Exhibit No.:	
Issue:	Rate of Return
Witness:	Kathleen C. McShane
Type of Exhibit:	Surrebuttal Testimony
Sponsoring Party:	Laclede Gas Company
Case No.:	GR-99-315

LACLEDE GAS COMPANY

GR-99-315

SURREBUTTAL TESTIMONY

OF

KATHLEEN C. McSHANE

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KATHLEEN C. McSHANE

Q. Please state your name and business address.

A. My name is Kathleen C. McShane, and my business address is 4550 Montgomery Avenue, Suite 350N, Bethesda, Maryland 20814.

Q. Are you the same Kathleen C. McShane who previously filed testimony and schedules in this proceeding?

A. Yes.

Q. What is the purpose of your surrebuttal testimony?

A. The purpose of my surrebuttal testimony is to correct several erroneous conclusions in the rebuttal testimony filed by Messrs. Broadwater and Burdette.

Impact of ROE Recommendation on Market/Book Ratio

Q. At page 4 of his rebuttal testimony, Mr. Broadwater claims that if the Commission accepts the adjustment to the DCF test results that you have proposed, Laclede's market/book ratio will be driven up, which will, in the next case, support an even greater adjustment to the DCF test results. Is this claim true?

Q. No. The DCF test results incorporate investor expectations of long-term future growth, which can be estimated from investor expectations of the longer-term return on book value and the dividend payout ratio ($g = b(r)$). In principle, if investor expectations of the return on <u>book</u> equity are achieved (i.e., the company is allowed and earns the return on book equity the investor expects), the investor's <u>market</u> return will equal the DCF cost of equity, and the market/book ratio will neither rise nor fall. Table 1 demonstrates that, at a

Table 1

EFFECT OF REALIZED EXPECTED BOOK RETURN AND CONSTANT MARKET RETURN REQUIREMENT ON MARKET/BOOK RATIO						
		Year 1	Year 2	Year 3	Year 4	Year 5
1	Book Value $(1)_{t-1} + (6)_{t-1} - (7)_{t-1}$	$10.00 a/	$10.46	$10.93	$11.43	$11.95
2	Market Value $(2)_{t-1} \times (1 + (8)_{t-1})$	$15.50 a/	$16.21	$16.94	$17.71	$18.52
3	**Market/Book Ratio (2)/(1)**	**1.55 b/**	**1.55**	**1.55**	**1.55**	**1.55**
4	Payout Ratio c/	65%	65%	65%	65%	65%
5	**Book Return on Equity c/**	**13.0%**	**13.0%**	**13.0%**	**13.0%**	**13.0%**
6	Earnings per Share (1) x (5)	$1.30	$1.359	$1.421	$1.486	$1.553
7	Dividends per Share (4) x (6)	$0.845	$0.883	$0.924	$0.966	$1.010
8	Growth (5) x (1-(4))	4.55%	4.55%	4.55%	4.55%	4.55%
9	Dividend Yield (7)/(2)	5.45%	5.45%	5.45%	5.45%	5.45%
10	**Market Return** **$[((2) + (7)_{t-1})/(2)_{t-1}] - 1$**	--	**10.0%**	**10.0%**	**10.0%**	**10.0%**

a/ For illustrative purposes
b/ Recent Laclede market/book ratio
c/ *Value Line* projection

market cost of equity of 10%, an expected and earned return on book equity of 13%, and a current market/book ratio of 1.55 (equal to Laclede's recent market/book ratio):

(1) the investor will earn a market return of 10%, while the return on book equity is 13%; and,

(2) the market/book ratio will remain at 1.55.

As Table 1 shows, consistent with the assumptions of the DCF test, the earnings, dividends, book value and market value will all grow at the same rate; hence, the market/book ratio will not be driven up, contrary to Mr. Broadwater's contention. Changes in the market/book ratio will only occur when earnings expectations are not met or the investors' return requirement changes (e.g., due to higher costs of capital).

Q. Has Mr. Broadwater made other statements which support the adoption rather than rejection of a market to book adjustment?

A. Yes. In his deposition at page 57, Mr. Broadwater also agreed that his recommended return on book value of 9.0-10.0% would <u>not</u> result in a market return to the investor of 9.0-10.0%. He then proceeded to comment that my recommended return on book equity of 12.75% would likewise not produce a return on market value to investors of 12.75%. Mr. Broadwater's latter statement, however, is demonstrative of the need to recognize the difference between the allowed returns on <u>book</u> equity and the return on the <u>market</u> value of the stock.

If the Commission allows a Laclede return of 12.75% on book value, earnings per share will be approximately $1.99 ($12.75% x $274,770,663 common equity ÷ 17,627,987 shares).

The total market return to the investor will be approximately 10%, comprised of the recent dividend yield of 5.7% ($1.34/$23.55) and capital appreciation of approximately 4.2%, equal to the earnings retention growth [12.75% ROE (1 - ($1.34 DPS/$1.99 EPS))].

Impact of Mr. Broadwater's Recommendations on Laclede's Interest Coverage and Bond Ratings

Q. In his rebuttal testimony and/or deposition, Mr. Broadwater agreed that the pro forma interest coverage ratios he had calculated in his direct testimony were incorrect and that the corrected coverage ratios would lie below the Standard & Poor's guidelines for an A rating. What are the implications to ratepayers if Laclede's debt ratings were reduced from AA- to the BBB category?

A. The costs of both debt and equity, over the longer-term, would be more expensive to ratepayers. In the case of debt, Baa rated utility debt has been 44 basis points more expensive than Aa debt over the past decade (source: *Moody's Bond Record*, various issues). Although there is currently no discernible difference between the cost of equity for AA and BBB rated LDCs, an article entitled "Utility Bond Ratings and the Cost of Capital", by Laurent Baptiste, Gregory Borges, and Gary Carr, *Public Utilities Fortnightly*, October 27, 1988, found that the cost of equity for BBB rated utilities was approximately 11% higher than for AA utilities. At a market-derived cost of equity of 10.5% for a AA utility, the market cost of equity for a BBB utility would be in excess of 11.5% (10.5% x 1.11), more than one percentage point higher than the cost of equity to a AA rated utility.

Ratepayers' interests would not be well served if the allowed returns on book equity were set at levels that would promote a reduction in Laclede's bond ratings. The pre-tax cost of capital that they would be required to pay would, over the long term, exceed the cost of capital of a AA rated LDC.

Flotation Costs

Q. At page 5 of his rebuttal testimony, Mr. Broadwater questions your application of a flotation cost allowance only to the risk premium test. Is there an inconsistency in your testimony?

A. No. The flotation cost adjustment in the DCF test is implicitly included in the market/book adjustment. A further adjustment for flotation costs would be a double-count. The comparable earnings test is not a market-derived cost of attracting equity; a flotation cost adjustment is neither relevant nor appropriate.

With respect to the methodology for estimating a reasonable flotation cost adjustment, my approach, in contrast to Mr. Broadwater's, considers the flotation cost adjustment to be an integral component of the cost of equity, which permits a company to recover all costs associated with issuing additional stock as required to meet its obligation to serve, at not less than book value per share, and thus without harming (diluting) the investment of existing shareholders, and which positions the company at all times such that if it needs to issue additional equity to meet its obligation to serve, it can do so without harm to its existing shareholders. That approach is consistent with the manner in which Laclede has historically positioned its return on equity proposals.

Comparable Earnings

Q. Both Mr. Broadwater (page 5) and Mr. Burdette (page 8) claim that the comparable earnings test results do not meet the Bluefield standard, because the companies themselves are not of equivalent risk to Laclede. Do you have any comments?

A. Yes. Mr. Broadwater's and Mr. Burdette's criticism would have some merit if no adjustments to the returns of the sample had been made to ensure that the resulting returns were equivalent to those "being made…in other business undertakings which are attended by corresponding risks and uncertainties" (from Bluefield Case as stated in Burdette Rebuttal testimony, p.8, lines 9-12). However, since the returns for the low risk industrials were adjusted downward to achieve the Bluefield standard by reference to an accepted measure of relative risk, the witnesses' criticism is without merit.

Q. Mr. Broadwater also criticizes the comparable earnings test, because it does not measure investors' required returns. Is he correct?

A. The comparable earnings test is not intended to measure the investor's required return, which is a return on market value. It is intended to measure returns achieved and achievable by companies of comparable risk in a manner compatible with that used to set allowed returns for utilities. To the extent regulators set returns on equity for utilities on original cost book value, not market value, the comparable earnings test will measure returns for similar risk competitive companies on that very basis. As a result, the comparable earnings test is the most compatible with the reality of how allowed returns are set.

Q. On pages 6 and 7 of his rebuttal testimony, Mr. Burdette criticizes the LDC sample used in your risk premium and discounted cash flow (DCF) test. He notes that his sample of six companies is contained within your larger samples, and contends that the remaining companies are questionable as to their appropriateness to serve in a proxy group for Laclede. What are your comments?

A. The proof is in the pudding, to use a somewhat trite expression; the impact of the sample selection on the test results is negligible.

In the case of the CAPM, the beta for Mr. Burdette's sample is 0.625; the beta for my sample was 0.59. Hence, Mr. Burdette's sample actually produces a higher cost of equity. For the DCF-based equity risk premium test, the difference in the sample selection results in a minimal 20 basis point difference in the estimated LDC risk premium (4.9% for my sample vs. 4.7% for Mr. Burdette's sample).

Table 2 shows the impact of sample selection on the results of the DCF test, using my methodology.

Table 2

DCF TEST RESULTS		
	Ms. McShane's Sample (13 companies)	Mr. Burdette's Sample (6 companies)
IBES Growth:		
Average	5.7%	5.5%
Median	5.5	5.6
Dividend Yield (Adjusted for Growth):		
Average	4.8	4.8
Median	5.0	5.0
DCF Cost of Equity:		
Average	10.5	10.3
Median	10.5	10.6

The results are virtually identical.

Given the similarity of results of the three tests, despite the difference in the samples, Mr. Burdette's contention that the results of my analysis are questionable is unsupported.

Q. In addition, Mr. Burdette claims that there is circularity in your analysis, due to the inclusion of Atmos Energy, a company with operations in Missouri, in your sample. What are your comments?

A. On the one hand, Mr. Burdette criticizes the inclusion of one company (in a larger sample of companies) with operations within the same jurisdiction as Laclede. On the other hand, he criticizes my analysis for not applying the DCF model solely to Laclede (Burdette, page 8). The witness cannot have it both ways. The application of the DCF test to Laclede only is a blatant exercise in circularity. Clearly, if there is a problem with circularity in including a <u>single</u> company with <u>some</u> operations in Missouri, there is a much bigger circularity problem in Mr. Burdette's relying principally on the results of a test applied to the very utility whose returns this Commission will be setting.

Q. Does this conclude your surrebuttal testimony?

A. Yes.

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of Laclede Gas Company's	)	
Tariff to Revise Natural Gas	)	Case No. GR-99-315
Rate Schedules	)	

AFFIDAVIT

Kathleen C. McShane, of lawful age, being first duly sworn, deposes and states:

1. My name is Kathleen C. McShane. My business address is 4550 Montgomery Avenue, Suite 350-N, Bethesda, Maryland 20814; and I am a Senior Vice President of Foster Associates, Inc.

2. Attached hereto and make part hereof for all purposes is my surrebuttal testimony, consisting of pages 1-8, inclusive.

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.

Kathleen C. McShane

Kathleen C. McShane

Subscribed and sworn to before me, the undersigned Notary Public, this 17th day of August, 1999, at Bethesda, Maryland.

Patricia J Bradley

My Commission Expires 10/14/02