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Missouri Public Service Commission

EXHIBIT

Exhibit No.:	
Issue:	Rate of Return
Witness:	Daniel J. Lawton
Type of Exhibit:	Surrebuttal
Sponsoring Party:	OPC
Case No:	GR-2009-0355
Date Prepared:	October 14, 2009

SURREBUTTAL TESTIMONY

OF

DANIEL J. LAWTON

Submitted on Behalf of the Office of the Public Counsel

MISSOURI GAS ENERGY

Case No. GR-2009-0355

OCTOBER 14, 2009

OPC Exhibit No. 71
Case No(s). GR-2009-0355
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Surrebuttal Testimony of Daniel J. Lawton

Case No. GR-2009-0355

October 14, 2009

I. INTRODUCTION

Q1. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Daniel J. Lawton and my business address is 701 Brazos, Suite 500, Austin, Texas 78701.

Q2. ARE YOU THE SAME DANIEL J. LAWTON WHO PREVIOUSLY FILED DIRECT TESTIMONY AND REBUTTAL TESTIMONY IN THIS CASE IDENTIFIED AS CASE NO. GR-2009-0355 BEFORE THE MISSOURI PUBLIC SERVICE COMMISSION ("COMMISSION")?

A. Yes, I am.

Q3. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?

A. The purpose of this surrebuttal testimony is to address the rebuttal testimony filed by Mr. Hanley on or about September 25, 2009. Specifically, I address Mr. Hanley's cost of capital update as well as various comments Mr. Hanley makes regarding my direct testimony.

Q4. HOW HAS MR. HANLEY UPDATED HIS ANALYSIS?

A. Based on his rebuttal testimony at page 2, lines 16-19, Mr. Hanley asserts that the "significant changes in the capital markets" in the seven month period since his original analysis made the update necessary. The result of his update is to reduce his original equity return recommendation of 11.25% down to 10.50%. Thus, Mr. Hanley has abandoned his calculations and estimates contained in his direct testimony and now proposes a 10.50% equity return. Mr. Hanley's revised overall rate of return recommendation after updates is 8.01%[1] versus his original estimate of 8.434%.

Q5. WHAT IMPACT DOES MR. HANLEY'S LOWER RECOMMENDED EQUITY RETURN AND OVERALL COST OF CAPITAL HAVE ON REVENUE REQUIREMENTS?

A. Employing the Company's original rate base investment level of $604,971,779 and a tax gross-up factor of 1.62308, Mr. Hanley's revisions reduce the Company's claimed revenue requirements by about $3.9 million per year. I have included in my Schedule (DJL-1SR) a summary of this calculation.

Q6. DID MR. HANLEY ALSO UPDATE HIS ALTERNATIVE COST OF CAPITAL ESTIMATE?

A. Yes. In his direct testimony Mr. Hanley recommended a 15.25% cost of equity for Southern Union under the assumption that the actual Southern Union capital structure would be employed in this case. Now, Mr. Hanley has updated that specific Southern Union equity return to a level of 13.9%, a 135 basis point reduction to his earlier recommendation.

Q7. DO YOU HAVE ANY COMMENTS REGARDING MR. HANLEY'S NEW OR UPDATED RECOMMENDATIONS IN THIS CASE?

A. While Mr. Hanley's updates represent a significant reduction to his original recommendation – his primary analysis is actually closer to 10% rather than his claimed 10.5%. When the errors in his update are corrected Mr. Hanley's analyses support a 10% equity return.

[1] Rebuttal Testimony of F. Hanley, Schedule (FJH-21) p. 1 of 55.

Q8. PLEASE SUMMARIZE HOW MR. HANLEY ARRIVED AT HIS UPDATED 10.50% EQUITY RETURN RECOMMENDATION.

A. Mr. Hanley employed the same Discounted Cash Flow ("DCF"), Risk Premium ("RP") and Capital Asset Pricing Models ("CAPM") with updated market data. I have summarized his model results in the following table.

Table 1
Summary of MGE Witness Hanley
Equity Return Estimates and Updates

Model	ROE Original Estimates[2]	ROE Updated Estimates[3]
DCF	9.82%	9.20%
RP	12.36%	10.94%
CAPM	11.33%	10.83%
Average	11.09%	10.32%
Business Risk Adj.	0.15	0.19
Recommended ROE	11.25%	10.50%

Q9. WHAT COMMENTS DO YOU HAVE WITH REGARD TO MR. HANLEY'S DCF ANALYSIS?

A. I agree with Mr. Hanley's DCF results of 9.20% which are consistent with the range of results from my DCF analysis presented in my direct testimony.

Q10. DO YOU HAVE ANY COMMENTS REGARDING MR. HANLEY'S RISK PREMIUM AND CAPITAL ASSET PRICING MODEL RESULTS?

A. Yes, as can be seen from Table 1 above, these RP and CAPM results, while declining from his original analysis, continue to overstate the cost of equity. The primary problem

[2] Direct FJH-1 p. 2 of 17.
[3] Schedule FJH-21 p. 2 of 55.

with Mr. Hanley's RP and CAPM analysis is his estimate of risk premium – it is substantially overstated.

Mr. Hanley calculates his risk premium for his RP analysis at page 34 of 55 of his Schedule (FJH-21). Line 5 of Schedule (FJH-21) shows a risk premium of 4.66%. The problem with his 4.66% risk premium estimate, which is calculated at pages 38-39 of his Schedule, is that Mr. Hanley assumes an enormous annual market return to investors of 17.09% over the next 3-5 years.[4] When Mr. Hanley calculated this same risk premium in his direct testimony just six months ago – he assumed investors could expect annual returns of 28.85%.[5] Such returns exceed the range of reasonableness and should be excluded. Moreover, Mr. Hanley's estimates of investor expected annual returns of 28.85% 6 months ago and new estimates of these same investor expectations of 17.09% do not instill confidence in terms of the credibility of his calculations.

Moreover, even Mr. Hanley apparently has doubts about these estimates. For example, in his direct testimony when he calculated investor expected returns at 28.85% - he gave such estimates a 20% weight.[6] Now, with his new estimate of 17.09% investor expected returns, he believes a 40% weighting is appropriate. These weighting factors employed by Mr. Hanley are not based on analysis, research or rigorous investigation – but simply the arbitrary judgment of Mr. Hanley with no basis in financial economic or any other theory.

Mr. Hanley's analysis just cannot be supported. Such data manipulations are little more than a recipe for mischief rather than a sound basis for setting just and reasonable rates.

[4] See Hanley Rebuttal Testimony, Schedule FJH-21, p. 39, line 4.
[5] See Hanley Direct Testimony at Schedule FJH-15, page 6 of 9, line 4.
[6] *Id.* at footnote 5.

Q11. WHAT ARE THE RESULTS OF MR. HANLEY'S RISK PREMIUM AND CAPM ANALYSES IF YOU CORRECT FOR THE PROBLEMS ASSOCIATED WITH HIS EXTREME FORECAST OF MARKET RETURNS?

A. Just correcting his analysis by removing the forecasted returns and relying on Mr. Hanley's historical risk premium calculations results in a risk premium of 3.89% rather than his estimated 4.66% for the comparable group. I have included the corrected analysis in my Schedule (DJL-2SR). Combining the 3.89% risk premium with Mr. Hanley's prospective bond yield of 6.28% results in a RP cost of equity estimate of 10.17%. Again, a result consistent with my 10.0% recommendation.

Mr. Hanley's CAPM estimate suffers from the same infirmities as the risk premium calculation described above.[7] I have corrected Mr. Hanley's analysis by removing the impact of the unsupported 17.09% estimate of investor annual return expectations. These calculations are included in my Schedule (DJL-3SR). The net result is that when Mr. Hanley's CAPM analysis is corrected it supports an equity return of 9.5%.

Q12. PLEASE SUMMARIZE THE RESULTS OF CORRECTING MR. HANLEY'S EQUITY RETURN ESTIMATES.

A. The impact of removing <u>only</u> Mr. Hanley's unsupported forecasts of 17.09% annual returns to shareholders and accepting all his remaining assumptions regarding risk premium and capital asset pricing model estimates results in a cost of equity range of 9.0% to 10.2%. These results are summarized as follows:

1. DCF	9.20%
2. Risk Premium	10.18%
3. CAPM	9.0% - 9.5%

[7] See Schedule FJH-21 p. 51, Footnote 1

Average 9.5%

The end result is the analyses, when performed correctly, support an equity return in the 10% range.

Q13. MR. HANLEY TESTIFIES AT PAGE 9 OF HIS REBUTTAL TESTIMONY THAT THREE OF YOUR PROXY COMPANIES - NICOR, NISOURCE, INC. AND UGI CORPORATION, SHOULD NOT BE INCLUDED IN YOUR COMPARABLE GROUP. DO YOU HAVE ANY COMMENTS?

A. Yes. First, my twelve company comparable group is based on Value Line investment survey designation of natural gas companies. More importantly, this is a non issue because if you examine the results in my Schedule (DJL-8) and (DJL-9) in my direct testimony – removing these three companies doesn't change the results. It appears that Mr. Hanley is attempting to raise an issue that has no meaningful impact on the analysis and results.

Q14. AT PAGES 10 THROUGH 13 OF MR. HANLEY'S REBUTTAL TESTIMONY HE ARGUES THAT THERE SHOULD BE NO DECOUPLING ADJUSTMENT – DO YOU HAVE ANY COMMENTS?

A. Yes. Mr. Hanley continues to believe all forms of decoupling ranging from weather adjustments to full decoupling through straight-fixed variable rate design are equivalent. Mr. Hanley is incorrect. I addressed this issue in my rebuttal testimony and Mr. Hanley continues to rely on his flawed analysis. Mr. Hanley provides no analysis identifying the various impacts of different decoupling methods used in the gas industry – instead, he incorrectly assumes they are all the same. Even his own schedules show very different methods of decoupling are employed in the industry – and they are not equivalent.

Q15. MR. HANLEY ASSERTS AT PAGES 16-17 OF HIS REBUTTAL TESTIMONY THAT YOU RELIED EXCLUSIVELY ON YOUR DCF RESULTS, IS THAT CORRECT?

A. No. At page 44 of my direct testimony I provide the results of all my analyses as well as identify the relevant range of results. Mr. Hanley is incorrect in his assumptions on this matter.

Q16. AT PAGE 20 OF HIS REBUTTAL TESTIMONY MR. HANLEY ASSERTS YOUR SUSTAINABLE GROWTH RATES SHOULD NOT BE REILED ON – DO YOU HAVE ANY COMMENTS?

A. I employ a wide range of growth estimates ranging from analysts' consensus estimates from Value Line, Zacks, and Thomson's, as well as project sustainable or internal growth estimates. Reliance on a single or small sample of growth estimates can lead to erroneous conclusions – thus a wider array of growth calculations will temper any bias or error in growth estimates.

I would also note that the sustainable growth estimates shown in my direct testimony at Schedule (DJL-7) page 1 of 4, column M, are <u>higher</u> than the average earnings per share forecast. Thus, if anything I relied on higher growth rates in earnings which would cause my resulting equity return estimate for MGE to be higher. My average sustainable growth estimate for the group is 5.59%,[8] Mr. Hanley's average updated growth estimate is 5.07%.[9] Again, Mr. Hanley is raising a non-issue.

[8] Direct Testimony of Daniel Lawton (DJL-7), page 1, Column M.
[9] Hanley Rebuttal Schedule FJH-21, page 55.

Q17. AT PAGES 22-33 OF HIS REBUTTAL TESTIMONY MR. HANLEY SUGGESTS YOUR RISK PREMIUM AND CAPM ESTIMATES ARE FLAWED – HOW DO YOU RESPOND?

A. I have addressed Mr. Hanley's risk premium and CAPM calculations earlier in my testimony. Simply removing his flawed estimate of investors expecting 17% annual returns and accepting every other assumption made by Mr. Hanley – results in risk premium estimates and CAPM results that are consistent with my return recommendations. These results are shown on Schedules (DJL-2SR) and (DJL-3SR).

The bottom line is that the market evidence from DCF analyses, risk premium estimate and CAPM results support a lower equity return than MGE is requesting.

Q18. AT PAGE 35 OF HIS REBUTTAL TESTIMONY MR. HANLEY SUGGESTS YOU FAILED TO RECOGNIZE INCREASED FINANCIAL RISK ASSOCIATED WITH EMPLOYING SUG'S CAPITAL STRUCTURE. IS MR. HANLEY CORRECT?

A. No. Mr. Hanley fails to consider all the Company related beneficial impacts from decoupling. Financial risk relates to debt leverage and in this case the amount of debt held by the comparable group companies relative to the SUG actual capital structure. The general financial risk viewed from an investor or rating agency prospective is the risk that a company may not have adequate cash flow to meet financial obligations. Thus, a company with proportionately more debt and interest obligations is riskier than an equivalent company with less debt and lower interest obligations.

In this case, under the Company's decoupling proposal the Company's cash flow is assured each month through customer minimum bill payments. Fixed revenues, i.e. revenues not subject to volatility or interruption under the Company's proposal amount to about 92% of the Company's entire margin requirements. The Company's own evidence does not support Mr. Hanley's financial risk arguments. The guaranteed cash flows diminish financial risk claims.

Q19. AT PAGE 36 OF HIS REBUTTAL TESTIMONY MR. HANLEY STATES THAT YOUR FINANCIAL METRICS GUIDELINES HAVE BEEN SUPERSEDED BY A NEW SET OF GUIDELINES. DO YOU HAVE ANY COMMENTS?

A. Yes. My financial metric analysis continues to be supported even under Mr. Hanley's Schedule FJH-21 page 18 of 55. The guidelines I outlined in my direct testimony at Schedule DJL-13 are consistent with the mid-range of S&P's current guidelines. Again, Mr. Hanley attempts to raise a non-issue.

Q20. HAS MR. HANLEY RAISED ANY ISSUE OR PRESENTED ANY REBUTTAL EVIDENCE THAT WOULD CAUSE YOU TO CHANGE ANY OF YOUR RECOMMENDATIONS IN THIS PROCEEDING?

A. No. Mr. Hanley's rebuttal evidence (once corrected for flawed forecast of investor expected returns) generally supports my recommended 10% equity return. While Mr. Hanley did change his flawed initial recommendation of an 11.25% equity return – his new 10.50% is on the high end of reasonable results and a 10% return is supported by his own evidence.

Q21. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.

MGE GAS CASE
DOCKET NO.GR 2009-0355
IMPACT ON REVENUE REQUIREMENTS OF UPDATED COST OF CAPITAL

LINE NO.	DESCRIPTION	COMPANY FILED REQUEST	COMPANY UPDATED RETURN
1	RATE BASE	$604,954,779	$604,954,779
2	REQUESTED RATE OF RETURN ON INVESTMENT	8.43%	8.01%
3	REQUESTED RETURN GROSSED UP FOR TAX	11.80%	11.15%
4	RETURN AND TAXES REQUIRED	$71,380,598.63	$67,479,807.86
5	DIFFERENCE		**($3,900,790.76)**
6			
7			

		RATIO	COST	WEIGHTED COST	WEIGHTED COST W/ TAXES
8	**COMPANY ORIGINAL CLAIMED CAPITAL COST**				
9	LONG-TERM DEBT	41.06%	6.08%	2.50%	2.50%
10	SHORT-TERM DEBT	10.94%	4.92%	0.54%	0.54%
11	TOTAL DEBT	52.00%			
12	COMMON EQUITY	48.00%	11.25%	5.40%	8.76%
13	TOTAL RETURN REQUEST	100.00%		8.43%	11.80%
14					

		RATIO	COST	WEIGHTED COST	WEIGHTED COST W/ TAXES
15	COMPANY UPDATED CAPITAL COST				
16	LONG-TERM DEBT	41.06%	6.08%	2.50%	2.50%
17	SHORT-TERM DEBT	10.94%	4.37%	0.48%	0.48%
18	TOTAL DEBT	52.00%			
19	COMMON EQUITY	48.00%	10.50%	5.04%	8.18%
20	TOTAL RETURN REQUEST	100.00%		8.01%	11.15%

MGE GAS CASE
DOCKET NO.GR 2009-0355
CORRECTION'S TO WITNESS HANLEY'S
EQUITY RISK PREMIUM ESTIMATES

LINE NO.	DESCRIPTION	A MR. HANLEY'S ORIGINAL RISK PREMIUM ESTIMATE	B MR. HANLEY'S UPDATED RISK PREMIUM ESTIMATE	C CORRECTED RISK PREMIUM
1	Arithmetic mean total return rate on Standard & Poor's Composite Index-1926-2007	12.30%	11.70%	11.70%
2	Arithmetic mean yield on Aaa an Aa orporate Bonds 1926-2007	6.10%	6.10%	6.10%
3	Historical Equity Risk Premium	6.20%	5.60%	5.60%
4	Hanley weighting for Historical Premium	80.00%	60.00%	100.00%
5	Forecasted 3-5 Year Total Annual Market Return	**28.85%**	**17.09%**	
6	Prospective Yield on Aaa Rated Corporate Bonds	**5.08%**	**5.60%**	
7	Forecasted Equity Risk Premium	**23.77%**	**11.49%**	
8	Hanley weighting for Forecasted Premium	**20.00%**	**40.00%**	
9	Conclusion on Equity Risk Premium	9.71%	7.96%	5.60%
10	Adjusted Value Line Beta	0.70	0.65	0.65
11	Beta Adjusted Equity Risk Premium	6.80%	5.17%	3.64%
12	Mean Equity Risk Premium employing Public Utility Baa Bonds	4.13%	4.15%	4.15%
13	Average Risk Premium	5.46%	4.66%	3.90%
14	Prospective Bond Yield	6.89%	6.28%	6.28%
15	Risk Premium ROE Estimate	**12.35%**	**10.94%**	**10.18%**
16				
17	Sources:			
18	Column A Hanley Schedule FJH-15			
19	Column B Hanley Schedule FJH-21			
20	Column C equals Column B excluding line 5-8			