EXHIBIT

Exhibit No.:	
Issue(s):	Return on Equity
Witness/Type of Exhibit:	Schafer/Surrebuttal
Sponsoring Party:	Public Counsel
Case No.:	ER-2014-0351

SURREBUTTAL TESTIMONY

OF

LANCE C. SCHAFER

Submitted on Behalf of the Office of the Public Counsel

EMPIRE DISTRICT ELECTRIC COMPANY

CASE NO. ER-2014-0351

March 24, 2015

OPC Exhibit No. 312
Date 4-14-15 Reporter XF
File No. ER-2014-0351

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of The Empire District Electric Company for Authority to File Tariffs Increasing Rates for Electric Service Provided to Customers in the Company's Missouri Service Area.	))))	Case No. ER-2014-0351

AFFIDAVIT OF LANCE SCHAFER

STATE OF MISSOURI)
) ss
COUNTY OF COLE)

Lance Schafer, of lawful age and being first duly sworn, deposes and states:

1. My name is Lance Schafer. I am the Public Utility Financial Analyst for the Office of the Public Counsel.

2. Attached hereto and made a part hereof for all purposes is my surrebuttal testimony.

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.

Lance Schafer
Public Utility Financial Analyst

Subscribed and sworn to me this 24th day of March 2015.

NOTARY PUBLIC NOTARY SEAL STATE OF MISSOURI

JERENE A. BUCKMAN
My Commission Expires
August 23, 2017
Cole County
Commission #13754037

Jerene A. Buckman
Notary Public

My Commission expires August 23, 2017.

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OF
LANCE C. SCHAFER

The Empire District Electric Company

CASE NO. ER-2014-0351

SECTION 1: INTRODUCTION AND BACKGROUND

Q. PLEASE STATE YOUR NAME.

A. My name is Lance C. Schafer.

Q. ARE YOU THE SAME LANCE C. SCHAFER WHO FILED TESTIMONY EARLIER IN THIS PROCEEDING?

A. Yes.

Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?

I will respond to the rebuttal testimony of the Empire District Electric Company ("Empire" or "Company") witness Dr. James H. Vander Weide and Staff witness Shana Griffin (formerly Atkinson).

SECTION 2: RESPONSE TO DR. VANDER WEIDE'S REBUTTAL TESTIMONY

Q. PLEASE SUMMARIZE DR. VANDER WEIDE'S REBUTTAL TESTIMONY REGARDING YOUR ANALYSIS OF EMPIRE'S COST OF COMMON EQUITY.

A. Dr. Vander Weide has the following five principal areas of disagreement with my analysis:

1. He apparently believes that my proxy group is too small;
2. He believes my calculation of the annualized dividend does not take into account the quarterly payment of dividends;
3. He believes I should not have used the 30-year STRIPS rate in my CAPM;
4. He disagrees with my use of the geometric mean return to calculate the risk premium in my CAPM; and
5. He disagrees with my use of the historical total return on government bonds to establish the risk premium in the CAPM.

PROXY GROUP

Q. ON WHAT BASIS DOES DR. VANDER WEIDE QUESTION YOUR PROXY GROUP?

A. Dr. Vander Weide spends much of his rebuttal testimony specifically comparing my use of eleven electric utilities in my proxy group, as well as Staff's use of twelve electric utilities, to his own use of twenty-eight utilities. Dr. Vander Weide apparently believes that my proxy group is simply too small, because, as he states:

> [...] it is desirable to include a large group of comparable companies in a proxy group because standard cost of equity methods such as the discounted cash flow ("DCF"), risk premium, and capital asset pricing model ("CAPM") require inputs of quantities that are not easily measured, but the uncertainty in the estimates of these inputs can be reduced by applying cost of equity methods to a large sample of comparable risk companies.[1]

[1] See the Rebuttal Testimony of Dr. Vander Weide, p. 34, lines 17-23.

Q. DOES DR. VANDER WEIDE PROVIDE AN ESTIMATE OF THE NUMBER OF COMPANIES HE WOULD CONSIDER "LARGE" WHEN ESTABLISHING A PROXY GROUP?

A. No. Furthermore, Dr. Vander Weide does not specify what number of companies would constitute a "small" proxy group. He simply states "[...] efforts to make a comparable group to be precisely comparable in risk would cause the size of the sample group to be so small as to reduce the accuracy of the cost of equity estimate."[2]

Q. BY WHAT METRIC DOES DR. VANDER WEIDE COMPARE THE INVESTMENT RISK OF THE COMPANIES IN HIS PROXY GROUP TO THE INVESTMENT RISK OF THE COMPANIES IN YOUR PROXY GROUP?

A. Dr. Vander Weide states that the average investment risk of our proxy groups is similar based on the average S&P bond rating and the average Value Line Safety Rank of our proxy groups.

Q. IF DR. VANDER WEIDE BELIEVES THE INVESTMENT RISK OF HIS AND YOUR PROXY GROUPS TO BE THE SAME, WHY DOES HE PREFER HIS PROXY GROUP?

A. Dr. Vander Weide apparently prefers his proxy group simply because it is larger.[3]

Q. WHY IS YOUR PROXY GROUP SMALLER THAN DR. VANDER WEIDE'S?

[2] Ibid., p. 12, lines 15-17.

[3] See the Rebuttal Testimony of Dr. Vander Weide, p. 34, lines 15-17.

A. As I discussed in my rebuttal testimony, Dr. Vander Weide does not consider a company's amount of regulated activity to be an important criterion in establishing his proxy group.[4] As a result, his proxy group contains several companies that receive more revenue from regulated natural gas than they do from regulated electricity.[5] Additionally, Dr. Vander Weide and I use a different criterion regarding companies that have undergone or are currently undergoing mergers and/or acquisitions.[6]

Q. WHY DOES DR. VANDER WEIDE BELIEVE THAT A COMPANY THAT RECEIVES MORE OF ITS REGULATED REVENUE FROM NATURAL GAS THAN IT DOES FROM REGULATED ELECTRICY IS COMPARABLE TO EMPIRE?

A. Dr. Vander Weide believes that the most relevant factors for risk comparability are Standard & Poor's credit rating and Value Line's Safety Rank.[7] He does not believe that the type and amount of regulated activity impacts comparability. As I showed in my rebuttal testimony, Dr. Vander Weide thus believes that a company such as Integrys Energy, which receives 38% of its revenue from regulated gas and only 18% of its revenue from regulated electricity, is comparable to Empire, which receives 91% of its revenue from regulated electricity.[8]

[4] See the Rebuttal Testimony of Mr. Schafer, pp. 4-8.

[5] *Ibid.*

[6] See the Rebuttal Testimony of Mr. Schafer, pp. 8-12.

[7] See the Rebuttal Testimony of Dr. Vander Weide, p. 8, lines 9-15.

[8] See the Rebuttal Testimony of Mr. Schafer, p. 7, line 13.

Q. DOES DR. VANDER WEIDE PROVIDE EVIDENCE THAT INVESTORS REQUIRE SIMILAR RETURNS FROM NATURAL GAS AND ELECTRIC UTILITY COMPANIES?

A. No.

Q. DO YOU STILL BELIEVE YOUR PROXY GROUP IS REASONABLE?

A. Yes.

ANNUALIZED DIVIDEND

Q. WHY DOES DR. VANDER WEIDE DISAGREE WITH THE CALCULATION OF YOUR PROXY GROUP'S ANNUALIZED DIVIDEND?

A. He believes my calculation of the annualized dividend for my DCF models does not take into account the quarterly payment of dividends.[9]

Q. IS DR. VANDER WEIDE CORRECT?

A. No. Dr. Vander Weide's criticism on this issue is misplaced and based on his mistaken belief that the quarterly DCF model should be used. As I have shown in my rebuttal testimony, the quarterly DCF model requires the utility company to continue compensating an investor on dividends that have already been paid out to the investor.[10]

[9] See the Rebuttal Testimony of Dr. Vander Weide, p. 35-37.

[10] See the Rebuttal Testimony of Mr. Schafer, p. 15-18.

Dr. Vander Weide's attempt to confuse the issue of how annualized dividends are calculated with the defense of his quarterly DCF model is opportunistic and disingenuous. For example, he states "Mr. Schafer's equation for the first period dividend, $D_1 = D_0 (1 + ½ g)$ cannot be derived from the assumption that dividends are paid annually"[11], which he then attempts to bolster by saying "Mr. Schafer explains his use of his equation for the first period dividend by noting that it accounts 'for the fact that dividends are paid on a quarterly basis.'"[12]

However, the fact that dividends are paid quarterly and that, when calculating the D_1 input for the DCF model, analysts account for the different timing of dividend increases across the companies in a proxy group with the formula $D_1 = D_0 (1 + ½ g)$ is *in no way* related to Dr. Vander Weide's misguided belief that Empire should continue compensating investors on money (dividends) it has already paid out to them.

30-YEAR STRIPS RATE

Q. WHAT IS DR. VANDER WEIDE'S CRITICISM?

A. He believes I should not have used the current interest rate on 30-year treasury zero coupon STRIPS to estimate the risk-free component of my CAPM.[13]

[11] See the Rebuttal Testimony of Dr. Vander Weide, p. 36, lines 6-8.

[12] Ibid, p. 36, lines 11-13.

[13] See the Rebuttal Testimony of Dr. Vander Weide, p. 39, lines 19-23.

Q. DID YOU USE THIS RATE TO CALCULATE EMPIRE'S RETURN ON EQUITY?

A. No. Dr. Vander Weide and I both agree that the current rate is artificially depressed due to the Federal Reserve's efforts to stimulate the economy.[14] In my direct testimony, I present the results of the CAPM using both the current and forecasted risk-free rates in order to illustrate why it is appropriate to use the forecasted rate.[15] However, only the result from using the forecasted rate was included in my calculation of Empire's cost of equity. Dr. Vander Weide's concern on this issue is simply unfounded.

GEOMETRIC VERSUS ARITHMETIC MEAN

Q. WHAT IS DR. VANDER WEIDE'S CONCERN?

A. He disagrees with my use of the geometric mean return to calculate the risk premium in my CAPM.[16]

Q. DOES DR. VANDER WEIDE'S ARGUMENT IN FAVOR OF THE USE OF THE ARITHMETIC MEAN TO ESTIMATE THE RISK PREMIUM ON THE MARKET PORTFOLIO TAKE INTO ACCOUNT ALL RELEVANT INFORMATION ON THIS ISSUE?

[14] See the Direct Testimony of Dr. Vander Weide, pp. 39-40.

[15] See the Direct Testimony of Mr. Schafer, pp. 29-37.

[16] See the Rebuttal Testimony of Dr. Vander Weide, p. 40, lines 7-10.

A. No. Dr. Vander Weide simply ignores strong evidence that the exclusive use of the arithmetic mean will overstate the required return. As I outlined in my direct testimony, exclusive use of the arithmetic mean return would only be appropriate if each period's return was independent.[17] In reality, a period of high (low) return has been shown more likely to be followed by a period of low (high) return—in other words, the returns show correlation and, therefore, are not completely independent.[18] Nowhere in his testimony does Dr. Vander Weide address this issue.

INCOME RETURN VERSUS TOTAL RETURN ON LONG-TERM GOVERNMENT BONDS

Q. WHAT IS DR. VANDER WEIDE'S CONCERN?

A. He disagrees with my use of the historical total return on government bonds to establish the risk premium in the CAPM.[19]

Q. WHY DOES DR. VANDER WEIDE BELIEVE THAT YOU SHOULD HAVE USED THE INCOME RETURN ON LONG-TERM GOVERNMENT BONDS INSTEAD OF THE TOTAL RETURN?

A. Dr. Vander Weide states that "because the total return includes capital gains and losses, and capital gains and losses are highly uncertain, the total return is not risk free."[20]

[17] See the Direct Testimony of Mr. Schafer, p. 32-36.

[18] *Ibid.*

[19] See the Rebuttal Testimony of Dr. Vander Weide, p. 40, lines 15-19.

Therefore, Dr. Vander Weide recommends using only the income return on long-term government bonds in order to calculate the risk premium.

Q. WHY IS DR. VANDER WEIDE'S USE OF THE INCOME RETURN INAPPROPRIATE?

A. For a long-term government bond, the income return is the coupon payment. However, investors are unable to receive the coupon payment without actually purchasing the security. As soon as the security is purchased, it is the total return that is the relevant yield for an investor.

SECTION 3: RESPONSE TO STAFF'S REBUTTAL TESTIMONY

Q. WHAT CONCERN DOES MS. GRIFFIN RAISE REGARDING YOUR ANALYSIS OF EMPIRE'S COST OF COMMON EQUITY?

A. First, Ms Griffin believes my analysis does not appropriately account for Empire's risk profile.[21] Second, she questions why I recommend the midpoint of my estimates. Third, she believes that the dividend yield adjustment I made to account for the actions of the Federal Reserve is unnecessary.

Q. HOW DOES MS. GRIFFIN ACCOUNT FOR EMPIRE'S RISK PROFILE?

A. Ms. Griffin explains the risk adjustment she made as follows:

[20] See the Rebuttal Testimony of Dr. Vander Weide, p. 40, line 23, and p. 41, lines 1-2.

[21] See The Rebuttal Testimony of Shana Griffin, p. 9, lines 16-18.

> Staff's recommended ROE for Empire is 25 basis points higher than Staff's recent recommendation for Ameren Missouri's rate case because Staff added 25 basis points due to Empire's lower credit rating, which is based on the business and financial risks of Empire's regulated utility operations. The spreads between 'BBB+' rated utility bonds and 'BBB' rated utility bonds have averaged approximately 25 basis points during the period October 2014 through December 2014.[22]

Q. DID MS. GRIFFIN MAKE THE SAME RISK ADJUSTMENT IN EMPIRE'S LAST RATE CASE, ER-2012-0345?

A. Yes. However, Empire's credit rating at the time of the 2012 case was lower, so Staff's adjustment was based on the spread between BBB+ and BBB- rated utility bonds, which at that time was 45 basis points (Staff actually used 50 basis points).[23]

Q. DO YOU BELIEVE IT IS APPROPRIATE TO ADD A BOND YIELD SPREAD TO A FINAL RECOMMENDED ROE IN ORDER TO ACCOUNT FOR RELATIVE RISK?

A. No. Staff presents no evidence that the amount of a bond yield spread translates directly into the amount that should be applied to adjust an allowed return on equity. Moreover, Staff's direct application of the bond yield spread to the allowed ROE to reflect the relative risk between Ameren and Empire takes no other element but the bond rating into consideration. Issues such as capital structure, differences in management, and differences in operating characteristics affect the relative risk profile of these companies.

[22] See Staff's Cost of Service Report, p. 48, lines 5-10.

[23] See Staff's Cost of Service Report from ER-2012-0345, p. 54, lines 7-12.

Representing all elements of a company's relative risk profile with a bond yield spread for the purposes of setting an allowed ROE merits, at the very least, further investigation into the soundness of the adjustment.

Q. ON WHAT FINANCIAL MODEL WOULD THE DIFFERENCE IN BOND RATINGS HAVE THE MOST IMPACT?

A. The difference in bond yields would have the most impact on the bond-yield-plus-risk-premium method. In that method, a risk premium is added to a bond yield. If the risk premium is the same for two companies, then the difference in the return-on-equity results for those two companies will depend on the bond yield. The lower bond rating will translate into a higher bond yield, which will then result in a higher calculated return on equity than that of the company whose bonds are rated higher.

However, the bond-yield-plus-risk-premium method is only one of several methods analysts use to calculate the return on equity.

Q. DOES MS. GRIFFIN USE THE BOND-YIELD-PLUS-RISK-PREMIUM METHOD IN HER ANALYSIS?

A. Ms. Griffin relies on the DCF method and the CAPM to calculate the cost of equity.[24] She also uses a "rule of thumb" method to test the reasonableness of her results.[25] Both the CAPM and the "rule of thumb" methods are variations of the bond-yield-plus-risk-

[24] See Staff's Cost of Service Report, p. 14, lines 14-17.

[25] See Staff's Cost of Service Report, pp. 45-46.

premium method. However, neither of these methods features bond yields based specifically on Empire's credit rating.

Q. DO THE RETURN-ON-EQUITY RESULTS OF THE COMPANIES IN YOUR PROXY GROUP CONFIRM THE SOUNDNESS OF ADDING 25 BASIS POINTS TO THE FINAL RECOMMENDED ROE BASED ON A BOND YIELD SPREAD?

A. No. This can be seen by looking at the CAPM, constant-growth DCF, and multi-stage DCF results. In all of these models, the calculated return on equity was actually *higher* for the companies rated BBB+ than it was for the companies rated BBB—this strongly contradicts Ms. Griffin's risk adjustment.

Q. PLEASE EXPLAIN.

A. First, the CAPM model requires an input of the measure of a company's systematic risk. Three of my proxy group companies have an S&P rating of BBB+. For those companies, the average measure of beta is .83. For the four companies in my proxy group whose S&P rating is BBB, the average measure of beta is .8. Therefore, according to the CAPM, the BBB+ rated companies are ***less risky*** than the BBB rated companies. This translates directly into the results of the model. The average return-on-equity result for the BBB+ rated companies is 8.87%. The average return-on-equity result for the BBB rated companies is 8.69%.

Second, the constant-growth DCF model uses stock prices as one of its inputs. If investors' required return on equity for BBB rated companies were 25 basis points higher than their required returns on BBB+ rated companies (as Ms. Griffin believes), then the results of the model would reflect that. However, the average return-on-equity result for the BBB+ rated companies in my proxy group is 9.48%. The average return-on-equity result for the BBB rated companies is 9.35%.

Third, the multi-stage DCF model also uses stock prices as one of its inputs. If investors' required return on equity for BBB rated companies were 25 basis points higher than their required returns on BBB+ rated companies, then the results of the model would reflect that. Instead, the average return-on-equity result for the BBB+ rated companies in my proxy group is 8.92%. The average return-on-equity result for the BBB rated companies is 7.87%.

Averaging the results of the three models above, the return-on-equity results for the BBB rated companies is actually ***45 basis points lower*** than the return-on-equity results for the BBB+ rated companies. These results contradict Ms. Griffin's bond-yield-spread adjustment to account for relative risk.

Q. ARE THE RETURN-ON-EQUITY RESULTS THAT MS. GRIFFIN CALCULATES FOR THE BBB+ COMPANIES IN HER PROXY GROUP ALSO LOWER THAN THE RETURN-ON-EQUITY RESULTS SHE CALCULATES FOR THE BBB COMPANIES?

A. Yes. First, Ms. Griffin's constant-growth DCF result is based on her proposed proxy-group dividend yield and range of growth. However, in her workpapers, Ms. Griffin presents each company's dividend yield. The average dividend yield for the BBB+ companies in question is 3.83%. Adding Staff's proposed growth range (3.5% to 4.5%) to the dividend yield results in an average return-on-equity result of 7.33% to 8.33%. In contrast, the average dividend yield for the BBB companies in Staff's proxy group is 3.26%. Adding Staff's proposed growth range to the dividend yield results in an average return-on-equity result of 6.76% to 7.76%. Therefore, the average return-on-equity result for the BBB companies is actually ***57 basis points lower*** than the average return for the BBB+ companies.

Second, Staff's multi-stage DCF model also shows that the BBB rated companies have a lower required return on equity than the BBB+ companies. All four versions of Staff's multi-stage DCF model show that the BBB rated companies have an average return on equity that is ***44 basis points lower*** than the average of the BBB+ companies. The four models are summarized in the following table:

Staff's Multi-Stage DCF Model Results

Model Version based on Terminal Value	Average Result for BBB Companies	Average Result for BBB+ Companies	Difference
3.00%	7.15%	7.60%	0.45%
3.50%	7.54%	7.98%	0.44%
4.00%	7.93%	8.36%	0.43%
4.40%	8.25%	8.67%	0.42%
Average			**0.44%**

Third, Staff's CAPM results also show that Ms. Griffin's 25-basis-point adjustment is unwarranted. The CAPM average result for the BBB+ companies is 6.67%. The CAPM average result for the BBB companies is 6.68%. The difference is thus 1 basis point.

Averaging the results of the three models above, Staff's return-on-equity results for the BBB rated companies is in fact ***33 basis points lower*** than the return-on-equity results for the BBB+ rated companies. These results contradict Ms. Griffin's bond-yield-spread adjustment to account for relative risk.

It bears repeating that I am not suggesting that lower bond ratings lead to lower required returns on equity. I am stating that many factors are involved when attempting to quantify the effect of a bond rating on a required return on equity, so to reduce the issue to a simple measure of the bond yield spread is simply unsound. Furthermore, since the results of both Ms. Griffin's and my models discussed above strongly contradict Ms. Griffin's adjustment, there is certainly no reason to believe my recommended return on equity is too low based on this concern. There is, however, ample evidence that Ms. Griffin should not have applied her risk adjustment in the first place.

Q. WHAT EFFECT DID MS. GRIFFIN'S RISK ADJUSTMENTS HAVE ON HER FINAL RECOMMENDED ROE FOR THE INSTANT CASE AS COMPARED TO HER RECOMMENDATION IN THE EMPIRE ER-2012-0345 CASE?

A. The following table presents Ms. Griffin's recommendations in both the instant case and the Empire case ER-2012-0345. I have added additional items of comparison that I will discuss shortly:

A Comparison of Staff's 2012 and 2014 Empire Recommendations

	ER-2012-0345	**ER-2014-0351**
Final Recommendation:	9.50%	9.50%
Portion of the Final Recommendation that Staff Inappropriately Assigns to Company-Specific Risk:	0.50%	0.25%

Recommendation Before the Risk Adjustment:	9.00%	9.25%
Staff's Calculated Change in the Cost of Equity Between 2012 and 2014:	a *DECREASE* of "at least 25 to 75 basis points"*	
The Change Between Staff's 2012 and 2014 Recommendations Before the Risk Adjustments:	an *INCREASE* of 25 basis points	
The Change Between Staff's 2012 and 2014 Final Recommendations:	0.00%	

*See Staff's Cost of Service Report, p. 11, lines 18-20

Q. SO, REMOVING THE RISK ADJUSTMENT, STAFF'S FINAL RECOMMENDATION IN THE INSTANT CASE IS ACTUALLY HIGHER THAN IT WAS IN THE 2012 EMPIRE CASE EVEN THOUGH STAFF STATES THAT THE COST OF EQUITY HAS DECREASED 25 TO 75 BASIS POINTS SINCE THEN?

A. Surprisingly, yes.

Q. WHY IS THAT THE CASE?

A. Staff has changed its method of calculating the final recommended ROE since the 2012 case. As I explained in my rebuttal testimony, Staff has adopted this technique because of two stated concerns: 1) that Commissions do not set authorized ROEs based on the cost of capital, and 2) that the Commission has found Staff's past recommendations too low.[26]

[26] See the Rebuttal Testimony of Mr. Schafer, pp. 35-36.

However, the technique Staff is using in the instant case appears to produce results that contradict the results Staff recommended in the ER-2012-0345 case, because although Staff believes that the cost of equity has decreased, Staff's final recommendation in the instant case does not reflect that decrease when viewed in relation to Staff's final recommendation from the ER-2012-0345 case.

Q. DO YOU BELIEVE STAFF'S FINAL RECOMMENDED ROE IN THE INSTANT CASE SHOULD BE USED AS A POINT OF REFERENCE FOR DECIDING WHETHER OR NOT YOUR RECOMMENDATION IS TOO LOW OR TOO HIGH?

A. No. I do not believe Staff's recommendation should be used to judge my recommendation because: 1) Staff's recommendation is the result of a new technique that Staff has adopted in order to compensate for the concerns it feels that the Commission has had with Staff's past recommendations, and 2) Staff's recommendation includes an inappropriate adjustment for risk.

My goal as an analyst is not to produce an estimate that is merely appropriate in relation to what Staff feels the Commission will accept—especially when one considers that Staff actually believes the true cost of equity to be much, much lower than Staff's final recommendation. In fact, the results of Staff's constant-growth DCF model produce a range of 7.2% to 8.2%.[27] The results of Staff's multi-stage DCF model produce a range of 7.30% to 8.10%. The results of Staff's CAPM produce a range of 6.60% to 7.82%.[28]

[27] See Staff's Cost of Service Report, p. 34, lines 15-16.

[28] See Staff's Cost of Service Report, p. 45, lines 8-9.

The average produced by these models is **7.54%.** My recommendation is 9.05%. If my recommendation were viewed from the perspective of what Staff actually believes the cost of equity to be, my recommendation could be viewed as excessively high—not too low, as Ms. Griffin implies.[29]

Q. MOVING ON, MS. GRIFFIN MENTIONS THAT YOU RECOMMEND THE MIDPOINT OF YOUR RANGE.[30] WHY DID YOU CHOOSE THE MIDPOINT OF YOUR RANGE?

A. In my direct testimony, I describe what I believe to be significant interest-rate risk that the company faces.[31] Recommending an estimate from the bottom half of my calculated range would be inconsistent with the level of risk that I described.

Q. IF YOU HAD RECOMMENDED THE AVERAGE OF YOUR ESTIMATES RATHER THAN THE MIDPOINT, WHAT WOULD THAT AVERAGE HAVE BEEN?

A. The average of my estimates is 8.98%. This is 7 basis points lower than my final recommendation of 9.05%.

Q. MS. GRIFFIN ALSO DISAGREES WITH YOUR DIVIDEND YIELD ADJUSTMENT. ON WHAT DOES SHE BASE HER DISAGREEMENT?

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[29] See the Rebuttal Testimony of Shana Griffin, p. 9, lines 14-18.

[30] See the Rebuttal Testimony of Ms. Griffin, p. 10, lines 5-7.

[31] See the Direct Testimony of Mr. Schafer, pp. 17-20.

A. Ms. Griffin does not believe that the influence of the Federal Reserve should be accounted for in my analysis by means of an adjustment. She states:

> First, even assuming the Fed increases the Fed Funds rate in the next year, these increases are already factored into current long-term rates. If the Fed were to unexpectedly increase or decrease interest rates, then this may have an impact on long-term rates, but because these are changes to short-term rates, it will not have a dramatic impact on long-term rates as *these are impacted by competitive market forces rather than monetary policy* [emphasis added].[32]

Q. DOES THE FEDERAL RESERVE BELIEVE THAT MONETARY POLICY INFLUENCES LONG-TERM RATES?

A. Yes. According to the Federal Reserve Bank of New York,

> Movements in the fed funds rate may have implications for the loan and investment policies of financial institutions, especially for commercial bank decisions concerning loans to businesses, individuals and foreign institutions. Financial managers may compare the fed funds rate with yields on other investments before choosing the combinations of maturities of financial assets in which they will invest or the term over which they will borrow. Interest rates paid on other short-term financial securities—commercial paper and Treasury bills, for example—often move up or down roughly in parallel with the funds rate. Yields on long-term assets—corporate bonds and Treasury notes, for example—are determined in part by expectations for the fed funds rate in the future.[33]

Q. MS. GRIFFIN ALSO STATES THAT THE DIVIDEND YIELD IS CURRENTLY LOWER THAN IT WAS IN THE PAST BECAUSE "INVESTOR'S REQUIRED

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[32] See the Rebuttal Testimony of Ms. Griffin, p. 12, lines 8-13.

[33] Source: The Federal Reserve Bank of New York, Fedpoint: Federal Funds and Interest on Reserves. http://www.newyorkfed.org/aboutthefed/fedpoint/fed15.html

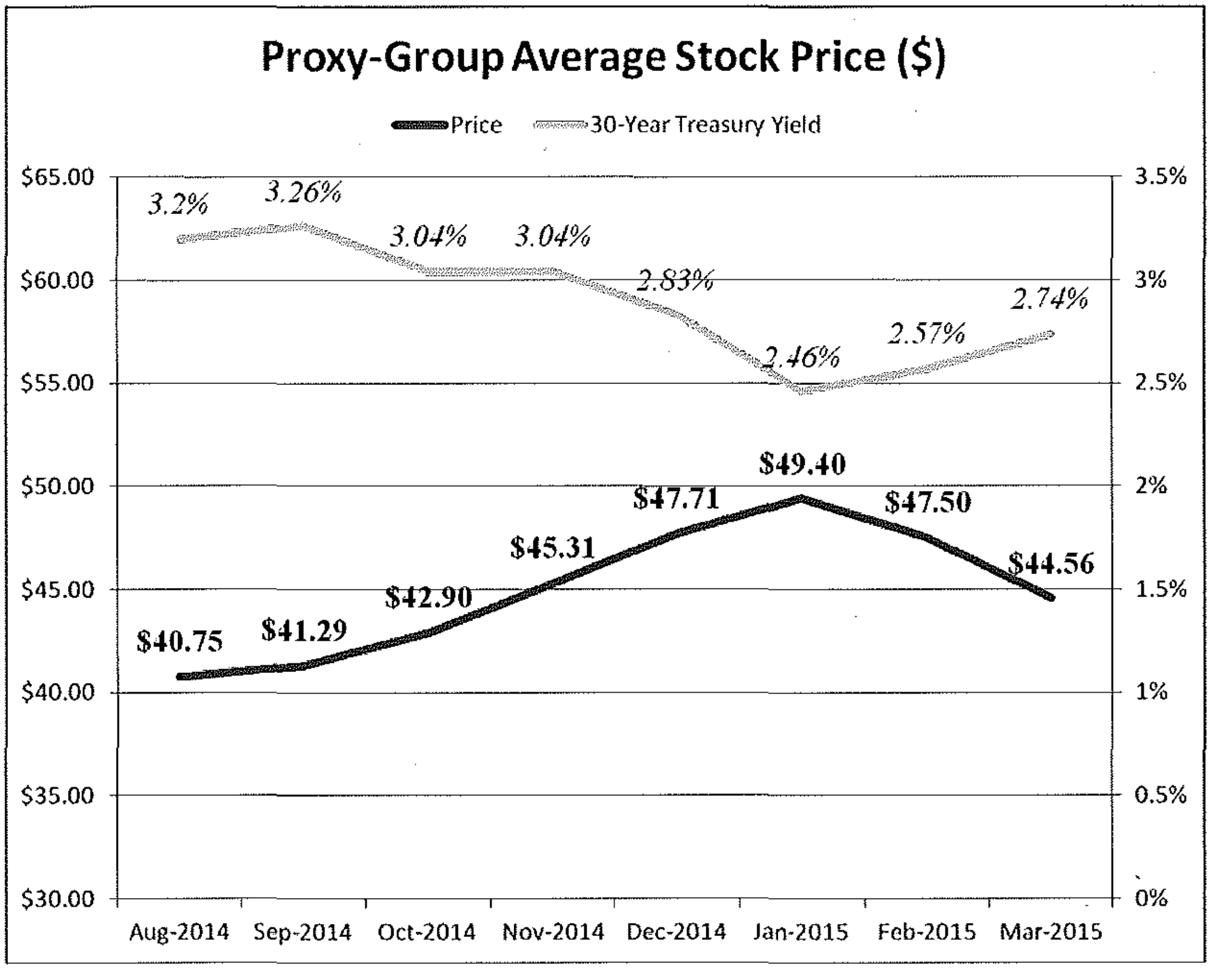
RETURNS ON UTILITY STOCKS HAVE DECLINED."[34] WHAT IS YOUR REACTION TO THIS STATEMENT?

A. If investors' current return requirements are more influenced by the results of an extraordinary monetary policy than they are by expectations of the performance of the utility industry, then there is reason for concern.

Ms. Griffin claims that future expectations are already factored in to the current rates.[35] However, her opinion simply does not correspond to the current economic reality. The following chart shows the volatility in the average monthly stock prices of my proxy group and the average monthly Treasury yields from August 2014 to March 10, 2015:

[34] See the Rebuttal Testimony of Ms. Griffin, p. 11, line 22.

[35] See the Rebuttal Testimony of Ms. Griffin, p. 12, line 9.



From August 2014 to January 2015, my proxy group's average stock price increased 21% as the Treasury yield approached historic lows.

The question that must be answered is the following: did investors believe that the utility companies in my proxy group were growing at an extraordinary rate that justified this incredible price increase (21%), or was the increase in price a reaction to extremely low Treasury yields? If that increase in price was a reaction to extremely low Treasury yields, should analysts simply ignore these events and not take into consideration their impact on financial data used to determine the Company's ROE going forward?

I have already shown that my proxy group's average forecasted growth rates changed very little between November and January, so the likelihood that the price movements in the above chart were caused by influences external to investors' perceptions of the utility industry is extremely high.[36] Ms. Griffin also agrees that growth is not the driver of the current low dividend yields caused by these high stock prices.[37] However, when Ms. Griffin proposes that the reason for the increased stock prices and low dividend yields is simply that investors now require lower returns,[38] she is not giving enough consideration to the extraordinary reason why they are "requiring" these returns.

My adjustment to the dividend yield and my use of forecasted interest rates were conscious attempts to confront the interest-rate risk faced by the Company. To date, the underlying premise for those adjustments has corresponded to economic reality. As the Treasury yield has begun to increase in expectation of an increase in the federal funds rate, my proxy group's average stock price has dropped 9.8% since January—this movement is what my adjustment was intended to address.

Q. WHAT WAS YOUR PROXY GROUP'S AVERAGE DIVIDEND YIELD AT THE TIME YOU FILED DIRECT TESTIMONY?

A. 3.19%

[36] See the Direct Testimony of Mr. Schafer, p. 17, lines 1-2.

[37] See the Rebuttal Testimony of Ms. Griffin, p. 12, lines 1-2.

[38] See the Rebuttal Testimony of Ms. Griffin, p. 11, line 22.

Q. AT PRESENT, WHAT IS YOUR PROXY GROUP'S AVERAGE DIVIDEND YIELD?

A. As of March 11, 2015, my proxy group's average dividend yield was 3.70%. Therefore, the dividend yield has increased by 51 basis points.

Q. HOW MANY BASIS POINTS DID YOUR CALCULATED DIVIDEND YIELD ADJUSTMENT REPRESENT?

A. 60 basis points.

Q. DOES THIS INDICATE THAT YOUR CALCULATED DIVIDEND YIELD ADJUSTMENT WAS REASONABLE?

A. Yes, it does.

Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?

A. Yes.