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MISSOURI PUBLIC SERVICE COMMISSION

FINANCIAL AND BUSINESS ANALYSIS DIVISION

FINANCIAL ANALYSIS DEPARTMENT

SURREBUTTAL TESTIMONY

OF

CHRISTOPHER C. WALTERS

LIBERTY UTILITIES (Midstates Natural Gas) CORP.,
d/b/a Liberty

CASE NO. GR-2024-0106

Jefferson City, Missouri
September 2024

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I. INTRODUCTION

Q. Please state your name and business address.

A. My name is Christopher C. Walters. My business address is 16690 Swingley Ridge Road, Suite 140, Chesterfield, MO 63017.

Q. Are you the same Christopher C. Walters who previously filed Direct Testimony and Rebuttal Testimony on behalf of Staff of the Missouri Public Service Commission ("Commission")?

A. Yes, I am.

Q. What is the purpose of your surrebuttal testimony?

A. The purpose of my surrebuttal testimony is to respond to certain criticisms offered in the rebuttal testimonies of Office of Public Counsel's witness David Murray, and Liberty Midstates witness John Cochrane.

My silence with regard to any position taken by Liberty Midstates or any other party in this proceeding does not indicate my endorsement of that position.

II. SUMMARY

Q. Please summarize the rest of your surrebuttal testimony.

A. In Section III, I will respond to certain criticisms offered in the rebuttal testimony of Mr. Murray as it relates to my recommended embedded cost of debt. In Section IV, I will respond to the rebuttal testimony of Mr. Cochrane as it relates to my recommended capital structure and COE analysis.

Q. Based on the rebuttal testimony filed by the parties in this case, do you have any changes to your recommendations?

A. No. I continue to recommend the Company's return on equity ("ROE") be set at 9.45%, the capital structure be set at 50% common equity and 50% long-term debt, and continue to assume an embedded cost of long-term debt of 5.58%.

III. RESPONSE TO MR. MURRAY

Q. Please summarize Mr. Murray's criticisms of your recommendations.

A. Mr. Murray criticizes my adoption of 5.58% cost of debt for Liberty Midstates, asserting that it is based on Liberty Midstates' affiliate Promissory Notes, which he argues lack economic legitimacy. He believes these internal transactions are designed to manipulate capital structure and debt costs for rate case purposes, rather than reflecting actual market costs. He points out that other Missouri utilities have lower embedded costs of debt, and contends that the affiliate financing process is driven by internal bookkeeping needs rather than economic substance.

Q. Please respond.

A. The concept of the embedded cost of debt for Liberty Midstates is interesting as it does not issue its own debt and relies entirely on affiliates for access to external capital.

Based on my understanding, this Commission determined in a previously litigated proceeding for Liberty Midstates that the embedded cost of long-term debt for Liberty Utilities Company ("LUCo") should be used for establishing Liberty Midstates' cost of debt, particularly when it uses LUCo's capital structure as Liberty Midstates' capital structure. This Commission has previously found as follows:

> Having chosen Staff's capital structure, which is based on Liberty Utilities Company's capital structure, it follows that the appropriate cost of debt should be based upon Liberty Utilities Company's embedded cost of debt.[1]

Because Liberty Midstates does not issue its own debt, it would not be unreasonable to use LUCo's embedded cost of debt in a manner relatively consistent with how Mr. Murray has proposed. However, I am not recommending LUCo's capital structure be used here. Rather, I am proposing a hypothetical capital structure consisting of 50.0% common equity and 50.0% long-term debt. However, I will note that 5.58% is consistent with yields on recent long-term utility bonds. As shown on my Exhibit CCW-13 as part of my direct testimony, the 13-week average yield on A-rated utility bonds was 5.69% and 5.92% for Baa-rated utility bonds. Similarly, the 26-week average yields on A-rated and Baa-rated utility bonds was 5.58% and 5.82%, respectively. These yields are consistent with the average yields for July of 5.64% and 5.85% for A-rated and Baa-rated utility bonds, respectively. Should LUCo go to the capital markets to access debt capital, it is likely that the interest rate on that debt would be consistent with the 5.58% cost rate that I have assumed in my recommended overall rate of return. I still believe an embedded cost of debt of 5.58% is reasonable and consistent with the current utility debt market.

[1] Missouri Public Service Commission, File No. GR-2014-0152, Report and Order at 19. December 3, 2014.

IV. RESPONSE TO MR. COCHRANE

Q. Please summarize Mr. Cochrane's criticisms of your recommendations.

A. Aside from the embedded cost of debt assumed in my recommended overall rate of return, Mr. Cochrane takes issue with several aspects of my testimony. He takes particular issue with my recommended capital structure, my recommended proxy group, and the various analyses used to support my recommended ROE. In particular, he disagrees with my sustainable growth and multi-stage growth Discounted Cash Flow ("DCF") models, as well as various inputs to my Capital Asset Pricing Model ("CAPM").

Q. Please summarize Mr. Cochrane's criticisms of your recommended capital structure.

A. Mr. Cochrane disagrees with my recommendation of a 50.0% common equity ratio, instead advocating for a higher 52.9% (updated to 52.5%). He argues that my recommendation is flawed because it is based on the proxy group's average common equity ratio, which includes companies with risk profiles different from those of a gas utility like Liberty Midstates, such as water utilities. Mr. Cochrane also criticizes my use of the proxy group to derive the equity ratio. He believes that by including non-gas companies, I have distorted the comparison, and that rounding the common equity ratio to 50.0% ignores the equity ratios typically authorized for gas utilities, which tend to be higher. Additionally, he points to historical data showing that the common equity ratios for gas utilities over the past twelve years averaged 51.80%, with even higher ratios of 52.45% and 52.25% for 2023 and 2024. He contends that these numbers better support his recommended equity ratio of 52.5% for Liberty Midstates. Overall, he believes my reliance on the proxy group and average

common equity ratio does not accurately reflect Liberty Midstates' risk profile or the equity ratios typically authorized for gas utilities.

Q. Please respond.

A. Mr. Cochrane's criticisms are without merit and should be given little weight. Mr. Cochrane's primary criticism is that my recommended 50% equity ratio is too low compared to Liberty Midstates' proposed 52.9%. However, my recommendation is consistent with industry standards and comparable companies in the gas utility sector. It balances the need to mitigate financial risk while ensuring that ratepayers are not burdened with unnecessarily high costs.

An important point that Mr. Cochrane overlooks is the need to consider the capital structures of the proxy group used to assess Liberty Midstates' cost of equity. These companies serve as the benchmark for determining an appropriate cost of equity, so their capital structures must be considered when developing Liberty Midstates' capital structure. The companies in my proxy group have an average equity ratio closer to 50%, which provides a more accurate reflection of Liberty Midstates' financial risk profile.

Furthermore, Mr. Cochrane's proposed equity ratio of 52.9% would lead to overcapitalization, which would increase the cost of capital without adequate justification. This, in turn, would result in higher rates for customers. My 50% equity ratio recommendation, on the other hand, is consistent with a recent decision by this Commission and mitigates unnecessary cost increases to customers.

Q. Please summarize Mr. Cochrane's criticisms of your proxy group.

A. Mr. Cochrane argues that my group includes only five gas utilities, with the remaining companies being six water utilities and one multi-utility, which he believes are

inappropriate comparisons for a natural gas utility like Liberty Midstates. He contends that water utilities, in particular, face different risks and should not be used in the analysis to determine the cost of equity for a gas utility. Additionally, Mr. Cochrane takes issue with my decision to exclude Chesapeake Utilities and NiSource from the proxy group. He argues that both companies are strong gas utilities that should have been included. In his view, excluding them while adding companies with different risk profiles distorts the analysis and leads to an inaccurate assessment of the appropriate cost of equity for Liberty Midstates.

Q. Please respond.

A. My proxy group is reasonable because it provides a broader, more balanced representation of utility companies with similar risks to Liberty Midstates. While Mr. Cochrane criticizes the inclusion of water utilities and a multi-utility, these companies still operate in regulated environments similar to gas utilities, sharing comparable regulatory frameworks, risk profiles, and market conditions. This allows for a more diversified and reliable estimation of the cost of equity. Regarding the exclusion of Chesapeake Utilities and NiSource, I made these decisions deliberately. Chesapeake was excluded because it is not rated by either S&P or Moody's, and its recent merger and acquisition activity introduces volatility that can distort its risk profile. NiSource was excluded due to its recent significant asset sale, which fundamentally altered its business profile. Including these companies would have introduced unnecessary risk and uncertainty into the analysis. The water utilities included in my proxy group, though different in their specific operations, still offer valid points of comparison because they operate in regulated environments and are subject to many of the same financial risks as gas utilities. In fact, my broader proxy group allows for a more comprehensive evaluation of the market and

risk conditions facing Liberty Midstates, leading to a more accurate determination of the appropriate cost of equity.

Q. Please summarize Mr. Cochrane's criticisms of your sustainable growth DCF analysis.

A. Mr. Cochrane has several concerns with my sustainable growth DCF analysis. First, he critiques the methodology I used to calculate the sustainable growth rates, arguing that my results are inconsistent with the inputs I selected. Specifically, he claims that my calculated sustainable growth DCF result is inconsistent with the expected ROE I use as an input. He calls my methodology "circular," because I use an expected ROE as part of my formula, yet the results of my analysis yield a lower ROE than the input. Additionally, Mr. Cochrane criticizes my sustainable growth DCF results for being lower than any state-authorized ROE for a gas utility in the past 45 years. He points out that my results, which average around 8.58%, are lower than any historical authorized ROEs for gas distribution utilities, which he believes makes my results unreasonable. He emphasizes that no state commission has authorized an ROE below 8.58% for gas utilities over the past several decades, and as a result, my analysis should be disregarded.

Q. Please respond.

A. As a practical matter, all models available for estimating the cost of equity are subject to limiting assumptions or other methodological constraints. Using multiple methods provides a more comprehensive, and therefore, more reliable perspective on investors' return requirements. For this reason alone, it is important to perform a thorough analysis, and apply informed, reasoned judgement in the interpretation of the results. The use of multiple DCF models and considering those results is consistent with that approach and financial texts.

For example, using the retention growth methodology is a recognized reasonable method for estimating sustainable dividend growth and should not be ignored.

As noted by the CFA curriculum text:

> "We define the sustainable growth rate as the rate of dividend (and earnings) growth that can be sustained for a given level of return on equity, assuming that the capital structure is constant through time and that additional common stock is not issued. The reason for studying this concept is that it can help in estimating the stable growth rate in a Gordon growth model valuation, or the mature growth rate in a multistage DDM in which the Gordon growth formula is used to find the terminal value of the stock."

The expression to calculate the sustainable growth rate is: $g = b$ x ROE.[2]

Notably, the same CFA text observes that "caution is appropriate in assuming that dividends displace earnings."[3] However, that same text concludes that "[n]evertheless, the equation can be useful as a simple expression for approximating the average rate at which dividends can grow over a long horizon."[4] Further, *Brigham and Houston* state that, "Companies that retain a high percentage of their earnings rather than paying them out as dividends generate more retained earnings and thus need less external capital."[5] The sustainable growth model is a valid model and should be considered in determining the Company's cost of equity.

Q. Please respond to Mr. Cochrane's assertion that your sustainable growth DCF model result of 8.58% is lower than any state-authorized ROE for a gas utility in the past 45 years.

[2] See CFA Program Curriculum, 2014, Level II, Volume 4, "Dividend Discount Valuation," at page 264.
[3] See CFA Program Curriculum, 2014, Level II, Volume 4, "Dividend Discount Valuation," at pages 265-266.
[4] *Ibid.* at 266.
[5] See *Fundamentals of Financial Management*, Eugene F. Brigham and Joel F. Houston, Eleventh Edition 2007, Thomson South-Western, a Division of Thomson Corporation at page 558.

A. I would note that the referenced average of 8.58% is the average of all my proxy companies. On that same exhibit, Exhibit CCW-7, I also present the average and medians for just the gas companies which is 8.87% and 8.77%, respectively. Regardless of which point estimate is considered, they are all consistent with authorized ROEs for regulated utilities over the last few years. As shown on Exhibit CCW-1SR, there are at least 40 authorized ROE decisions which I am aware that range from a low of 7.36% to a high of 8.91% since 2017. There are several natural gas decisions between 8.7% and 8.8%. Mr. Cochrane's assertions are without merit and should be given little weight.

Q. Please summarize Mr. Cochrane's criticisms of your multi-stage DCF analysis.

A. Mr. Cochrane has several concerns with my multi-stage DCF analysis. First, he notes that my results, which average 8.10% and have a median of 7.93%, are significantly lower than historical authorized returns for gas utilities. He points out that nine of the twelve results in my analysis fall below 8.56%, which he believes makes my estimates unreasonable when compared to past regulatory decisions. Additionally, he critiques my use of a 4.14% long-term growth rate in the final stage of the analysis, asserting that this growth rate is too low and does not align with historical economic performance or utility industry growth expectations. He argues that his proposed long-term growth rate of 5.5% is more appropriate, based on historical GDP growth and inflation rates.

Q. Please respond.

A. With regard to his comparison to historical authorized ROEs for gas utilities, I have responded above. Concerning his criticisms of my use of expected GDP growth rather than historical GDP growth, I would note that I relied on the consensus forecast for GDP growth, meaning it is completely rooted in investor expectations and considered as part of the

investment decision making process. I provided projected GDP growth rates from several sources which corroborate my use of 4.14%. In the long run, earnings growth will be limited by several factors, including, but not limited to, competition and market saturation. In addition to the texts cited in my direct testimony in support of the premise that GDP is a long-term cap on growth, I would like to refer Mr. Cochrane to the following excerpts. First, as detailed in the Chartered Financial Analyst ("CFA") Institute's curriculum:

> For earnings growth to exceed GDP growth, the ratio of corporate profits to GDP must trend upward over time. It should be clear that the share of profits in GDP cannot rise forever. At some point, stagnant labor income would make workers unwilling to work and would also undermine demand, making further profit growth unsustainable. *Thus, in the long run, real earnings growth cannot exceed the growth rate of potential GDP.*[6] (emphasis added)

Additionally, Dr. Roger A. Morin details in his book, *New Regulatory Finance*, as follows:

> It is useful to remember that eventually all company growth rates, especially utility services growth rates, converge to a level consistent with the growth rate of the aggregate economy.
>
> * * *
>
> […] it is quite possible that a company's dividends can grow faster than the general economy for five years*, but it is quite implausible for such growth to continue into perpetuity.*[7] (emphasis added)

Thus, my use of projected GDP growth as an upper limit for company or industry growth is wholly defensible.

Q. Please summarize Mr. Cochrane's criticisms of your CAPM analysis.

[6] CFA Program Curriculum, 2014 Level II Vol.1, "Ethical and Professional Standards, Quantitative Methods, and Economics" Reading 15 – Economic Growth and the Investment Decision, pages 608-609.
[7] Roger A. Morin, New Regulatory Finance, pages 308-309.

A. Mr. Cochrane has several concerns with my CAPM analysis. First, he criticizes my use of historical Beta values in six of my nine CAPM calculations. He argues that using a 0.75 historical Beta instead of the current 0.85 Beta for my proxy group results in unreliable outcomes. He claims that the six results using the historical Beta should be ignored because they don't reflect the current market situation.

Second, Mr. Cochrane points out that my CAPM results based on the Kroll market risk premium are too low, with some results as low as 8.76% and 8.77%, which are below any authorized gas utility ROE in the past 45 years. He argues that these results are outliers and should be disregarded as they fall below the returns calculated in my other CAPM models.

Third, he takes issue with my market risk premium calculation, claiming I mixed historical market returns with a current projected Treasury rate, which he believes is an inconsistent methodology. He argues that this mismatch of historical data with forward-looking rates undermines the validity of my risk premium-derived market returns.

Lastly, Mr. Cochrane asserts that one of my nine CAPM cases, which uses a projected 4.20% 30-year Treasury bond rate, a current Beta of 0.85, and an expected market return of 12.09%, yields a more reasonable ROE of 11.03%. He believes this result is more aligned with current market conditions, while the other eight CAPM results should be ignored

Q. Please respond.

A. As an initial matter, Mr. Cochrane is factually incorrect in his assertion that results as low as 8.76% and 8.77% are below any authorized gas utility ROE in the past 45 years. This is discussed above and presented in my Exhibit CCW-1SR.

Mr. Cochrane's concern with my use of Beta estimates other than the five-year Beta estimates provided by *Value Line* overlooks an important factor: Betas based on the most recent

five years of stock prices and volatility do not necessarily reflect current investor expectations. The COVID-19 pandemic, for example, had a significant impact on market volatility in early 2020, with the S&P 500 falling over 40%. This extreme market reaction has distorted the current Beta values, causing them to be abnormally high. Betas derived from such a short, tumultuous period may not be representative of the true, long-term systematic risk facing the proxy companies. For this reason, I used a long-term average Beta of 0.75 in several of my CAPM models, which smooths out short-term volatility and better reflects the true, long-term risks that investors consider when determining the cost of equity. This approach aligns with standard practices in financial analysis, where longer historical data is often favored for Beta calculations to avoid the distortions caused by short-term market anomalies. Therefore, while Mr. Cochrane prefers to use the 0.85 Beta derived from a five-year period, I believe that relying solely on this figure ignores the broader market context and results in an inflated estimate of the cost of equity.

In addition, in my rebuttal testimony, I provided evidence in Table CCW-3R demonstrating that investor's perception of risk for utility stocks as measured by Beta has subsided significantly when looking at the most recent three years of prices and volatility. As I explained in that testimony, all beta estimates calculated over a 5-year historical price period (i.e. *Value Line* betas) will include the unprecedented volatility and market prices caused by the onset of the COVID-19 pandemic in early 2020. It is unreasonable to assume that those prices and resulting volatility resemble investor expectations going forward. Prior to the market fallout from the pandemic, utility beta estimates were at several year lows. Subsequent to the period of peak volatility from the pandemic, utility betas have actually declined back toward their normalized levels.

Q. Please respond to Mr. Cochrane's criticisms of your expected market return based on the real historical market return.

A. The use of historical data is perfectly acceptable in market risk premium estimation. For example, Dr. Morin states in his book, *New Regulatory Finance*:

> "Although realized returns for a particular time period can deviate substantially from what was expected, it is reasonable to believe that long-run average realized returns provide an unbiased estimate of what were expected returns. This is the fundamental rationale behind the historical risk premium approach. Analysts and regulators often assume that the average historical risk premium over long periods is the best proxy for the future risk premium.
>
> * * *
>
> From a statistical viewpoint, to the extent that the historical equity risk premium estimated follows what is known in statistics as a random walk, one should expect the equity risk premium to remain at its historical mean. The best estimate of the future risk premium is the historical mean. Since, as discussed in Chapter 4, there is little evidence that the MRP has changed over time, it is reasonable to assume that these quantities will remain stable in the future.
>
> * * *
>
> There are two broad approaches to estimating the risk premium: retrospective and prospective. Each has its own strengths and weaknesses, hence the need to utilize both methods.
>
> * * *
>
> Therefore, a regulatory body should rely on the results of both historical and prospective studies in arriving at an appropriate risk premium, data permitting. Each proxy for the expected risk premium brings information to the judgment process from a different light.
>
> * * *
>
> Faced with this myriad, and often conflicting, evidence on the magnitude of the risk premium, a regulator might very well be confused about the correct market risk premium. The author's opinion is that a range of 5%

> to 8% is reasonable for the United States with a slight preference for the upper end of the range."[8]

As described above, my inclusion of a historical component in estimating the market risk premium is perfectly acceptable.

Q. Mr. Cochrane's testimony seems to suggest that your use of historical betas was intentionally used to lower the results of your CAPM analysis. Is this an accurate characterization of what the intent was behind your choice to include historical average betas dating back to 2014?

A. Absolutely not. Prior to the onset of a global pandemic in early 2020, utility Beta estimates were at historically low levels. During the 2018 to early 2020 period I included the same historical betas as part of my CAPM analysis even though they were, not surprisingly, higher than current betas. For example, below is an excerpt from my direct testimony filed in a previous Ameren Missouri rate case.

> Q: What beta did you use in your analysis?
> A: As shown in Schedule CCW-16, the proxy group average and median Value Line beta estimates are 0.57 and 0.55, respectively. In my experience, a beta of this level is relatively low compared to previous years. Given the sudden drop in beta estimates over the last year or so, I have also calculated the average beta measured since 2014. The historical average Value Line beta since then is 0.68 and has ranged from 0.58 to 0.75.[9]

Mr. Cochrane's assertion that I incorporated long-term betas simply because they produce a lower result is out of touch with reality and should be rejected in its entirety.

Q. Does this conclude your surrebuttal testimony?

A. Yes, it does.

[8] See Roger A. Morin, *New Regulatory Finance*, Pub. Util. Reports, Inc. (2006) at pages 156-157 and pages 162-163. (emphasis added)
[9] Missouri Public Service Commission, Case No. ER-2019-0335, Direct testimony of Christopher C. Walters, CFA at 44, December 4, 2019.

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of the Request of Liberty Utilities (Midstates Natural Gas) Corp. d/b/a Liberty to Implement a General Rate Increase for Natural Gas Service in the Missouri Service Areas of the Company	))))	Case No. GR-2024-0106

AFFIDAVIT OF CHRISTOPHER C. WALTERS

STATE OF MISSOURI)
) ss.
COUNTY OF ST. LOUIS)

COMES NOW CHRISTOPHER C. WALTERS and on his oath declares that he is of sound mind and lawful age; that he contributed to the foregoing *Surrebuttal Testimony of Christopher C. Walters*; and that the same is true and correct according to his best knowledge and belief.

Further the Affiant sayeth not.

CHRISTOPHER C. WALTERS

JURAT

Subscribed and sworn before me, a duly constituted and authorized Notary Public, in and for St. Louis County, State of Missouri, at my office in Chesterfield, Missouri, on this 16th day of September 2024.

MARIA E. DECKER
Notary Public - Notary Seal
STATE OF MISSOURI
St. Louis City
My Commission Expires: May 5, 2025
Commission # 13706793

Notary Public