Exhibit No.: _____
Issue: ROE
Witness: James M. Anderson
Exhibit Type: Rebuttal
Sponsoring Party: Summit Natural Gas of Missouri, Inc.
Case No.: GR-2014-0086
Date: July 11, 2014

MISSOURI PUBLIC SERVICE COMMISSION

CASE NO. GR-2014-0086

REBUTTAL TESTIMONY

OF

JAMES M. ANDERSON

ON BEHALF OF

SUMMIT NATURAL GAS OF MISSOURI, INC.

Jefferson City, Missouri
July 2014

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REBUTTAL TESTIMONY

JAMES M. ANDERSON

SUMMIT NATURAL GAS OF MISSOURI, INC.

I. INTRODUCTION

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is James M. Anderson. My business address is 8400 E. Prentice Ave, Suite 500, Greenwood Village, CO 80111.

Q. HAVE YOU PREVIOUSLY SUBMITTED TESTIMONY AND SCHEDULES IN THIS CASE?

A. Yes. I submitted Direct Testimony and Schedules in this case on behalf of Summit Natural Gas of Missouri, Inc. ("SNG" or "Company") as part of the Company's original filing on January 2, 2014.

Q. ARE YOU SPONSORING ANY SCHEDULES IN SUPPORT OF YOUR REBUTTAL TESTIMONY?

A. No.

II. PURPOSE OF TESTIMONY

Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

A. The purpose of my rebuttal testimony is to respond to several issues raised by Staff Cost-of-Capital Witness Mr. David Murray in the Staff Report – Revenue Requirement Cost of Service, filed in Case No. GR-2014-0086 on May 30, 2014 (the “Staff Report”), section V. Rate of Return, on pages 6 through 37.

Q. PLEASE SUMMARIZE YOUR REBUTTAL TESTIMONY.

A. Specifically, I will respond to the following topics:

1) The calculation of a risk premium to be added to Company’s Return on Equity (“ROE”).

2) The use of the “Total Return” model to calculate the cost of common equity.

3) The ability of SNG to attract capital and maintain its financial integrity.

4) The selection of the “risk-free” interest rates on U.S. government debt.

5) The cost of common equity for publicly traded utilities over the past several years.

6) The relationship of IIF, Summit Utilities, Inc. and SNG.

7) The Staff’s assumed capital structure.

III. ADJUSTMENT TO THE COMPANY’S ROE FOR RISK

Q. WHAT IS THE UNADJUSTED ROE THAT STAFF AND YOU RECOMMENDED FOR SNG?

A. Staff’s unadjusted ROE was estimated at 7.8% to 8.8%; see page 36, lines 17 and 18 of the Staff Report. My unadjusted ROE was 10.6%; see table 1 on page 43 of my direct testimony.

Q. WHY DID THE STAFF’S UNADJUSTED ROE VARY FROM YOUR UNAJUSTED ROE?

A. The largest portion of the variance was caused by the use of the Total Return model in addition to the discount cash flow (DCF) model and capital asset pricing model (CAPM) in my calculations. Staff only used the DCF and CAPM models. Without the Total Return model, my unadjusted ROE would have been 9.65%. The other primary difference is due to the risk-free interest rate for U. S. government debt, which can vary significantly by the date selected by the person performing the calculation. Both the Total Return model and the selection of the interest rate on the U.S. government debt are discussed further below.

Q. DID STAFF ADJUST ITS ROE BY A RISK PREMIUM?

A. Yes, Staff adjusted its ROE by a 2% risk premium, see page 36, line16.

Q. WHAT WAS STAFF'S ADJUSTED ROE?

A. Staff's adjusted ROE with the risk premium for SNG was 9.8% to 10.8%.

Q. DID STAFF GIVE A REASON TO MAKE A RISK PREMIUM ADJUSTMENT?

A. Yes, the Staff said that "it is important to compare the subject company's risk level to that of the proxy group" (see page 35, lines 4 and 5 of the Staff Report).

Q. HOW DID THE STAFF MAKE ITS COMPARISON OF SNG TO THE PROXY GROUP?

A. Staff estimated that SNG would have a 'BB' credit rating based on: 1) the Staff's understanding of the S&P and Moody's processes and procedures (without any specific reference to these processes and procedures), and 2) the interest rate currently being paid by Colorado Natural Gas, Inc. (also a wholly-owned subsidiary of SNG's parent corporation, Summit Utilities, Inc.). Staff then compared the interest rates for BBB rated utility bonds and BB utility bonds. No reference or source was given for the rates used for the comparison or the dates that these rates occurred. Staff goes on to say that 'A' rated utility bonds have a spread of approximately 200 basis points lower than BB rated utility bonds, without providing a specific rate for 'A' rated bonds or a reference. Staff suggests that the 200 basis points difference between Colorado Natural Gas's interest rate and the 'A' rate utility bonds would be an appropriate risk premium adjustment for SNG. This is described in the Staff Report on page 35, lines 21 to 31 and page 36, lines 1 to 19.

Q. DID STAFF ANALYZE AND COMPARE THE CIRCUMSTANCES THAT MIGHT JUSTIFY DRAWING A PARALLEL BETWEEN THE COST OF DEBT OF SNG AND CNG?

A. No. The Staff Report contains no analysis that would justify relying on the interest rate being paid by CNG as an appropriate cost of debt for SNG.

Q. IS THE CURRENT INTEREST RATE THAT COLORADO NATURAL GAS PAYS A FAIR INDICATOR OF SNG'S CREDIT RATING?

A. No, because: 1) the interest rate was set over two years ago, 2) Colorado Natural Gas (CNG) has proportionately higher earnings before interest, taxes, depreciation and amortization than SNG, 3) CNG has 40% less debt than SNG, 4) CNG has 16% more customers than SNG, and 5) CNG's interest rate is a variable rate that has been fixed by a swap contract. Because CNG's net interest rate is a function of a swap contract, CNG bears the risk that the contra-party to the swap contract may default if interest rates raise. By taking this additional risk, CNG's contractual fixed interest rate is lower than it may have otherwise been had the lender taken the risk of higher interest rates by offering CNG a fixed rate rather than the variable rate. Staff made no analysis of the risks encountered by CNG compared to the risks faced by SNG, nor did Staff provide any evidence comparing, CNG's credit rating to SNG's credit rating.

Q. YOU MENTIONED PREVIOUSLY THAT IN THE STAFF REPORT, STAFF REFERRED TO ITS UNDERSTANDING OF THE CREDIT RATING AGENCY'S PROCESSES AND PROCEDURES FOR ASSIGNING CREDIT RATINGS, WHAT ANALYSIS OR CALCULATION OF CREDIT RATINGS DID THE STAFF PERFORM USING THE RATING AGENCY'S PROCESSES AND PROCEDURES?

A. Staff did not provide an analysis or calculation of SNG's credit rating using the credit rating agency's processes and procedures in the Staff Report. In Moody's Investors Service's *Rating Methodology for Regulated Electric and Gas Utilities of August, 2009*, Moody's provides four broad rating factors. These rating factors and the weighting for the factors are: 1) regulatory framework – 25%, 2) the ability to recover costs and earn returns – 25%, 3) diversification – 10% and 4) financial strength, liquidity and key financial metrics – 40%. By way of contrast, a number of these factors are applied to SNG in my direct testimony; see page 24, lines 18 to 20, page 25, lines 1 to 21 and page 32, lines 6 to 11.

Q. WHAT IS YOUR EXPERIENCE IN OBTAINING CREDIT RATINGS FOR ISSUERS OF DEBT AND BONDS?

A. I have been an investment banker since 1971. Over the past 43 years, I have assisted municipalities, municipal utilities, investor owned utilities and other corporations in obtaining credit ratings. This assistance includes preparing presentations for the credit rating agencies, meeting with the credit rating agencies and debt issuers, and representing debt issuers in continuing credit rating reviews by the credit rating agencies. Over the past 25 years, my brokerage firm (where I am a principal and an owner) has obtained credit ratings for over 200 separate debt or bond issuers.

Q. BASED ON YOUR EXPERIENCE AND SNG'S FINANCIAL POSITION AT THE END OF THE SEPTEMBER 30, 2013, TEST YEAR, COULD SNG OBTAIN A 'BB' CREDIT RATING ON ITS DEBT?

A. No. SNG lacks the financial metrics, the service area diversification and sufficient ability to recover its costs to obtain a 'BB' credit rating. SNG's and its predecessors' returns on equity over the past six years has been either very low or negative; see Schedule JMA-1 to my direct testimony. This has resulted in a poor cash flow to interest coverage ratio and a low cash flow to debt ratio, two important sub-sets of one of Moody's broad rating factors. The lack of SNG's service area diversification is discussed in my direct testimony beginning on page 24. SNG has never been able to recover the 2010 substantial increase in its property taxes. This event negatively impacts Moody's rating factors on the ability to recover costs that has a 25% weighting on the overall credit rating. For these reasons, I believe that SNG's rating would be in the single 'B' range.

Q. WHAT IS THE CURRENT SPREAD BETWEEN THE INTEREST RATE FOR AN 'A' RATED UTILITY BOND AND A 'B' RATED BOND?

A. According to Bloomberg Finance, L.P., as of July 1, 2014, the Bloomberg Valuation average yield on an 'A' rated 30-year fixed rate utility bond is 4.25%. Bloomberg does not provide average yields for 'B' utility bonds; however, its average yield for 30-year 'B' corporate bonds is 7.54%. This is a spread of 3.29%.

Q. IF YOU USED THE STAFF'S APPROACH TO CALCULATING THE RISK PREMIUM, WHAT WOULD BE THE RISK PREMIUM?

A. Based on the current spread of 'A' rated debt to 'B' rated debt, the risk premium would be 3.30%.

Q. DID YOU ADJUST YOUR ROE BY RISK PREMIUM?

A. Yes, by a total risk premium of 5.1%.

Q. HOW DID YOU DETERMINE YOUR RISK PREMIUM?

A. In my direct testimony, I provided twelve specific additional risks that SNG encounters that other Missouri gas utilities and the utilities in my proxy group do not face. Each of those additional risks was assigned a risk premium. The total risk premium is 5.1%.

Q. DID STAFF TAKE INTO CONSIDERATION ANY OF THE SPECIFIC RISK FACTORS THAT YOU CONSIDERED?

A. It did not; however, Staff did acknowledge that construction of new gas systems (an additional risk confronted by SNG in all of its divisions) at the Lake of the Ozark is an additional risk, (see page 18, line 7 to 8 of the Staff

Report), Staff did not, however, factor this risk into its risk premium.

Q. DO YOU BELIEVE THAT IT IS APPROPRIATE TO ASSIGN A RISK PREMIUM TO SNG'S ROE?

A. Yes, as SNG's equity holders clearly bear additional risks that the common equity holders of other utilities do not. Based on the Staff Report, the Staff also believes a risk premium is justified.

IV. TOTAL RETURN MODEL

Q. WHAT IS THE TOTAL RETURN MODEL?

A. The Total Return model is the rate of return representing the actual price appreciation of a stock with cash dividends reinvested on the dividend payment date over a given period.

Q. WHY IS THE TOTAL RETURN MODEL USEFUL IN CALCULATING THE ROE?

A. The Total Return for dividend paying stocks is used by both institutions and individual investors to compare the return on their equity investments. Had an equity investor invested in the proxy group of stocks used in my direct testimony for the period from December, 2007 (the effective date of one of SNG's predecessor's last rate case) and October, 2013 (the end of SNG's test period in this case), the investor would have received a 12.5% return on its equity investment; see page 47 of my direct testimony and Schedule JMA-7. A 12.5% rate of return on an investment in SNG is the rate where the investor is indifferent to investing in SNG or the proxy group of gas utilities, provided the risk is the same.

V. ABILITY TO ATTRACT CAPITAL & MAINTAIN FINANCIAL INTEGRITY

Q. DOES THE COMMISSION ALLOWING A UTILITY A CERTAIN ROE ENABLE A UTILITY TO ATTRACT CAPITAL AND MAINTAIN ITS FINANCIAL INTEGRITY?

A. It is up to the utility to earn its allowed rate of return in order to attract capital and maintain financial integrity. The individual risks that the utility is subject to have a direct effect on its ability to earn an allowed rate of return. Even if a utility is able to earn its allowed rate of return, it may not be able to attract capital because its rate of return on equity is not sufficient, given its specific risks.

Q. HOW DOES THE RATE OF RETURN ON EQUITY RECOMMENDED BY STAFF IMPACT SNG?

A. In my opinion, Staff's recommended return on equity is not sufficient for SNG to attract additional equity capital, given its additional risks. Summit Utilities' equity holders are unlikely to invest additional equity in Missouri, which would effectively end the expansion of SNG's utility plant in Missouri. If that were the case, additional state residents will not receive the $1,000 annual fuel savings that Mr. Davis, who testified in the local public hearing in Lebanon[1], said he enjoyed after SNG built the Lebanon system. If SNG cannot attract additional capital, the economic development that is dependent on the availability of a natural gas utility could also be lost to Missouri communities, such as Bolivar and Buffalo, which will not get natural gas service because SNG lacks

1 Transcript of Proceedings, Local Public Hearing, June 17, 2014, Lebanon, MO, page 8, lines 18 to 21.

sufficient capital to expand. This result would not serve the public interest.

VI. CALCULATION OF THE RISK-FREE RATE OF RETURN

Q. WHAT IS THE RISK-FREE RATE OF RETURN AND HOW IS IT USED TO DETERMINE A UTILITY'S RETURN ON EQUITY?

A**.** The risk free rate of return is the rate of return or yield available on U.S. government 30-year bonds. It is used to calculate the cost of common equity in the CAPM model.

Q. WHAT RISK-FREE RATE OF RETURN DID STAFF USE IN THE STAFF REPORT?

A. Staff used 3.60% as of April 30, 2014 (see page 32, lines 8 to 10 of the Staff Report) for calculation of the CAPM model.

Q. WAS THIS THE APPROPRIATE RISK-RATE?

A. No. Staff elected to use a test period of the twelve months ending December 31, 2014; see page 6, lines 23 and 24 of the Staff Report, rather than the test period ending September 30, 2013 that the Company had filed. On December 31, 2013, the yield for the 30-year U.S. Treasury Bond was 3.95%[2]. Staff elected to use the rate of 3.60% from April 30, 2014, which is not consistent with the matching principle and is 35 basis points lower. This makes a material difference. By using a rate 35 basis points lower, the Staff's recommended return on equity may also be 35 basis points lower. Had Staff used the appropriate risk-free rate of 3.95%, its recommended rate of return using the CAPM model would have been 10.15% to 11.15% rather than the 9.8% to

2 The Wall Street Journal web site markets section.

10.8% reflected in the Staff Report.

VII. COST OF COMMON EQUITY FOR PUBLICLY TRADED UTILITIES

Q. WHAT CALACULATION OF THE COST OF COMMON EQUITY DID STAFF MAKE IN THE STAFF REPORT?

A. Beginning on page 12, line 21 and continuing to page 14, line 13 of the Staff Report, the Staff places a high degree of importance on the fact that the market price of publicly traded utility common stocks has risen in 2013 and in the first quarter of 2014 and that this price increase indicates that the cost of common equity has fallen.

Q. IN YOUR OPINION IS STAFF CORRECT ABOUT THE COST OF COMMON EQUITY?

A. No. Just the opposite is evident if a longer period is reviewed. At the end of the first quarter of 2014, the Dow Jones Utility Average (a measure of the equity price for a basket of utility stocks) closed at 532.13, down 25.56 points or 4.8% from its all-time high of 557.69 in January, 2008. From January, 2008 through September 30, 2013, the average earnings per share and dividend payout for the referenced group of natural gas companies used in my direct testimony have increased. This increase in earnings per share and dividends and the corresponding reduction in the Dow Jones Utility Average would suggest that the cost of common equity has actually materially increased over the past six years, as equity investors are earning higher returns per share and more dividend income at the same, or slightly lower, average market price per share.

VIII. RELATIONSHIP OF IIF, TO SUMMIT UTILITIES AND SNG

Q. IN THE STAFF REPORT, STAFF STATES THAT SUMMIT UTILITIES AND SNG ARE SUBSIDARIES OF IIF, IS THAT CORRECT?

A. No. Neither SNG nor Summit Utilities is a subsidiary of IIF. SNG and Summit Utilities file a consolidated income tax return, prepare consolidated financial statements and have consolidated audit reports as a subsidiary and parent company. Neither SNG nor Summit files a consolidated income tax return with IIF or prepares consolidated financial statements or audit reports with IIF. SNG and Summit Utilities have the same board of directors, but the SNG and Summit boards of directors are separate and composed of different members than IIF's board of directors. IIF holds equity investments in many different companies, and Summit Utilities is one of its smaller portfolio companies. IIF's interest in Summit Utilities is exactly the same as Vanguard Group Funds' $806.9 million investment in Ameren Corp. or American Century Funds' $146 million investment in Laclede Group (market values as of June 27, 2014[3]).

Q. ON PAGE 15, LINES 16 TO 18 OF THE STAFF REPORT, WITH REGARD TO IIF, STAFF STATES: "…..SUBSIDIARIES RARELY ARE FINANCED AS SEPARATE AND DISTINCT ENTITIES." AND "…..IF A SUBSIDIARY DOES PERFORM ITS OWN FINANCING FUNCTIONS, ITS CREDIT RATING IS DEPENDENT ON OR EVEN DRIVEN BY THAT OF THE PARENT COMPANY." DOES THIS HAVE ANY MEANINGFUL APPLICATION TO SNG?

3 Bloomberg Finance L.P.

A. No. Staff fails to explain how it has determined that Summit Utilities or SNG are subsidiaries of IIF or how additional financial information on IIF would help it to further evaluate SNG's and Summit Utilities' capital structure, return on equity, or the cost of debt. To the contrary, it is a common practice for the utility subsidiaries to incur long-term debt rather than the utility's parent company because the revenue producing assets securing the debt are held by the regulated utility subsidiary. The incurrence of debt by utility subsidiaries is common enough that Moody's Investors Service explains the different ways that utility holding companies and their subsidiaries obtain debt and its approach to assigning a credit rates to the utility subsidiaries of utility holding companies in *Moody's Rating Methodology Handbook, February, 2001*, pages 479 to 490. As shown in this handbook, the credit ratings of the utility subsidiaries are often higher than the holding companies' ratings. Finally, Staff offers no evidence that SNG's lenders relied on IIF's or SUI's credit in making loans to SNG.

IX. CAPTIAL STRUCTURE

Q. **WHAT IS SNG'S AND SUMMIT UTILITIES' CAPITAL STRUCTURE?**

A. On September 30, 2014, the end of the test period filed by the Company, SNG's capital structure was 43% long-term debt and 57% common equity. SNG has no outstanding preferred stock. For the same period, Summit Utilities' capital structure was 39% long-term debt and 61% common equity. Summit Utilities also has no outstanding preferred stock. On December 31, 2013, the end of the test period selected by Staff, SNG's capital structure was

42.5% long-term debt and 57.5% common equity and Summit Utilities capital structure was 37.5% long-term debt and 62.5% common equity.

Q. HOW DOES SNG'S CAPITAL STRUCTURE COMPARE TO OTHER MISSOURI UTILITIES?

A. SNG has slightly more equity than the other Missouri utilities compared in Schedule JMA-6 in my direct testimony. As a comparison, at September 30, 2013, the ending date of the Company's filed test period, Ameren's debt to equity ratio was 47.5% to 52.5%.

Q. WHAT CAPITAL STRUCTURE DOES STAFF PROPOSE TO USE IN THIS RATE CASE?

A. Staff recommended that a capital structure of 60% long-term debt and 40% common equity be used in this rate case; see page 1, lines 17 to 18 of the Staff Report.

Q. WHAT ARE STAFF'S REASONS FOR RECOMMENDING A DIFFERENT CAPITAL STRUCTURE THAN THE ACTUAL CAPITAL STRUCTURE?

A. On page 19, lines, 18 to 20 of the Staff Report, Staff said that, in a SNG application made in 2012, SNG indicated: "…..that its request was for purposes of recapitalizing the Company in order to target a capital structure of approximately 40 percent equity and 60 percent debt". On lines 22 and 23 of page 19, Staff goes on to say: "This is also likely the capital structure the Company investor, IIF, used for purposes of evaluation its investment decisions".

Q. WHAT ARE YOUR CONCERNS ABOUT STAFF'S REASONS FOR ITS RECOMMENDED CAPITAL STRUCTURE?

A**.** Staff's hypothetical capital structure is based solely on what the Company had targeted as an approximate capital structure and on what Staff believes IIF may have made its investment decision. By doing so, Staff ignores the amount of debt that lenders in the U.S. capital markets will actually lend. Since the great recession, banks and other lenders have significantly reduced the risks that they are willing to take. This has clearly had an impact on the amount of debt that SNG can obtain. Further, Staff ignores the additional risks, outlined in my direct testimony, which SNG suffers as compared to other Missouri utilities. These additional risks also impact the amount that lenders are willing to lend. Staff is attempting to impose a capital structure that no other Missouri utility employs.

Q. WHAT IS THE IMPACT OF STAFF'S RECOMMENDED CAPITAL STRUCTURE ON SNG'S EQUITY HOLDERS?

A. By using a capital structure that materially understates the actual amount of equity, the rate of return on the equity is significantly reduced. Further, the amount recovered from ratepayers for the income taxes due on income earned on the equity is also substantially reduced. When both of these factors are considered, the estimated total reduction in the return on equity is approximately 41%; that is, rather than the Staff's recommended return on equity of 10.3%, the Company's effective return on equity is only 6.37%.

Q. WHAT IS THE DEBT TO EQUITY RATIO FOR THE FOUR SNG'S

DIVISIONS INCLUDED IN THIS RATE CASE?

A. It is not possible to calculate the exact debt to equity ratio of the four divisions without allocating equity capital, debt capital, current assets, and other liabilities to each division; however, a good approximation can be made by using the combined rate base of $147,403,657 for the four divisions from the Staff's Accounting Schedule 02. On page 17, lines 12 to 18 of the Staff Report, Staff acknowledges that of the $100 million of SNG's outstanding debt, $53 million is being used to finance the system in the Lake of the Ozarks division, which is not part of this rate case. Therefore, the remaining $47 million of debt applies to the four SNG's divisions in this rate case. The Staff's combined rate base was $112,228,944 at the end of the 2013 (adjusted for certain items agreed to by SNG and the Staff). This would result in an estimated debt to equity ratio for the four SNG's divisions in this rate case, of 41.9% debt to 58.1% equity. This ratio is very close to SNG's actual 42.5% to 58.5% debt to equity ratio at December 31, 2013.

Q. WHAT DEBT TO EQUITY RATIO WOULD YOU RECOMMEND BE USED IN THIS RATE CASE?

A. I would recommend SNG's actual debt to equity ratio at the end of 2013 be used in this rate case. Staff has not provided adequate reasons to not use the actual debt to equity ratio.

Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?

A. Yes.

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Summit Natural Gas of Missouri Inc.'s Filing of Revised Tariffs To Increase its Annual Revenues For Natural Gas Service	))))	Case No. GR-2014-0086

AFFIDAVIT OF JAMES M. ANDERSON

STATE OF COLORADO)
) ss
COUNTY OF JEFFERSON)

James M. Anderson, being first duly sworn on his oath, states:

1. My name is James M. Anderson. I work in Littleton, Colorado and I am employed by Municipal Capital Markets Group, Inc. as the Senior Vice President.

2. Attached hereto and made a part of hereof for all purposes is my Rebuttal Testimony on behalf of Summit Natural Gas of Missouri, Inc. consisting of 16 pages, all of which have been prepared in written form for introduction into evidence in the above-referenced docket.

3. I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded are true and correct.

James M. Anderson
James M. Anderson

Subscribed and sworn to before me this 9th day of July, 2014.

Erin Campbell
Notary Public

My commission expires: 6/7/2016

ERIN CAMPBELL
NOTARY PUBLIC
STATE OF COLORADO