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Rate of Return
Burdette/Rebuttal
Public Counsel
GR-2001-292

REBUTTAL TESTIMONY
OF

MARK BURDETTE

FILED

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Missouri Public
Service Commission

Submitted on Behalf of
the Office of the Public Counsel

MISSOURI GAS ENERGY

Case No. GR-2001-292

May 22, 2001

**BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI**

In the Matter of Missouri Gas Energy's)
Tariff filing for General Rate Increase.) Case No. GR-2001-292

AFFIDAVIT OF MARK BURDETTE


[illegible]

Mark Burdette, of lawful age and being first duly sworn, deposes and states:

1. My name is Mark Burdette. I am a Financial Analyst for the Office of the Public Counsel.
2. Attached hereto and made a part hereof for all purposes is my direct testimony consisting of pages 1 through 13.
3. I hereby swear and affirm that my statements contained in the attached testimony are true and correct to the best of my knowledge and belief.


Mark Burdette

Subscribed and sworn to me this 22nd day of May 2001.


Bonnie S. Howard
Notary Public

My commission expires May 3, 2005.



1 **REBUTTAL TESTIMONY**

2 **OF**

3 **MARK BURDETTE**

4
5 **MISSOURI GAS ENERGY**

6 **A DIVISION OF SOUTHERN UNION COMPANY**

7 **CASE NO. GR-2001-292**

8
9
10 **INTRODUCTION**

11 Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

12 A. Mark Burdette, P.O. Box 7800, Jefferson City, Missouri 65102-7800.

13 Q. ARE YOU THE SAME MARK BURDETTE WHO FILED DIRECT TESTIMONY IN
14 THIS PROCEEDING?

15 A. Yes, I am.

16 Q. WHAT IS THE PURPOSE OF THIS TESTIMONY?

17 A. I will respond to the direct testimony of Staff witness David Murray and Missouri Gas
18 Energy witness John C. Dunn.

19 Q. HAVE ANY OF THE PARTIES REACHED AGREEMENT ON ANY COST OF CAPITAL
20 ISSUES IN THIS PROCEEDING?

21 A. Yes. The Staff and The Office of the Public Counsel have agreed on several issues related
22 to cost of capital.

23 1) Debt: for the purposes of True-up in this case, Public Counsel will adopt Staff's
24 calculations of the level and embedded costs of both long term debt and short term debt.

25 2) Preferred stock: it is my understanding that Staff has adopted Public Counsel's

1 position on the calculation of the embedded cost of preferred stock to use in this
2 proceeding. I believe Staff and Public Counsel will also agree on the level of preferred
3 stock to include in the capital structure.

4 Q. WHAT ARE YOUR COMMENTS CONCERNING MR. DUNN'S DIRECT TESTIMONY?

5 A. I will comment primarily on three areas: current market conditions and interest rates; capital
6 structure; and return on common equity.

7 Q. WHAT ARE YOUR COMMENTS REGARDING MR. DUNN'S CHARACTERIZATION
8 OF THE FINANCIAL MARKETS AND INTEREST RATES?

9 A. Mr. Dunn mentions several times that the technology sector of the market is riding high,
10 reducing the attractiveness of utility stocks. He also comments multiple times that current
11 interest rates are high, leading to higher capital costs. The following statements are taken
12 from Dunn-Direct.

13 Simply put, investors have lost interest in the old economy because the
14 risk-reward profile of the new economy is much better. [Page 3, lines 5-6]

15
16 This has caused the Federal Reserve to raise interest rates six times since
17 June 1999 and more increases are possible. These changes in interest rates
18 have a powerful impact on utilities because utilities are capital intensive.
19 These interest rate changes have caused the cost for all other forms of
20 capital, including equity capital, to also increase. [Page 3, lines 10-14]

21
22 It should be noted that the current market and the underlying technological
23 drivers has caused investors to migrate away from traditional lower-risk
24 investments to new economy alternatives which investors perceive to offer
25 much greater returns for a modest increase in risk. [Page 8, lines 17-20]

26
27 I would note that the preceding assertion by Mr. Dunn, that the technology sector offers
28 "much greater returns" for a "modest" increase in risk relies on a violation of the basic
29 tenant of finance that is the risk-reward tradeoff. The market prices securities and
30 investments based on the risk of that investment and the returns of other investments of
31 similar risk. Any investment opportunity offering even the perception of a return over and

1 above the risk-appropriate return would be a fleeting opportunity, as investors quickly
2 scrambled to take advantage.

3 Both of these assertions (higher interest rates and the attractive technology sector),
4 according to Mr. Dunn, point to a relatively higher cost of equity for MGE. However,
5 neither of these assertions are true for the markets at this time.

6 Q. HOW HAVE THE FINANCIAL MARKETS CHANGED FOR THE TECHNOLOGY
7 SECTOR SINCE MR. DUNN FILED HIS DIRECT TESTIMONY?

8 A. The once high-flying technology sector, especially Internet-related stocks, have come
9 tumbling back to earth. The following quotes are from the Wall Street Journal Year-End
10 Review, January 2, 2001.

11 The pundits will be debating for years about the big winners and losers in
12 the presidential election, but there can be no debate about the big stock-
13 market loser in 2000: It was technology stocks.

14
15 Perhaps the biggest question for the coming year is whether the tide will
16 turn again in 2001, with the big loser (tech stocks) once again becoming the
17 big winner, or whether the tech wreck will continue.

18
19 The NASDAQ Composite Index plunged 39.3% to 2470.52, the worst year
20 since it was created in 1971, giving back almost all of 1999's record 86%
21 rocket ride. Its peak-to-trough 54% plunge represented a loss of \$3.3
22 trillion in paper wealth, equivalent (in dollars if not in effect) to one-third
23 of the houses in America sliding into the ocean.

24 But the Dow Jones Industrial Average fell only 6.2% to 10786.85
25 for the year. Though that broke a nine-year winning streak and represented
26 its worst calendar year since 1981, the Dow's peak-to-trough decline of just
27 16% was less than that of 1990, failing to meet the 20% bear market rule of
28 thumb.

29
30 The WSJ's Year-End review also provides information pertinent to Mr. Dunn's assertion
31 that investors are turning away from utility stocks.

32 The top-performing stocks, meanwhile, included some that had been given
33 up for dead in the previous year, **notably utilities** and health-care stocks,
34 including hospital companies, drug distributors, medical-device makers and
35 drug companies. Home builders took off in the booming economy. **But**
36 **technology and communications stocks, once thought likely to rise for**

1 **years to come, brought up the rear.** [Wall Street Journal Year-End
2 Review, January 2, 2001] [Emphasis added]
3

4 The slide in the technology sector continued in 2001. According to the Wall Street
5 Journal's Stock Market Quarterly Review, April 2, 2001:

6 The index ended the just-completed quarter down 25.5%, or 630 points, its
7 worst point slide for a first quarter. But the dismal performance was
8 slightly better than the fourth quarter's plunge last year of 1,202 points -- a
9 record 32.7%.
10

11 The technology sector *was* "high-flying" not because it was able to sustain a violation of the
12 risk-return tradeoff, but rather because the high returns were appealing and helped steer
13 attention away from the accompanying high risk. However, the reality of the risk of the
14 technology sector can no longer be overshadowed by the high returns.

15 Q. HOW HAVE INTEREST RATES CHANGED SINCE MR. DUNN FILED HIS DIRECT
16 TESTIMONY IN NOVEMBER, 2000?

17 A. Yes, they have gone down significantly. The Federal Reserve has cut interest rates a total
18 of five times since January, 2001. The Federal Funds rate is currently at 4.0%, down from
19 6.5% in November, 2000 when Mr. Dunn filed his direct testimony. The Discount rate is
20 currently 3.5%, down from 6.0% in November, 2000.

21 I agree with Mr. Dunn that actions by the Federal Reserve, and certainly the interest
22 rates set by that body, have impacts on the cost of capital for companies. Obviously the
23 cost of capital, as reflected by the interest rates set by the Federal Reserve, have dropped
24 **dramatically** since Mr. Dunn filed his direct testimony.

25 Recommendations for return on equity must be appropriate for the then current
26 market conditions, and, to any extent possible, take into consideration expectations for the
27 future. Mr. Dunn's recommended ROE for MGE in this proceeding is not reflective of the
28 current financial conditions facing the company.

1 Q. WHAT DOES THE DRAMATIC DROP IN INTEREST RATES MEAN FOR MR.
2 DUNN'S ROE RECOMMENDATION?

3 A. The cost of equity recommendation for MGE which Mr. Dunn calculated in November is
4 no longer valid nor applicable in this proceeding. The Federal Funds rate has dropped to
5 4.0% from 6.5%, a decrease of more than 38%. The discount rate has dropped to 3.5%
6 from 6.0%, a decrease of more than 41%.

7 Q. WHAT ARE YOUR COMMENTS REGARDING MR. DUNN'S PROPOSED CAPITAL
8 STRUCTURE?

9 A. Mr. Dunn proposes to use a hypothetical capital structure for MGE for ratemaking purposes
10 consisting of 50% common equity and 50% long term debt. However, his hypothetical
11 capital structure is wholly unrelated to how MGE's utility assets are actually financed. Mr.
12 Dunn proposes a phantom capital structure that contains 50% common equity, far above the
13 actual level of common equity of approximately 33% (Burdette-Direct, Schedule MB-1).
14 He also completely ignores Southern Union's \$100 million of Trust Originated Preferred
15 Securities (loosely referred to as Preferred Stock for these proceedings). Given that
16 common equity is the most expensive form of financing, the use of a hypothetical capital
17 structure containing an inflated level of common equity would serve no other purpose but to
18 inappropriately increase the overall cost of capital, resulting in artificially inflated rates.

19 Q. WHAT IS MR. DUNN'S BASIS FOR PROPOSING A HYPOTHETICAL CAPITAL
20 STRUCTURE?

21 A. Mr. Dunn asserts that MGE's rates should be based on a capital structure with a 50% equity
22 ratio because other gas distribution companies he analyzed maintain approximately 50%
23 equity ratios.

24 MGE should have capital ratios similar to its industry subset. [Dunn-Direct,
25 page 16, lines 11-12]
26

1 Q. WHO DETERMINES THE ACTUAL CAPITAL STRUCTURE FOR SOUTHERN UNION
2 COMPANY?

3 A. Southern Union's management determines the Company's capital structure, and that
4 management has created an actual capital structure that contains approximately 33%
5 common equity. It is a violation of just and reasonable rates for MGE's customers to pay
6 rates based on a more expensive, nonexistent capital structure.

7 Q. WHAT ARE YOUR COMMENTS REGARDING MR. DUNN'S ASSERTION THAT MGE
8 SHOULD HAVE A COMMON EQUITY RATIO OF 50%?

9 A. I suggest Mr. Dunn inform Southern Union's management of his findings so that they can
10 properly align their Company's capital structure with the industry in which it primarily
11 operates.

12 It is not the responsibility of Missouri's ratepayers to make up any perceived
13 financial shortfall resulting from management decisions. Southern Union Company is
14 primarily involved with the distribution of natural gas to consumers and the Company's
15 management has sole discretion to decide how to finance those operations. Southern Union
16 shareholders, and not Missouri's ratepayers, bear the responsibility for those choices.

17 Q. WHAT ARE YOUR COMMENTS REGARDING MR. DUNN'S RECOMMENDED COST
18 OF COMMON EQUITY?

19 A. Mr. Dunn's recommendation is based on an analysis of eleven companies he characterizes
20 as comparable to MGE. He also makes several inappropriate upward adjustments to his
21 calculated cost of common equity.

22 Q. ARE MR. DUNN'S COMPARABLE COMPANIES ACTUALLY COMPARABLE TO
23 MGE?

24 A. No, not all of them. Mr. Dunn chose eleven companies to use for his analysis, six of which
25 I also used in my analysis. I will list all eleven companies and comment on each.

26 These six companies are common to Mr. Dunn's and my analysis:

1. AGL Resources, Inc.
2. Cascade Natural Gas Corp.
3. Northwest Natural Gas
4. Piedmont Natural Gas
5. South Jersey Industries.
6. WGL Holdings / Washington Gas Light.

Mr. Dunn used Washington Gas Light, which was reorganized and is now named WGL Holdings, Inc. I used WGL Holdings in my analysis.

Mr. Dunn's additional five companies are either not comparable to MGE or should not be used in this proceeding:

1. Atmos Energy Corp.:
2. Laclede Gas Company:

Atmos and Laclede have operations under the jurisdiction of the Missouri Public Service Commission, and both should appropriately be excluded from the analysis due to circularity.

3. Energen Corp.

According to C.A. Turner Utility Reports, Energen Corp. receives only 66% of its revenues from the distribution of natural gas. Therefore, Energen's business risk is simply not comparable to a natural gas distribution company such as MGE.

4. New Jersey Resources

According to C.A. Turner Utility Reports, New Jersey Resources receives only 64% of its revenues from the distribution of natural gas. Therefore, New Jersey Resources' business risk is simply not comparable to a natural gas distribution company such as MGE.

5. UGI Corp.

According to C.A. Turner Utility Reports, UGI Corp. receives only 24% of its revenues from the distribution of natural gas. Therefore, UGI Corp.'s business risk is simply not comparable to a natural gas distribution company such as MGE.

Q. WHAT ADJUSTMENTS DID MR. DUNN MAKE TO HIS COST OF COMMON EQUITY CALCULATION?

A. Mr. Dunn discusses five specific adjustments he made to his cost of common equity, each one increasing his recommendation. The first two adjustments he made concern the

1 dividend yield he used for the DCF. These adjustments flow through directly to ROE. The
2 other adjustments are all increases directly to ROE.

3 Q. WHAT WOULD BE MR. DUNN'S RECOMMENDED COST OF COMMON EQUITY
4 WITHOUT HIS ADJUSTMENTS?

5 A. Mr. Dunn's unadjusted recommendation is somewhat of a puzzle. However, I believe his
6 analysis shows an unadjusted DCF cost of common equity of approximately 10% - 11%.

7 Q. PLEASE EXPLAIN WHY YOU BELIEVE MR. DUNN'S UNADJUSTED DCF RESULT
8 IS APPROXIMATELY 10% - 11%.

9 A. The DCF model calls for a dividend yield and a sustainable growth rate. Mr. Dunn
10 calculates an unadjusted dividend yield of 5.0% and states "I concluded that the appropriate
11 dividend yield to include in my DCF calculation was 5.0%." (Dunn-Direct, page 33, line
12 24) However, only six lines later, Mr. Dunn states that an adjustment is necessary to his
13 dividend yield and proceeds to increase the average dividend yield for his *group* of
14 companies. The DCF model calls for an expected dividend yield for each company under
15 analysis. Mr. Dunn did not follow proper DCF methodology when arriving at his inflated
16 dividend yield.

17 I calculated an appropriate expected dividend yield of 5.04%. This number is quite
18 close to one of Mr. Dunn's dividend yields – the 5.0% yield he states he would use for his
19 DCF.

20 Mr. Dunn's apparent growth rate recommendation is similarly puzzling. On page
21 25 of his Direct testimony, Mr. Dunn shows various historical growth rates for his group of
22 companies. The average is 3.50%. On page 30 he states "I believe a reasonable investor
23 growth expectation for a smaller natural gas distribution company such as MGE is at least
24 6%. This is lower than the industry forecast rate by Value Line." Mr. Dunn then comments
25 on what growth rates he may find in a year from now, but he never actually specifies the

1 growth rate he is choosing for MGE for this proceeding. However, on page 35 Mr. Dunn
2 states "The calculated dividend yield is in the range of 5.0%" and "My analysis of
3 minimum growth indicates a growth rate in the range of 6.0% to as much as 7.0%." These
4 numbers would seem to indicate a result of 11% - 12%.

5 Q. WHAT DOES MR. DUNN'S GROWTH RATE ANALYSIS SHOW?

6 A. Mr. Dunn's growth rate analysis shows that his apparent recommended growth rate is
7 wholly unsupported by evidence. Following is a list of the average growth rates calculated
8 by Mr. Dunn:

9	Average historical growth:	3.50%	Schedule JCD-4
10	Average dividend growth:	2.38%	Schedule JCD-5
11	Average earnings growth:	9.81%	Schedule JCD-6
12	Average book value growth:	3.92%	Schedule JCD-7

13 The average earnings growth of 9.81% includes statistically outlying data such as the
14 23.65% growth rate for UGI Corp (see Schedule JCD-6). Excluding that single variable
15 lowers his average to 8.27%. Mr. Dunn appropriately excludes negative growth rates,
16 which would lower his average, yet he includes high growth rates that are obviously
17 statistical anomalies and are not sustainable in the long term. And a sustainable growth rate
18 is what is called for in the DCF. Excluding the other obviously unsustainable growth rates
19 of 14.23% for Cascade, 14.04% for New Jersey Resources, and 12.86% for Northwest
20 Natural Gas brings Mr. Dunn's average down to 5.55%.

21 Q. DO MR. DUNN'S GROWTH RATE CALCULATIONS MAKE INTUITIVE SENSE?

22 A. No, they do not. A good example is his calculations of growth in earnings per share, as
23 shown on Schedule JCD-6. In 1990, Cascade Natural Gas Corp. had earnings of \$1.26 per
24 share. In 1999, the company had earnings per share of \$1.24 – a decrease from the 1990

1 level. Yet Mr. Dunn calculates a *14.23% growth rate* for Cascade over that period. I doubt
2 many investors would put their money on that calculation nor assume a similar growth rate
3 would continue into the future.

4 Q. PLEASE DISCUSS MR. DUNN'S ADJUSTMENTS.

5 A. The first adjustment made by Mr. Dunn is to increase his average dividend yield from 5.0%
6 to 5.1% (Dunn-Direct, page 33, line 28). The Discounted Cash Flow model calls for the
7 calculation of an expected dividend yield, which is calculated by dividing the next expected
8 annualized dividend by the current stock price. The expected dividend yield calculation is
9 specific to each company when market data are available. However, Mr. Dunn calculates
10 an average spot dividend -- based on current rather than expected dividends. He then
11 increases his calculated average for all eleven companies by a single growth component,
12 rather than making his calculations company-specific. This is not the proper methodology
13 to use for the DCF because it ignores company-specific data.

14 2.) The second adjustment made by Mr. Dunn increases his dividend from 5.1% to
15 5.4% to account for flotation costs (Dunn-Direct, page 35, line 3). Flotation costs are the
16 costs associated with issuing new common equity, and they are properly considered when
17 new equity is issued. Even then, I believe the consideration of the recovery of flotation
18 costs should be a dollar-for-dollar basis and not a component of the market-driven cost of
19 common equity *rate*. However, Southern Union Company does not have a new equity issue
20 that warrants the consideration of flotation costs. As Mr. Dunn states, his upward
21 adjustment is in *anticipation* of new equity issues that *may* occur in the future (Dunn-
22 Direct, page 35, lines 10-14). Increasing the cost of common equity for MGE to account
23 for nonexistence equity flotation costs does nothing but increase rates for Missouri's
24 ratepayers.

1 3.) The third adjustment made by Mr. Dunn is to increase his recommended cost of
2 common equity in consideration of his general assertion that equity costs will increase in
3 the future (Dunn-Direct, page 36, line 11). Given the dramatic changes in the market and
4 interest rates just since the beginning of 2001, Mr. Dunn's assertion is questionable.

5 It is reasonable to anticipate that the cost of equity will be increasing from
6 its current lower levels to higher levels during the period these rates will be
7 in effect. This leads me to believe that a higher return than that indicated
8 by the raw DCF calculation is appropriate because the probability of a
9 worsening of equity market conditions increases each day. [Dunn-Direct,
10 page 36, lines 15-19]
11

12 Mr. Dunn uses this reasoning to increase his growth rate by a full percentage point. On
13 page 30, line 6 of Dunn-Direct, he comments that MGE's growth rate is at least 6%. On
14 page 36, his recommendation now has an upper bound based on a 7% growth rate. The
15 extent of his support for this calculation is to say "A higher level of return is also
16 indicated." [Dunn-Direct, page 36, line 3] The upward adjustment Mr. Dunn makes in this
17 portion of his testimony is simply unsupported by evidence or analysis.

18 Mr. Dunn's previous comments on the state of the technology sector of the market
19 and on the potential for increasing interest rates certainly did not come to pass. Similarly,
20 his assertion about the future of the equity market is merely speculation – and speculation
21 that has already been proven fallible during the first part of 2001. The MPSC should
22 dismiss such unsupported, qualitative rhetoric.

23 4.) Mr. Dunn then enters a discussion of risk, culminating in an upward adjustment
24 to his ROE recommendation. He begins the discussion with consideration of MGE's size.
25 The upward adjustment to ROE in consideration of size for regulated utilities remains an
26 undecided issue in financial literature. Also, an important point to remember is that MGE is
27 not a small, standalone company. It does not have publicly traded stock on which potential

1 market factors relating to small size can have influence. MGE is represented in the market
2 by the common equity of Southern Union Company.

3 Mr. Dunn then discusses elements of MGE's business risk (beginning on page 39,
4 line 9, through page 40, line 18). It should be pointed out that the risks Mr. Dunn discusses
5 are general business risks faced by the natural gas distribution industry, and not just MGE.
6 Certainly all gas distributors face fundamental variability of earnings and all invest in assets
7 with long lives.

8 The overall result of Mr. Dunn's qualitative discussion is that he raises his
9 calculated ROE range yet again, to 11.5% - 12.5%, and then recommends MGE receive the
10 upper bound of that range, or 12.5%. His final comment in that section of testimony is that
11 an even higher return might be appropriate as economic events unfold. What Mr. Dunn
12 fails to consider or mention is that a much lower return could also be appropriate as
13 economic events unfold, which, as I've shown, is exactly the situation that exists. He
14 recommends 12.5% at a time that the Federal Funds Rate and the Discount Rate were both
15 2.5% higher than they are now, and at a time that he considered the high-flying technology
16 sector to be reason to increase the ROE for MGE.

17 5.) The final adjustment made by Mr. Dunn is to increase his recommended overall
18 rate of return by an additional 25 basis points (0.25%) based on MGE's customer service.

19 As Mr. Dunn states:

20 In MGE's 1996 rate proceeding before the Missouri Public Service
21 Commission, in GR-96-285, the Commission found that MGE was
22 deficient in customer service. As a consequence, the Commission made a
23 penalty adjustment reducing the rate of return (to the low end of Staff's
24 return on equity range) to penalize the company for what the Commission
25 determined to be poor service. [Dunn-Direct, page 43, lines 1-5]
26

27 What Mr. Dunn fails to consider is that a regulated public utility has an *obligation to serve*
28 *their customers* in exchange for the opportunity to earn a fair return on the assets employed

1 to provide that service. The company is **supposed** to provide decent customer service as
2 part of their normal manner of doing business – the MPSC has made that clear. That MGE
3 has allegedly improved their level of customer service to an acceptable level is not reason
4 for a bonus return. That would be analogous to a new employee asking for a bonus for
5 showing up to work on time.

6 Q. WHY IS IT UNREASONABLE FOR MGE TO EXPECT A BONUS RETURN FOR
7 PROVIDING REASONABLE AND ACCEPTABLE LEVELS OF CUSTOMER SERVICE?

8 A. It is unreasonable to expect a bonus return because MGE has an obligation to provide
9 reasonable customer service as part of their obligation to serve.

10 It would be bad precedent for the MPSC to provide bonus returns to regulated
11 utilities for simply rising to a level of service the company should have been at in the first
12 place.

13 Q. IS MGE PROPOSING AN INCREASE TO THE FIXED CUSTOMER CHARGE AS PART
14 OF THIS PROCEEDING?

15 A. Yes. MGE proposed an increase in the fixed-customer charge in their direct testimony.
16 However, that issue has been included in a partial settlement agreement.

17 Q. WHAT EFFECT ON MGE WOULD AN INCREASED CUSTOMER CHARGE HAVE?

18 A. MGE would face lower fundamental business risk due to a decrease in the variability of
19 earnings. If MGE is able to permanently reduce the variability of earnings, then MGE faces
20 lower risk.

21 Q. DO YOU HAVE ADDITIONAL COMMENTS REGARDING THIS ISSUE?

22 A. No. I do reserve the right to comment on this issue in the future, if necessary.

23 Q. DOES THIS CONCLUDE YOUR TESTIMONY?

24 A. Yes.