrant, abnormal, atypical and anomalous.

Q. IS THERE ANY OTHER EVIDENCE OF THE ANOMALOUS NATURE OF THE MAY 22, 2011 TORNADO WHICH STRUCK JOPLIN?

A. Yes. Schedule FJH-2 is a copy of an article published May 23, 2011 in The Washington Post discussing the May 22, 2011 tornado in Joplin. It consists of three pages. As can be seen, the tornado was a rare "multi-vortex" tornado with multiple cyclones in a funnel. Moreover, the article indicates that the tornado was extraordinary, a "rare destructive phenomenon" and "the single deadliest tornado since officials began keeping records in 1950."

Q. PLEASE DESCRIBE SCHEDULE FJH-3.

A. Schedule FJH-3 is a nine page document from the website of Wikipedia, the free online encyclopedia. It contains a detailed discussion of the tornado which struck Joplin. It is shown on page 1 that the tornado was a "devastating EF5 multiple vortex tornado". It also indicates that "it ranks as one of Missouri's and America's deadliest tornadoes and is also the costliest single tornado in U.S. history" and was the "deadliest tornado to hit the United States since 1947." Pages 2 through 9 provide a detailed description of the extent of the damage, and indicate an expected insurance payout of $2.2 billion, as well as the description of casualties and response to this devastating disaster.

Q. WHAT SHOULD BE GLEANED FROM THE INFORMATION SHOWN IN SCHEDULES FJH-1 THROUGH FJH-3?

A. It should be apparent that this particular event was indeed anomalous and catastrophic. It clearly was not the type of event anticipated by investors. Consequently, such an event could not have been reflected in market prices paid by investors. Thus, the proxy gas distribution companies from which MGE's allowed rate of return on common equity in the last base rate case was determined did not reflect such an anomalous event of that magnitude much less the extended duration of recovery from it.

Q. AREN'T WEATHER EVENTS TAKEN INTO ACCOUNT BY INVESTORS IN THE PRICES PAID FOR THE COMMON STOCKS OF UTILITIES?

A. Yes, however as indicated *supra*, such a non-recurring anomalous, catastrophic event is not one which could reasonably be anticipated by investors and therefore is not reflected in market prices. In my experience, no expert cost of capital witness has ever claimed that such an anomalous event is reflected in the market prices paid by investors. Thus, anomalous events are not reflected in allowed common equity return rates derived from market prices. Consequently, an anomalous event such as the Joplin tornado of May 22, 2011 could not have been reflected in MGE's allowed rate of return on common equity in Case No. GR-2009-0355.

<u>**RELEVANCE OF OWNERSHIP**</u>

Q. AT PAGES 20-21 OF HIS REBUTTAL TESTIMONY, MR. LAFFERTY SUGGESTS THAT IF THE COMMISSION WERE TO DENY MGE'S REQUEST FOR ALLEGED LOSS OF MARGIN REVENUE, IT WOULD NOT HAVE AN ADVERSE EFFECT ON "THE COMPANY'S ABILITY TO ATTRACT CAPITAL FOR ITS OPERATIONS…". PLEASE COMMENT.

A. Mr. Lafferty's discussion relates to Southern Union Company (SUG). He somehow suggests that this is appropriate because this Commission has used the SUG capital structure in establishing rates for MGE. He also discusses the magnitude of the impending acquisition of SUG by Energy Transfer Equity. He then goes on to state that "[T]his would suggest that the market does not believe SUG and its underlying MGE division should have any problem earning sufficient returns or raising sufficient capital…". Mr. Lafferty's rationale is severely flawed.

Q. PLEASE EXPLAIN.

A. The overall cost of capital, or weighted average cost of capital (WACC) established by this Commission for MGE can be applied only to MGE's jurisdictional rate base and no other. The fact that the Commission, to date, has utilized SUG's capital structure does not change the fact that the WACC can **only** be applied to MGE's rate base. The fact that the SUG capital structure has been used simply means that those percentages are the presumed manner in which MGE's rate base is presumed to be financed. Moreover, the common equity cost rate established was (in my opinion properly) based upon a proxy group of actively traded gas distribution companies **– not SUG**. In effect, MGE is to

SUG the equivalent of a single asset in a portfolio of assets. In a portfolio of assets, each individual asset is expected to earn a return commensurate with the risk associated with each individual asset. For example, if I owned a portfolio of ten common stocks of varying enterprises, I would expect to earn a return on each common stock consistent with the risks related to each individual investment. I have prepared Schedule FJH-4, which consists of five pages, and is an excerpt from *Principles of Corporate Finance*, Fifth Edition by Richard A. Brealey and Stewart C. Myers. In discussing capital budgeting and risk at pages 3 and 4 (original pages 204-205), the authors state:

> *But the company cost of capital rule can also get a firm into trouble if the new projects are more or less risky than its existing business. Each project should be evaluated at its own opportunity cost of capital.* This is a clear implication of the value-additivity principle introduced in Chapter 7. For a firm composed of assets A and B, the firm value is
>
> Firm Value = PV (AB) = PV (A) + PV(B) = sum of separate asset values
>
> Here PV(A) and PV(B) are valued just as if they were mini-firms in which stockholders could invest directly …If the firm considers investing in a third project C, it should also value C as if C were a mini-firm. That is, the firm should discount the cash flows of C at the expected rate of return that investors would demand to make a separate investment in C. *The true cost of capital depends on the use to which the capital is put.*

(Emphasis in the first quoted paragraph is added. Emphasis in the last quoted paragraph contained in the original text.)

Q. PLEASE DESCRIBE THE INFORMATION CONTAINED IN SCHEDULE FJH-5.

A. Schedule FJH-5 consists of seven pages and is an excerpt from *Capital Investment and Financial Decisions*, Third Edition, by Haim Levy and Marshall Sarnat. In Chapter 17 – Defining the Cost of Capital, the authors state at pages 3 and 4 (original pages 464-465):

> The cost of capital and the discount rate are two concepts which are used throughout the book interchangeably. However, there is a distinction between the *firm's* cost of capital and specific *project's* cost of capital. (Emphasis contained in original text.) ….
>
> In any case where the risk profile of the individual projects differ from that of the firm, an adjustment should be made in the required discount rate, to reflect this deviation in the risk profile.

MGE's rate base is analogous to an investment in a project. In other words, risk and return relate to where the capital is invested, which is a fundamental precept of finance. Even relatively unsophisticated individual investors expect a return commensurate with the risk associated with where their capital is invested. In this instance, it is MGE's rate base to which (and only to which) the allowed overall cost of capital and fair rate of return can be applied.

In view of the foregoing, it is incredulous that Mr. Lafferty suggests that there is any nexus between SUG's dividend policy or impending acquisition value specified in the Second Amended Merger Agreement and this Commission's authorized rate of return on the common equity (ROE) financed portion of MGE's rate base, much less MGE's ability to earn that ROE.

Q. PLEASE SUMMARIZE YOUR ASSESSMENT OF MR. LAFFERTY'S PERCEPTION OF THE IMPACT OF THE MAY 22, 2011 JOPLIN TORNADO ON MGE'S RISK.

A. The enormity of such a catastrophic, anomalous event was not something anticipated by investors or reflected in the market prices paid for common stocks of the gas distribution proxies utilized to determine common equity cost rate applicable to MGE. Moreover, for the reasons described *supra*, neither MGE's ownership nor SUG's dividend policy or impending acquisition value are relevant to the ROE to which MGE's assets devoted to public service is entitled an opportunity to earn.

Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?

A. Yes, it does.

APPENDIX A

PROFESSIONAL QUALIFICATIONS

OF

FRANK J. HANLEY, CRRA
PRINCIPAL & DIRECTOR
AUS CONSULTANTS

PROFESSIONAL QUALIFICATIONS OF FRANK J. HANLEY

EDUCATIONAL BACKGROUND

I am a graduate of Drexel University where I received a Bachelor of Science Degree from the College of Business Administration. The principal courses required for this Degree include accounting, economics, finance and other related courses. I am also Certified by the Society of Utility and Regulatory Financial Analysts, formerly the National Society of Rate of Return Analysts, as a Rate of Return Analyst (CRRA).

PROFESSIONAL EXPERIENCE

In 1959, I was employed by American Water Works Service Company, Inc., which is a wholly-owned subsidiary of American Water Works Company, Inc., the largest investor-owned water works operation in the United States. I was assigned to its Treasury Department in Philadelphia until 1961. During that period of time, I was heavily involved in the development of cash flow projections and negotiations with banks for the establishment of lines of credit for all of the operating and subholding companies in the system, which normally aggregated more than $100 million per year.

In 1961, I was assigned to its Accounting Department where I remained until 1963. During that two-year period, I became intimately familiar with all aspects of a service company accounting system, the nature of the services performed, and the methods of allocating costs. In 1963, I was reassigned to its Treasury Department as a Financial Analyst. My duties consisted of those previously performed, as well as the expanded responsibilities of assisting in the preparation of testimony and exhibits to be presented to various public utility commissions in regard to fair rate of return and other financial matters. I also designed and recommended financing programs for many of American's operating subsidiaries and negotiated sales of long-term debt securities and preferred stock on their behalf either directly with institutional investors or through investment bankers. I was elected Assistant Treasurer of a number of operating subsidiaries in the Fall of 1967, just prior to accepting employment with the Communications and Technical Services Division of the Philco-Ford Corporation located in Fort Washington, Pennsylvania. While in the employ of the Philco-Ford organization, as a Senior Financial Analyst, I had responsibility for the pricing negotiations and analysis of acceptable rates of return to the corporation for all types of contract proposals with various agencies of the U.S. Government and foreign governments.

In the Summer of 1969, I accepted a position with the Financial Division of The Philadelphia National Bank. I was elected Financial Planning Officer of the bank in December 1970. While employed with The Philadelphia National Bank, my responsibilities included preparation of the annual and five-year profit plans. In the compilation of these plans, I had to perform detailed analyses and measure the various levels of profitability for each organizational unit. I also assisted correspondent banks in matters of recapitalization and merger, made recommendations and studies for their use before the various regulatory bodies having jurisdiction over them.

In September 1971, I joined AUS Consultants - Utility Services Group as Vice President. I was elected Senior Vice President in May 1975. I was elected President in September 1989. As a result of a reorganization of AUS Consultants by practice effective January 1, 2007, I am currently a Principal & Director of AUS Consultants.

EXPERT WITNESS QUALIFICATIONS

I have offered testimony as an expert witness on the subjects of fair rate of return and utility financial matters in more than 300 various cases and dockets before the following agencies and courts: before the Alaska Public Utilities Commission and its successor the Regulatory Commission of Alaska, the Arizona Corporation Commission, the Arkansas Public Service Commission, the California Public Utilities Commission, the Public Utilities Control Authority of Connecticut, the Delaware Public Service Commission, the District of Columbia Public Service Commission, the Florida Public Service Commission, Hawaii Public Utilities Commission, the Idaho Public Utilities Commission, the Illinois Commerce Commission, the Indiana Public Utility Regulatory Commission, the Iowa Utilities Board, the Public Service Commission of Kentucky, the Maryland Public Service Commission, the Massachusetts Department of Public Utilities, the Michigan Public Service Commission, the Minnesota Public Utilities Commission, the Missouri Public Service Commission, Nevada Public Utilities Commission, the New Jersey Board of Public Utilities, the New Mexico State Corporation Commission, the Public Service Commission of the State of New York, the North Carolina Utilities Commission, the Ohio Public Utilities Commission, the Oklahoma Corporation Commission, the Pennsylvania Public Utility Commission, the Rhode Island Public Utilities Commission, the Tennessee Public Service Commission, the Public Service Board of the State of Vermont, the Virginia State Corporation Commission, the Public Services Commission of the Territory of the U.S. Virgin Islands, the Washington Utilities and Transportation Commission, the Public Service Commission of West Virginia, the Wisconsin Public Service Commission, the Federal Power Commission and its successor the Federal Energy Regulatory Commission. I have testified before the New Jersey Division of Tax Appeals and the United States Bankruptcy Court - Middle District of Pennsylvania with regard to the economic valuation of utility property. Also, I have testified before the U.S. Tax

Court in Washington D.C. as an expert witness on the value of closely held utility common stock in a contested Federal Estate Tax case.

In addition, I have appeared as a Staff rate of return witness for the Arizona Corporation Commission, the Delaware Public Service Commission and the Virgin Islands Public Services Commission. I have testified on the fair rate of return on behalf of the City of New Orleans, Louisiana, and also acted as project manager for my firm in representing the City in the 1980-1981 rate proceeding of New Orleans Public Services, Inc. The City of New Orleans then had, as it does now, regulatory authority with regard to the retail rates charged by New Orleans Public Service, Inc., for electric and natural gas service. I have also acted as a consultant to the District of Columbia Public Service Commission itself -- not in the capacity of Staff. AUS Consultants is currently under contract to provide consulting services to the Regulatory Commission of Alaska (RCA). I have provided analyses and recommendations regarding cost of capital to the RCA.

I have testified before a number of local and county regulatory bodies in various states on the subject of fair rate of return on behalf of cable television companies as well as before an arbitration panel in Ohio and a State District Court in Texas. I have testified before the Public Works Committee of the Nebraska State Senate in relation to Legislative Bill 731 which proposed permitting Public Power Districts and Municipalities to enter the Cable Television field.

PROFESSIONAL ASSOCIATIONS,
PUBLICATIONS AND GUEST SPEAKER APPEARANCES

I am a Member of the Society of Utility and Regulatory Financial Analysts (SURFA), formerly known as the National Society of Rate of Return Analysts. I am a Certified Rate of Return Analyst (CRRA). I am a member of the Advisory Council of New Mexico State University's Center for Public Utilities which is endorsed by the National Association of Regulatory Utility Commissioners (NARUC). I am a member of the Executive Advisory Council of the Rutgers University School of Business at Camden. AUS Consultants is an associate member of the American Gas Association (AGA) and I am a member of AGA's Rate Committee. I am also an associate member of the Energy Association of Pennsylvania and the National Association of Water Companies. AUS Consultants is an associate member of the New Jersey Utilities Association.

I often attend SURFA meetings during which considerable information on the subject of rate of return is exchanged. I have also attended corporate bond rating seminars held by Standard & Poor's Corporation. I continuously review financial publications of institutions such as Standard & Poor's, Moody's Investors' Service, Value Line Investment Survey, and periodicals of various agencies of the U.S. Government.

I co-authored an article with A. Gerald Harris entitled "Does Diversification Increase the Cost of Equity Capital?" which was published in the July 15, 1991 issue of Public Utilities Fortnightly. Also, an article which I co-authored with Pauline M. Ahern entitled "Comparable Earnings: New Life for an Old Precept" was published in the American Gas Association's Financial Quarterly Review, Summer 1994. I also authored an article entitled "Why Performance-

Based Incentives Are Essential" which was published in THE CITY GATE, Fall 1995, a magazine published by the Pennsylvania Gas Association. I am a co-author, along with Pauline M. Ahern and Richard A. Michelfelder, an article entitled, "New Approach to Estimating the Cost of Common Equity Capital for Public Utilities", which is forthcoming in the JOURNAL OF REGULATORY ECONOMICS.

I have appeared as a guest speaker before an annual convention of the Mid-American Cable Television Association in Kansas City, Missouri and as a guest panelist on the small water companies' operation seminar of the National Association of Water Companies' 77th Annual Convention in Hollywood, Florida. I addressed the Second Annual Seminar on Regulation of Water Utilities sponsored by N.A.R.U.C., at the University of South Florida's St. Petersburg campus. I have spoken on fair rate of return to the Third and Fourth Annual Utilities Conferences, as well as the special conference on the cost of capital in El Paso, Texas sponsored by New Mexico State University. In 1983 I also made a presentation on the Cost of Capital in Atlantic City, New Jersey, at a seminar co-sponsored by Temple University. I have also addressed the Public Utility Law Section of the American Bar Association's Third Institute on Fundamentals of Ratemaking which was held in Washington, D.C. and I addressed a Conference on Cable Television sponsored by The University of Texas School of Law at Austin, Texas. Also, I addressed a meeting of the New England Water Works Association at Boxborough, Massachusetts, on the subject of Enterprise Financing. In addition, I was a speaker and mock witness in three different Utility Workshops for Attorneys sponsored by the Financial Accounting Institute held in Boston and Washington, D.C. I also was on a panel at the 23rd Financial Forum sponsored by the National Society of Rate of Return Analysts. The topic was Rate of Return Determination in the Diversified and/or Partially

Deregulated Environment. I addressed the 83rd Annual Meeting of the Pennsylvania Gas Association in Hershey, PA. My topic was the Cost of Capital Implications of Demand Side Management. In June 1993, I lectured on the cost of capital at the American Gas Association's Gas Rate Fundamentals Course. In October 1993, I was a guest speaker at the University of Wisconsin's Center for Public Utilities -- my topic was "Diversification and Corporate Restructuring in the Electric Utility Industry - Trends and Cost of Capital Implications." In October 1994, I was a guest speaker on a panel at the Fourteenth Annual Electric & Natural Gas Conference in Atlanta, Ga., sponsored by the Bonbright Utilities Center of the University of Georgia and the Georgia Public Service Commission. The panel topic was "Responses to Competition and Incentive Rates." In October 1994, I was a guest speaker on a panel at a conference and workshop called "Navigating the Shoals of Cable Rate Regulation" sponsored by EXNET in Washington, D.C. The panel topic was "Rate of Return." Also, in March 1995, I was a guest speaker on a panel at a conference entitled, "Current Issues Challenging the Regulatory Process" sponsored by New Mexico State University - Center for Public Utilities. My panel topic concerned the electric industry and was titled, "Impact of a Competitive Structure on the Financial Markets". In May 1995, I was a guest speaker at the 87th Annual Meeting of the Pennsylvania Gas Association in Hershey, PA. My topic was "The Pennsylvania Economy and Utility Regulation: Impact on Industry, Consumers and Investors." In May 1996, I was on a panel at the 28th Financial Forum of the Society of Utility and Regulatory Financial Analysts. The panel's topic was "Revisiting the Risk Premium Approach" and was held in Richmond, Virginia. From 1996 through 2005, I participated as an instructor in 2-3 seminars per year on the “Basics of Regulation” (and the ratemaking process in a changing environment) and also in a program called “A Step Beyond the

Basics", all sponsored by New Mexico State University's Center for Public Utilities and NARUC. In March 2002, I was a guest speaker before the Rate and Strategic Issues Committee of the American Gas Association in St. Petersburg, Florida. My topic was Rate of Return Strategies. In December 2002, I was a guest speaker at a seminar entitled, "Service Innovations and Revenue Enhancements for the Energy Distribution Business" sponsored by the American Gas Association in Washington, DC. My topic was "The Impact of Volatile Energy Markets on Rate of Return Strategies". In February 2003, I spoke at the Rutgers University-Camden, NJ M.B.A. Speaker Series. I addressed M.B.A. students and interested faculty on the role of the expert witness in the public utility ratemaking process. In November 2003, 2004, 2007, 2008 and 2010 and 2011, by invitation, I was a Guest Professor at Rutgers University – Camden for classes of undergraduate and graduate level accounting and finance students. In October 2006, I made a presentation entitled "Mergers & Acquisitions: A Regulatory Perspective" at the Bonbright Center Electric and Natural Gas Conference at the University of Georgia. In February 2008, I taught a course entitled, "The Basics of Cost of Capital Analysis" in Albuquerque, NM as part of a program entitled, "More Basic Practical Training" sponsored by New Mexico State University's Center for Public Utilities.