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*Issues:* *Rate of Return/Capital Structure*  
*Witness:* *David Murray*  
*Sponsoring Party:* *MoPSC Staff*  
*Type of Exhibit:* *Surrebuttal Testimony*  
*Case Nos.:* *GR-2004-0209*  
*Date Testimony Prepared:* *June 14, 2004*

**MISSOURI PUBLIC SERVICE COMMISSION**  
**UTILITY SERVICES DIVISION**

**SURREBUTTAL TESTIMONY**

**OF**

**DAVID MURRAY**

**MISSOURI GAS ENERGY**

**CASE NO. GR-2004-0209**

*Jefferson City, Missouri*  
*June 2004*

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

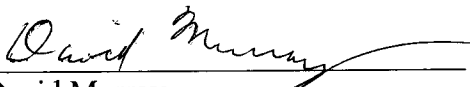
In the Matter of Missouri Gas Energy's       )  
Tariffs to Implement a General Rate       )  
Increase for Natural Gas Service       )

Case No. GR-2004-0209

AFFIDAVIT OF DAVID MURRAY

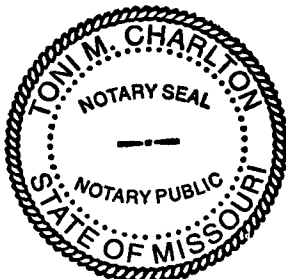
STATE OF MISSOURI       )  
                                      )  
COUNTY OF COLE       )       ss.

David Murray, being of lawful age, on his oath states: that he has participated in the preparation of the following surrebuttal testimony in question and answer form, consisting of 51 pages to be presented in the above case; that the answers in the following surrebuttal testimony were given by him; that he has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of his knowledge and belief.

  
\_\_\_\_\_  
David Murray

Subscribed and sworn to before me this 12th day of June 2004.

  
\_\_\_\_\_



TONI M. CHARLTON  
NOTARY PUBLIC STATE OF MISSOURI  
COUNTY OF COLE  
My Commission Expires December 28, 2004

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Surrebuttal Testimony of  
David Murray

1 Department will sponsor rebuttal testimony concerning the technical aspects of Mr.  
2 Gillen's rebuttal testimony. I will address Mr. Gillen's conceptual argument that no  
3 equity is attributable to Panhandle and how that is not possible from the perspective of an  
4 investor. I will not have a specific section in my testimony addressing Mr. Gillen's  
5 testimony and will address his position when discussing Mr. Dunn's position on the  
6 appropriate capital structure. Mr. Travis Allen sponsored rate-of-return direct and  
7 rebuttal testimony on behalf of the Office of the Public Counsel (OPC).

8 **Response to Dr. Morin's Rebuttal Testimony**

9 Q. Dr. Morin criticizes your heavy reliance on the Discounted Cash Flow  
10 (DCF) model in your analysis. Did you use any other models to check the reasonableness  
11 of your DCF recommendation?

12 A. Yes. I used the Capital Asset Pricing Model (CAPM) and the Risk  
13 Premium model to test the reasonableness of my DCF recommendation.

14 Q. What models did Mr. Dunn use in his analysis to arrive at his  
15 recommendation in this case?

16 A. Mr. Dunn relied on the DCF model to make his recommendation in this  
17 case.

18 Q. Did Mr. Dunn use any other models in his analysis in this case?

19 A. No. Mr. Dunn only used the DCF model. Mr. Dunn did not use any other  
20 models to test the reasonableness of his recommendation.

21 Q. Do you believe Dr. Morin would have made downward adjustments to  
22 Mr. Dunn's recommended cost of common equity?

1           A.     Yes. On page 48, lines 14 through 22, of his deposition, Dr. Morin  
2 indicated that he would make downward adjustments to a proxy group's estimated cost of  
3 common equity if the proxy group contains companies that have riskier, non-regulated  
4 operations. I addressed the riskier aspects of Mr. Dunn's comparable companies on page  
5 18, line 5 through page 21, line 5 of my rebuttal testimony. However, Mr. Dunn did not  
6 make any downward adjustments to consider this.

7           Q.     If the implication of Dr. Morin's criticism of your heavy reliance on the  
8 DCF is that this renders your results as not being credible, then what are the implications  
9 of this criticism on Mr. Dunn's testimony?

10          A.     It would render his recommendation as not being credible as well.

11          Q.     Do you believe that Mr. Dunn's analysis should be dismissed because of  
12 his sole reliance on the DCF model?

13          A.     No. However, as discussed in my rebuttal testimony, I have concerns with  
14 how Mr. Dunn determined the inputs for his DCF recommendation. Therefore, it is not  
15 the use of the DCF model that makes Mr. Dunn's recommendation unreasonable, but  
16 rather the inputs that Mr. Dunn used that make his recommendation unreasonable. I will  
17 also provide some "real world" observations that support the reasonableness of my  
18 recommendation versus Mr. Dunn's.

19          Q.     On page 6, lines 2 through 4, Dr. Morin criticizes your recommendation  
20 because it is "outside the zone of currently allowed rates of return for natural gas utilities  
21 in the United States and for his own sample of companies." How do you respond to this  
22 criticism?

1           A.     Dr. Morin is aware that allowed rates of return are not necessarily  
2 synonymous with the cost of capital to a utility. For reasons that may be specific to each  
3 case in which allowed rates of return are reported, it is possible that an allowed rate of  
4 return was set at some level that is above the cost of capital. I have recommended what I  
5 believe is the current cost of common equity for MGE in this proceeding based on the  
6 current capital and economic environment.

7           Q.     Dr. Morin listed allowed returns on equity (ROEs) for your comparable  
8 companies on page 10 and 11 of his rebuttal testimony. Do you think that this list of  
9 ROEs should have been qualified by Dr. Morin?

10          A.     Yes. The Commission's Financial Analysis Department subscribes to  
11 C.A. Turner Utility Reports. I have reviewed the May 2004 survey that Dr. Morin  
12 referenced to determine the allowed ROEs for these companies. Dr. Morin should have  
13 qualified his list with a statement that only one of the allowed ROEs had an indicated  
14 Commission Order date. The date of the order is important because it would provide  
15 context as to the capital and economic environment at the time of the order. The only  
16 allowed ROE with an indicated order date was New Jersey Resources' allowed ROE on  
17 January 1994, which is hardly relevant to today's low cost of capital environment. All of  
18 the other allowed ROEs do not indicate the date of the order (see attached Schedule 1).  
19 Dr. Morin's use of allowed ROEs without the order does not provide full context for the  
20 Commission. The Commission should make its decision in this case based on the facts  
21 provided to it about the current low cost of capital environment. Mr. Dunn freely  
22 admitted as much in his deposition. Quite frankly, we are in such a low cost of capital  
23 environment that without understanding the context of current interest rate levels as they

1 relate to history, may cause some to be a little uneasy about recommending lower costs of  
2 capital that actually reflect this environment.

3 Q. Did Dr. Morin indicate during his deposition that each Commission should  
4 have a “mind of its own” when recommending a reasonable rate of return for the utility it  
5 regulates?

6 A. Yes. Dr. Morin indicated the following in his deposition:

7 I think every Commission should have a mind of its own. We have  
8 a potential circularity problem if we focus strictly on what other  
9 commissions are doing. The authorized ROE is but one piece of  
10 the big giant puzzle here. If we were just to look at what other  
11 commissioners were doing, we'd be looking at sort of multiple  
12 mirror images of one another and nothing would ever change. So I  
13 think you have to go a little bit beyond that and look at the capital  
14 market data as well as authorized return.

15 Q. Did Dr. Morin appear to understand the context of the current lower level  
16 of interest rates in testimony given during his deposition on June 11, 2004?

17 A. I believe he understood that they are at historically low levels because he  
18 indicated on page 28, lines 1 through 2, that he did not think that long-term treasury  
19 yields were ever at 5 to 5½ percent prior to 1994.

20 Q. What were the yields on long-term treasuries in 1994?

21 A. Average monthly thirty-year U.S. Treasury Bonds yielded between 6.29  
22 percent to 8.08 in 1994 (see Schedule 5-2 attached to my direct testimony).

23 Q. Have long-term treasury yields ever been below the levels they are at right  
24 now?

25 A. Yes. It has been a while, but based on the 20-year U.S. Treasury yields,  
26 they were below their current level before 1966.

1           Q.     On page 11 through 13 of his rebuttal testimony, Dr. Morin argues for an  
2 adjustment to the recommended cost of common equity for flotation costs due to the  
3 issuance of common stock. Does Dr. Morin provide support that the issuances of  
4 common stock that Southern Union has made and will make in the future are a result of  
5 MGE's capital needs?

6           A.     No. Dr. Morin's flotation cost adjustment argument is a standard  
7 argument that he makes in every case for investor-owned utilities, as verified in his  
8 deposition at page 30, lines 10 through 13. The reason that Southern Union has had to  
9 issue and will continue to issue common stock is because of its leveraged situation  
10 resulting from the acquisition of Panhandle Eastern Pipe Line Company, LLC  
11 (Panhandle).

12          Q.     Did Dr. Morin admit during his deposition on page 31, line 13 through 16,  
13 that the Panhandle acquisition affected Southern Union's capital structure?

14          A.     Yes.

15          Q.     Dr. Morin indicates that you used a spot dividend yield in your dividend  
16 yield estimation. Is Dr. Morin correct in his assessment of how you determined the  
17 dividend yield in your analysis?

18          A.     No. A review of Schedule 18 shows that I averaged the expected dividend  
19 for 2003 and 2004 to determine an appropriate dividend yield to use in my cost of  
20 common equity recommendation. This dividend yield includes the 2004 projected  
21 dividend. Even if I applied a growth rate factor to a spot dividend yield, I would not  
22 agree that a 6 percent growth in the dividend would be reasonable to expect for my  
23 comparable companies.

1 Q. Does Dr. Morin contradict anything in his textbook, Regulatory Finance:  
2 Utilities' Cost of Capital, 1994, when he indicates on page 14, line 4 through 6 of his  
3 rebuttal testimony that “the appropriate dividend to use in the plain vanilla annual DCF  
4 model is the prospective dividend one year from now, rather than the current dividend  
5 yield...?”

6 A. Yes. On page 139 of his textbook, Dr. Morin states that “...it is the  
7 dividend that an investor who purchases the stock today expects a company to pay during  
8 the next 12 months that should be used...” This is important to note this because I  
9 criticized Mr. Dunn for adjusting a dividend that had already been adjusted to take into  
10 consideration the dividend that is expected to be received over the next 12 months.

11 Q. Did Dr. Morin confirm in his deposition that Value Line’s dividend yield  
12 already contemplates the estimated cash dividends to be paid over the next 12 months?

13 A. Yes. On page 43, lines 21 through 25 he confirms that this is the case.

14 Q. Is this the dividend yield that Mr. Dunn made a further adjustment to in  
15 order to estimate next year’s dividend in his direct testimony?

16 A. Yes.

17 Q. Dr. Morin indicates that you should have used the quarterly DCF model.  
18 What DCF model did Mr. Dunn use in his analysis?

19 A. Mr. Dunn used the annual DCF model just as I did. However, his results  
20 are already adjusted upward because of the high growth rate he recommends and because  
21 of all of his upward adjustments. It is not the form of the model that concerns Dr. Morin,  
22 it is the results achieved from the application of the model. As Dr. Morin knows, it is the

1 end result that is judged as reasonable and neither Dr. Morin nor Mr. Dunn provided  
2 anything that gives insight as to what investors are requiring on their investments.

3 Q. Dr. Morin criticized your use of four months of stock prices in order to  
4 determine your recommended dividend yield because it is “stale” and “violates the  
5 efficient market hypothesis.” How do you respond?

6 A. It is interesting to note that the original intent of the DCF model  
7 (sometimes referred to as the “dividend growth model” in college finance textbooks) was  
8 to determine a reasonable price to pay for a stock at a specific point in time. It appears  
9 that, based on the original intent of the DCF model, the use of a spot price is appropriate.  
10 When setting rates for a utility, which may be applied over an extended period, it would  
11 appear to be appropriate to determine the cost of common equity based on a company’s  
12 stock prices over some longer period. This lends support to my use of four months of  
13 stock prices, instead of determining the cost of common equity based on the current price  
14 of the security at the time of estimating the cost of common equity. The current price of  
15 the security may reflect either a temporary decreased or increased cost of common equity.  
16 Furthermore, statistically speaking, it is better to have a larger sample size when  
17 calculating an average.

18 Q. On page 18, line 10 through page 19, line 5, of his rebuttal testimony,  
19 Dr. Morin explains why you shouldn’t have considered negative growth rates in  
20 estimating your projected growth rates. Do you agree that you shouldn’t consider  
21 negative growth rates?

22 A. No. Dr. Morin states that negative growth rates should be excluded from  
23 any DCF analysis. While I agree that investors will not expect energy utilities to grow at

1 a negative growth rate forever, I do not agree that investors, and hence rate-of-return  
2 witnesses, should not take such growth rates into consideration. To do otherwise would  
3 be irresponsible. An investor should not pretend negative growth rates have not occurred  
4 and will not occur again. An investor should take into consideration these negative  
5 growth rates when estimating a reasonable sustainable growth rate for that investment. If  
6 a rate-of-return witness disregards negative growth rates, then that witness will  
7 recommend a higher dividend yield without considering that the reason for that higher  
8 dividend yield is because of lower growth rate expectations. The exclusion of negative  
9 growth rates results in a recommendation that not only has a higher growth rate, but a  
10 higher dividend yield because previous growth rates did not meet expectations so  
11 investors drove the price of the stock down.

12 It should be noted that I also included higher growth rates as well as lower  
13 growth rates in my averages in order to fully evaluate all of the growth rates. Dr. Morin's  
14 logic that investors do not expect energy utilities to grow at a negative growth rate  
15 forever also applies to the higher growth rates in my averages. However, because I  
16 included the negative growth rates, I also included the higher growth rates.

17 Q. How do you respond to Dr. Morin's allegation on page 19, lines 10  
18 through 11 that you used historical growth rates ending in 2002 with the intent of  
19 achieving certain results?

20 A. This is an incorrect allegation. In order for a growth rate to be classified  
21 as an historical growth rate, it would have to have an ending point that has actually  
22 occurred. At the time I filed my testimony on April 15, 2004, the Financial Analysis  
23 Department had not received the April 2004 Value Line CD-ROM that contained a

1 majority of the actual 2003 dividends per share (DPS), earnings per share (EPS) and book  
2 value per share (BVPS) information. The only information that was available to our  
3 Department at the time of the study was the estimated 2003 information. In order for the  
4 growth rates that I calculated to be considered historical, they would have to have  
5 actually occurred. I have attached an email from Value Line as Schedule 2 that indicates  
6 the exact date Value Line sent the April CD-ROM to our Department that contained  
7 actual rather than estimated information for 2003. As shown on the attached email, the  
8 April Value Line CD was mailed on April 20, 2004, which was after Staff's filing date of  
9 April 15, 2004. Also attached are the Value Line tear sheets, Schedules 3-1 through 3-8,  
10 from the March 2004 Value Line CD, which shows that a majority of the 2003  
11 information from this CD was estimated information, which is in bold font. The Value  
12 Line tear sheets, Schedules 4-1 through 4-8, from the April 2004 Value Line CD are also  
13 attached to show that a majority of the information on this CD was actual information.

14 Q. Did this issue come up in your deposition on May 4, 2004 as well?

15 A. Yes. On page 91, line 9 through 22 of my deposition, the following  
16 exchange occurred between Mr. Eric D. Herschmann and myself:

17 Q. ValueLine cut you off in April of 2004?

18 A. ValueLine never cut us off. It was the information we had  
19 when we were doing the study.

20 Q. You have access to ValueLine whenever you want, right?

21 A. Yes.

22 Q. You could have access to ValueLine whenever you want,  
23 right?

24 A. Yes, we do.

1 Q. And if ValueLine had come out with more recent numbers prior  
2 to your submitting and preparing your testimony, you still didn't  
3 make the effort to use those calculations, right?

4 A. No.

5 Q. Which Value Line CD did you have available at the time you performed  
6 your study?

7 A. The March 2004 CD.

8 Q. Mr. Allen was able to obtain the actual 2003 data for his study. Are you  
9 aware of how he was able to do so since he relied on Value Line as well?

10 A. Yes. Mr. Allen was able to obtain actual 2003 data by updating the data  
11 through Value Line's website. I was not aware that this data could be updated through  
12 Value Line's website. I relied on the most recent CD that was sent to our Department,  
13 which as shown on Schedule 2, wasn't sent until April 20, 2004.

14 Q. Even if you had calculated historical growth rates with actual 2003 data,  
15 would this change your recommendation?

16 A. No. The upper end of my recommended growth rate range falls within the  
17 range of projected growth rates indicated in columns (2), (3) and (4) on Schedule 16  
18 attached to my direct testimony. The projected growth rates indicated in columns (2) and  
19 (3), 4.81 percent and 4.75 percent, are consistent with the average Thomson Financial  
20 expected growth rates of 4.90 percent indicated on page 43 of Mr. Dunn's direct  
21 testimony. Therefore, I had already decided to give more weight to the projected growth  
22 rates than the historical growth rates in my analysis and still believe this is appropriate.

23 Q. What are the date of the references that you utilized for your projected  
24 growth rates?

1           A.     All of my projected growth rates are from sources published either in late  
2     2003 or early 2004.

3           Q.     Why do you believe it is important to specify what data you reviewed to  
4     calculate the historical growth rates?

5           A.     Because in the *Memorandum of Law of Missouri Gas Energy, A Division*  
6     *of Southern Union Company, In Support of Its Motion To Exclude Certain Testimony And*  
7     *Opinions of David Murray* filed on May 18, 2004 there is an assertion that the techniques  
8     used in my analysis are “driven by the result-oriented desire to keep MGE’s rate of return  
9     as low as possible.” The memorandum discusses my calculation of historical growth  
10    based on 2002 actual historical data as one such example. Dr. Morin reiterates the same  
11    accusation on page 19, lines 10 through 11 of his rebuttal testimony.

12          Q.     Do you agree with Dr. Morin’s position that dividend growth is an  
13    inappropriate proxy to use for estimating future growth for purposes of the DCF model?

14          A.     No. I agree that using dividend growth as the only proxy for future  
15    growth would be inappropriate, but I do not agree that the use of dividend growth along  
16    with book value growth and earnings growth is inappropriate. Many times historical  
17    dividend growth and future dividend growth can be used as a “check” on the  
18    reasonableness of earnings growth projections. If a company’s management does not  
19    believe that some of the earnings forecasts for its company are sustainable, then they will  
20    not recommend that the dividends be grown at the same rate as earnings. This provides  
21    some insight as to the long-term sustainable growth rate of the company. Dividends also  
22    can give some indication as to whether the earnings of the company are “real.” This has  
23    been an issue recently where many companies have either, fraudulently or through

1 accounting manipulations, inflated earnings. Therefore, dividends are still pertinent to  
2 investors in estimating the future growth of the company. This is especially true for  
3 traditional regulated utilities, in which dividends are one of the main investor attractions  
4 to such companies.

5 Q. Did Dr. Morin analyze the recent historical dividend payout ratios of your  
6 comparable companies, which would have been more relevant then just making general  
7 comments about the “energy utility” industry, which could include a wide array of  
8 companies?

9 A. No. In his deposition on June 10, 2004, page 28, line 17 through page 27,  
10 line 16, Dr. Morin explains how he came to the conclusion that the dividend payout is  
11 decreasing for my comparable companies. He did not look at the specific payout ratio  
12 trends for my comparable companies. He relied on EPS and DPS growth rates to arrive  
13 at his conclusion. My review of the payout ratios of my comparable companies showed  
14 that the payout ratios have increased for some of the companies, decreased for some of  
15 the companies and increased and decreased for some of the companies. Companies in the  
16 broad “energy utility” industry could include companies that have reduced their  
17 dividends to pursue non-regulated businesses. I believe if a witness is using companies  
18 that are experiencing this trend, then the companies chosen may not be appropriate to  
19 estimate the cost of common equity for a regulated natural gas distribution utility.

20 Q. On page 23, lines 7 through 10 of his rebuttal testimony, Dr. Morin claims  
21 that “[h]istorical growth rates have little relevance as proxies for future long-term growth.  
22 They are downward-biased by the sluggish earnings performance in the last five years,  
23 due to the structural transformation of the energy utility industry from a regulated

1 monopoly to a competitive environment.” Does the five-year historical EPS growth rate  
2 that Mr. Dunn relied on for his recommended growth rate of 6 to 7 percent confirm this  
3 statement?

4 A. No. When referring to his calculated 5-year historical EPS growth rate of  
5 7.18 percent, Mr. Dunn states the following: “[t]he data for the five year term is  
6 distinctly different from the ten year data. The earnings growth rate has increased  
7 significantly.” Mr. Dunn appears to rely on this 5-year historical growth rate for the  
8 upper end of his recommended growth rate range along with Value Line’s projected EPS  
9 growth rate of 6.93 percent.

10 Q. Did Dr. Morin indicate anything in his deposition about Value Line’s  
11 forecasts that raise some concern about Mr. Dunn’s heavy reliance on these growth rate  
12 projections?

13 A. Yes. Dr. Morin indicated the following:

14 Value Line is rather robust in their forecast of earnings growth for  
15 LDCs, for gas LDCs as compared to the consensus forecast of  
16 analysts that you find perhaps in Thompson or First Call or Yahoo  
17 Finance or any of the websites.

18 Q. How do you respond to Dr. Morin’s proposal on page 27, lines 8  
19 through 9, that historical growth rates and dividend forecasts should be dismissed?

20 A. Much the same way I do to just blindly dismissing negative growth rates.  
21 All of these growth proxies can be useful if critically analyzed by the analyst. I would  
22 not indicate that Mr. Dunn should just blindly dismiss the 7.18 percent 5-year historical  
23 EPS figure that he calculated on Schedule JCD-4. However, I think that he would want  
24 to critically analyze this growth rate to determine if the growth rate is reasonable when  
25 considering all of the other growth proxies that he reviewed. To rely on proxies that only

1 support the highest growth rates possible is not how prudent investors would evaluate a  
2 potential investment.

3 Q. Dr. Morin indicates that you have a fundamental problem with your risk  
4 premium model estimates because your cost of common equity developed from your  
5 DCF model does not match investors' expected return on equity used in your risk  
6 premium analysis. How do you respond to this criticism?

7 A. I believe Dr. Morin's criticism shows why Staff does not give much  
8 weight to the risk premium model when recommending a return on equity for a Missouri  
9 utility. The DCF model estimates the cost of common equity to the company. The cost  
10 of common equity is the investors' required rate of return, which may or may not be  
11 equivalent to the expected return on common equity of the investor. If an investor  
12 continues to expect a return on equity that is higher than the cost of common equity, then  
13 this may mean that the utility is in an overearnings situation. I have explained this before  
14 by using Staff's 2002 earnings complaint against AmerenUE as an example. Investors in  
15 AmerenUE may have expected that AmerenUE would continue to earn a certain return  
16 on common equity over AmerenUE's cost of common equity, but it wasn't until the  
17 Commission recognized AmerenUE's lower cost of common equity that investors'  
18 expected returns on common equity were ratcheted down. The same analogy can apply  
19 to the use of the Risk Premium model. This is why Staff only uses this model to check  
20 the reasonableness of its DCF results.

21 Q. What are the consequences of Dr. Morin's comment on page 29, lines 18  
22 through 19, about the return on common equity being set equivalent to the expected  
23 return on common equity?

1           A.     Dr. Morin's proposition is that commissions' allowed returns should be  
2 driven by what investors have come to expect and not based on the capital and economic  
3 environment which reflects a lower cost of capital. This would be as circular as  
4 recommending a cost of common equity based on past allowed returns in other  
5 jurisdictions. If a situation like this were to hold true in the real world, then investors  
6 would continue to expect the high returns on their investments that they received in the  
7 late 1990s and early 2000. As all real world investors know, this is not how investing  
8 works. It would only be natural that investors should expect that eventually regulatory  
9 commissions are going to start to recognize the lower cost of capital in the returns they  
10 allow their utilities.

11           Q.     Dr. Morin indicates that the risk-free rate you used in your study is "stale."  
12 When did you prepare the study that is the subject of this criticism?

13           A.     The study that I performed to recommend a cost of common equity was  
14 completed some time during March 2004. The only average monthly risk-free rate that I  
15 had available at the time of the study was February 2004. Because rates can fluctuate up  
16 or down from month-to-month, it is only appropriate for the analyst to choose some  
17 ending point in order to arrive at his recommendation. Just as the company witnesses had  
18 the advantage of knowing what happened to interest rates since the direct testimony was  
19 filed by Staff, I had the advantage of knowing what had happened to interest rates since  
20 Mr. Dunn filed direct testimony because he filed testimony five months before I did.  
21 However, in my rebuttal of Mr. Dunn, I tried to be mindful of this.

22           Q.     On page 32, line 19 through page 33, line 15 of his rebuttal testimony,  
23 Dr. Morin indicates that you used the wrong historical risk premium because you used

1 the total return for long-term government bonds rather than just the income return on the  
2 government bonds. Is an investor in government bonds only going to receive a return  
3 based on the coupon of the bond, which is the income from the interest rate stated on the  
4 bond?

5 A. Only if the investor holds the bond until maturity and bought the bond at  
6 par value. Otherwise investors will receive a total return, which is based on changes in  
7 the price of the bond and reinvestment returns. Therefore, it is appropriate to measure the  
8 market risk premium by comparing total returns on stocks versus total returns on risk-free  
9 treasuries because this is what investors will expect to receive.

10 Q. Dr. Morin indicates that Ibbotson Associates recommends the use of the  
11 income return rather than the total return because the “income component of total bond  
12 return (i.e. coupon rate) is a far better estimate of expected return than the total return (i.e.  
13 coupon rate + capital gain), as realized capital gains/losses are largely unanticipated by  
14 investors.” Is this your understanding as to why Ibbotson Associates recommends the use  
15 of the income return rather than the total return?

16 A. No. My understanding of Ibbotson Associates’ justification for the use of  
17 the income return rather than the total return is that they consider this to be the true  
18 “riskless portion of the return.”

19 Q. Dr. Morin criticizes your CAPM analysis that uses a short-term historical  
20 period because “historical risk premiums are only reflective of prospective risk premiums  
21 if measured over long periods.” Do you agree with this statement?

22 A. Yes. I did not give the short-term risk premium CAPM results any weight  
23 in arriving at my recommended cost of common equity. I stated that the long-term risk

1 premium CAPM results supported the upper end of my DCF analysis and, therefore, I  
2 gave this CAPM result more weight in my analysis. However, as I indicated in my direct  
3 testimony, the results from the short-term risk premium CAPM should not be ignored  
4 because it provides insight as to what has actually occurred in the equity markets and  
5 treasury bond markets. This short-term risk premium CAPM shows that stock market  
6 returns from 1993 through 2002 were actually lower than the returns on long-term U.S.  
7 Treasury bonds.

8 Q. Does Dr. Morin's criticisms about the use of the short-term risk premium  
9 period for the application of the CAPM contradict some of his other criticisms of your  
10 analysis?

11 A. Yes. Dr. Morin indicated that I should have used a current stock price  
12 rather than a four-month average of stock prices in my application of the DCF model  
13 because it reflects the most current investors expectations. As Dr. Morin pointed out in  
14 his criticism of my use of a short-term risk premium period in my application of the  
15 CAPM, investors expected returns over a longer period of time are going to be different  
16 than over a shorter period of time. This is exactly why it is important to look at an  
17 average of stock prices over some longer period of time so the rate of return witness can  
18 estimated investors' required rates of return over some longer period.

19 Q. Does Dr. Morin's criticism of your analysis of a short-term risk premium  
20 CAPM contradict any other part of his criticisms of your analysis?

21 A. Yes. Beginning on page 35 of his rebuttal testimony, Dr. Morin discusses  
22 his thirteenth criticism of my analysis. Dr. Morin claims that instead of looking at a  
23 longer period (nine years) to determine the risk premium investors require to invest in

1 Moody's Baa-rated utility bonds versus Moody's A-rated utility bonds, he believes I  
2 should have used the current spread between these ratings for my risk premium  
3 adjustment. If Dr. Morin believes it is appropriate to look at a longer period to evaluate  
4 the risk premium required when executing the CAPM, then one would believe that he  
5 would have the same position when measuring the risk premium investors require to  
6 invest in Moody's Baa-rated bonds rather than Moody's A-rated bonds.

7 Q. Dr. Morin indicates that the historical market risk premium that you used  
8 is not current based on the up-to-date 2004 edition of the Ibbotson Yearbook. Is this an  
9 accurate statement?

10 A. Yes. At the time Staff produced its study it only had a copy of the 2003  
11 edition of the Ibbotson Yearbook. The 2004 Yearbook is currently on order from  
12 Ibbotson.

13 Q. When did Ibbotson start sending the new edition of the Yearbook out to  
14 entities and individuals that ordered it?

15 A. It would have been sent sometime towards the end of March.

16 Q. When were you completing the study on the cost of capital for MGE?

17 A. It would have been toward the end of March to early April in order to have  
18 time for review by assigned attorneys and case coordinators.

19 Q. If you had received the 2004 Yearbook when you did your analysis, would  
20 this have changed your recommendation?

21 A. No. I was comfortable with my DCF recommendation that included  
22 historical growth rates and recent projected growth rates from various analysts. I decided  
23 to give more weight to the projected growth rates in my recommendation as can be

1 derived from the fact that the upper end of my recommendation falls above the higher  
2 end of a couple of the average projected growth rates indicated on Schedule 16 attached  
3 to my direct testimony. It is clear that I did not give the historical growth rates as much  
4 weight because the lower end of my projected growth rate range is over a 100 basis  
5 points higher than the average historical growth rates that I calculated in column (1).

6 Q. On page 34, line 22 through page 18, line 18 of his rebuttal testimony,  
7 Dr. Morin claims that you should have used the empirical CAPM. Do all financial texts  
8 suggest that it is appropriate to used the empirical CAPM?

9 A. No. The textbook by Aswath Damodaran, INVESTMENT  
10 VALUATION: Tools and Techniques for Determining the Value of Any Asset, 1996,  
11 which is a textbook used in the curriculum for students seeking the Chartered Financial  
12 Analyst (CFA) designation, does not recommend any adjustment to beta for the CAPM.  
13 This textbook follows the traditional execution of the CAPM throughout the text. Many  
14 individuals that are pursuing their CFA designation may either work in the investment  
15 field or intend to work in the investment field. Consequently, CFAs that are or will be  
16 making real world investment decisions have been taught the traditional CAPM.

17 Q. In his fourteenth criticism of your analysis starting on page 36 of his  
18 rebuttal testimony, Dr. Morin maintains that you didn't allow an adjustment to consider  
19 the riskier capital structure that you attribute to MGE. Is this correct?

20 A. No. I explained my upward adjustment of 32 basis points that I made to  
21 my recommendation in my direct testimony. This upward adjustment of 32 basis points  
22 takes into consideration the entire risk differential, both financial and business risk,  
23 between MGE and the proxy group that I used. The upward adjustment of 32 basis

1 points was based on the credit rating difference between Southern Union (BBB) and the  
2 proxy group (A). When evaluating the creditworthiness of a company, credit rating  
3 agencies perform a comprehensive evaluation of all of the risks to the company, which  
4 includes the financial risk and the business risk. The financial risk is the component of  
5 risk that is a function of the capital structure of the company. Therefore, by relying on a  
6 third party that performs this comprehensive analysis, I believe that I have adequately  
7 considered the increased risk due to my recommended capital structure.

8 Q. Do you have any evidence that supports the reasonableness of your  
9 recommended cost of common equity as it relates to the required risk premium because  
10 of Southern Union's leverage capital structure?

11 A. Yes. I have been tracking the yield on Southern Union's preferred stock,  
12 which is listed in the *Wall Street Journal*, since I filed direct testimony in this case.  
13 Southern Union issued this preferred stock in October 2003 at a coupon of 7.55 percent.  
14 Because of the attractiveness of this coupon, investors have bid the price up of the \$25  
15 stated par value preferred stock. This results in a lower required yield to investors that  
16 purchase Southern Union's preferred stock at the higher price. Since I have been  
17 tracking the yield on Southern Union's preferred stock, it has ranged between 7.1 percent  
18 to 7.3 percent.

19 Q. Why is it important to consider the required yield on Southern Union's  
20 preferred stock?

21 A. Because investors in Southern Union's preferred stock are subordinate to  
22 Southern Union's debt holders. Southern Union's preferred stock holders do not receive  
23 dividends on their preferred stock investment until the interest has been paid on Southern

1 Union's debt. This is of course if the Board of Directors declares such a dividend to be  
2 paid. The preferred stock holders would also be "next in line" to Southern Union's debt  
3 holders if Southern Union were to ever file for bankruptcy.

4           Consequently, the yield on Southern Union's preferred stock indicates the  
5 risk premium that the preferred stock investors are requiring because of Southern Union's  
6 leveraged capital structure. While I do not know precisely how much additional risk  
7 premium Southern Union common stock holders will require over the required yield on  
8 Southern Union's preferred stock, I do believe that my recommended cost of common  
9 equity of 8.52 percent to 9.52 percent is much closer to this required risk premium than  
10 Mr. Dunn's recommended cost of common equity of 12 percent. The midpoint of my  
11 recommendation represents approximately a 180 basis point risk premium over the  
12 required yield on Southern Union's preferred stock, whereas Mr. Dunn's recommended  
13 cost of common equity represents approximately a 480 basis point risk premium. As I  
14 will explain in more detail later in my surrebuttal testimony, when considering the fact  
15 that well known academicians and investors believe that the equity risk premium that the  
16 market requires over the Ten-Year U.S. Treasury is only 300 basis points, I believe this  
17 provides a tremendous amount of insight as to the reasonableness of my recommendation  
18 even in light of the leveraged capital structure that I am recommending for MGE.

19           Q.     Did Dr. Morin consider the current yield on Southern Union's preferred  
20 stock when considering the reasonableness of your recommendation in this case?

21           A.     No. He indicated he did not know the currently yield on Southern Union's  
22 preferred stock in his deposition, on page 35, line 3.

1           Q.     Do you think it is important to consider this type of information when  
2 determining the reasonableness of a recommended cost of common equity?

3           A.     Yes. As Dr. Morin recognized during his deposition when he stated that  
4 the End Result Doctrine of the *Hope* case indicates that the “methodology is really sort of  
5 immaterial if the end result is reasonable to both the consumer and the investor.” I  
6 believe the current yield on Southern Union’s preferred stock provides insight as to the  
7 reasonableness of my recommendation in this case.

8           **Response to Mr. Dunn’s Rebuttal Testimony**

9           Q.     On page 6, line 20 through 21, Mr. Dunn refers to your recommended  
10 common equity ratio as an “artificially” low equity ratio. Is your recommended common  
11 equity ratio in this case artificial?

12          A.     No. My recommended common equity ratio in this proceeding is the  
13 equity ratio that investors and credit rating agencies analyze when evaluating Southern  
14 Union’s operations. Credit rating agencies and investors do not evaluate the contrived  
15 equity ratio that Mr. Dunn is recommending in this case. Although Staff witness Mark L.  
16 Oligschlaeger is addressing the technical accounting aspects of Mr. Gillen’s rebuttal  
17 testimony in this case, there is one key sentence in Mr. Gillen’s rebuttal testimony that  
18 demonstrates the fact that a certain amount of common equity is associated with the  
19 Panhandle operations. On page 7, line 10 through 12 of his rebuttal testimony,  
20 Mr. Gillen states that Southern Union’s stand-alone equity represents all of Southern  
21 Union’s shareholder value, which includes Panhandle, because he indicates that  
22 Panhandle’s stand-alone equity was eliminated when Southern Union acquired  
23 Panhandle. Therefore, it is only logical to conclude that a certain amount of that equity

1 should be assigned to the Panhandle operations, regardless if Southern Union's witnesses  
2 believe that the process that I employed on page 21, line 18 through page 22, line 9 of my  
3 direct testimony is not the proper amount of equity to exclude. Mr. Dunn's capital  
4 structure recommendation is based on the premise that when an investor purchases a  
5 share of Southern Union common stock, this only represents an ownership interest in  
6 Southern Union's natural gas distribution operations. Mr. Gillen's statement about the  
7 fact that a share of Southern Union represents a share in all of its operations completely  
8 discredits Mr. Dunn's capital structure recommendation. In fact, I believe that  
9 Mr. Dunn's failure to specify in his direct testimony the type of Panhandle capital that he  
10 excluded from his recommended capital structure illustrates Mr. Dunn's own realization  
11 of the weakness of his position.

12 Q. Why do you believe Mr. Dunn chose to use the process he did to arrive at  
13 his recommend capital structure for MGE?

14 A. Because in the last case, Case No. GR-2001-292, Mr. Dunn recommended  
15 a hypothetical capital structure for MGE. In that case Staff demonstrated in its rebuttal  
16 testimony how such a capital structure recommendation indirectly resulted in a higher  
17 cost of capital recommendation because of Southern Union's increased leverage due to its  
18 acquisition of the New England properties. Staff deemed this to be in violation of  
19 Condition 6 placed on Southern Union in its applications to acquire these properties in  
20 Case Nos. GM-2000-500, GM-2000-502, GM-2000-503 and GF-2000-504. The  
21 condition was as follows:

22 Southern Union will not seek an increase in Cost of Capital for  
23 MGE as a result of this transaction. Any increases in the Cost of  
24 Capital Southern Union seeks for MGE will be supported by  
25 documented proof: that the increases are a result of factors not

1 associated with this transaction; that the increases are not a result  
2 of changes in business, market, economic, or other conditions for  
3 MGE caused by this transaction; or that the increases are not a  
4 result of changes in the risk profile of MGE caused by this  
5 transaction. Southern Union will ensure that the rates for MGE  
6 ratepayers will not increase as a result of this transaction.

7 This same condition, with some modifications, was placed on Southern Union in the  
8 Stipulation and Agreement filed in the Panhandle acquisition case, Case No.  
9 GM-2003-0238, as well. The exact condition was as follows:

10 Southern Union will not recommend an increase or claim Staff  
11 should make an adjustment to increase the cost of capital for MGE  
12 as a result of the Transaction. Any increases in cost of capital  
13 Southern Union seeks for MGE will be supported by documented  
14 proof: (1) that the increases are a result of factors not associated  
15 with the Transaction; (2) that the increases are not a result of  
16 changes in business, market, economic or other conditions for  
17 MGE caused by the Transaction; or (3) that the increases are not a  
18 result of changes in the risk profile of MGE caused by the  
19 Transaction. Southern Union will ensure that the retail distribution  
20 rates for MGE ratepayers will not increase as a result of the  
21 Transaction.

22 Q. What was Mr. Dunn's justification for proposing a hypothetical capital  
23 structure in the last rate case, Case No. GR-2001-292?

24 A. In his direct testimony in that case on page 17, line 28, through page 18,  
25 line 11, Mr. Dunn provided the following justification for using a hypothetical capital  
26 structure:

27 Q. Why is the Southern Union consolidated capital structure  
28 inappropriate for use in determining the revenue  
29 requirement for MGE?

30 A. A consolidated capital structure is only the summation of  
31 the financing of all of the individual division and subsidiary  
32 activities of a company, plus or minus accounting  
33 eliminations. With a diversified company such as Southern  
34 Union, the consolidated capital structure bears no particular  
35 relationship to any one of the individual lines of business.

1 Southern Union operates several natural gas distribution divisions.  
2 It also has investments in the non-utility business. It is these  
3 investments which diversify the capital arrangements of the  
4 company and combined with the appropriateness of adequate  
5 divisional accounting require the implementation of a division  
6 capital structure system. These non-utility investments are  
7 relatively recent commitments of the company in terms of their  
8 significance.

9 Q. What is Mr. Dunn's assessment of Southern Union's operations in this  
10 case?

11 A. On page 18, lines 1 through 14 of his rebuttal testimony, Mr. Dunn  
12 provides the following description of Southern Union:

13 Southern Union is a complicated company with different capital  
14 demands by different divisions and subsidiaries. It is comprised of  
15 two major business activities. The first is the distribution business,  
16 which in turn is comprised of a series of divisions operating in  
17 different states and jurisdictions. The second major business of  
18 Southern Union, the Panhandle Eastern pipeline operation, is  
19 entirely different. The Panhandle Eastern operations have different  
20 risks and, consequently, different capital mix requirements. The  
21 consolidated capital structure approach assumes that those  
22 responsible for financial decisions at Southern Union do not use  
23 contemporary financial theories and do not approach the matter  
24 seriously, a view which is beyond a doubt inappropriate and  
25 incorrect.

26 Therefore, it appears that Mr. Dunn now recognizes that the main business  
27 segment of Southern Union before its acquisition of Panhandle was natural gas  
28 distribution.

29 Q. Mr. Dunn claims that the Panhandle operation is "entirely different" than  
30 Southern Union's natural gas distribution operations. Does this contradict Southern  
31 Union's position regarding tax treatment of the sale of its Texas natural gas distribution  
32 operations to fund its purchase of the Panhandle operations?

1           A.     Yes. In its 2003 Annual Report, Southern Union indicated that it  
2 structured the "...Panhandle Energy acquisition and the sale of its Texas operations to  
3 qualify as a like-kind exchange under Section 1031 of the Internal Revenue Code of  
4 1986." The Internal Revenue Service defines properties of like-kind as: "[p]roperties are  
5 of like-kind, if they are of the same nature or character, even if they differ in grade or  
6 quality." Therefore, for purposes of justifying the use of different capital structures for  
7 ratemaking, Southern Union argues that its operations should be considered different, but  
8 for purposes of tax treatment, it argues the operations should be considered the same.

9           Q.     How does S&P currently view the business position of Southern Union on  
10 a consolidated basis and Panhandle on a stand-alone basis?

11          A.     In a recent research report issued by S&P on June 2, 2004, "New Business  
12 Profile Scores Assigned for U.S. Utility and Power Companies; Financial Guidelines  
13 Revised," S&P assigned a business profile of a "3" to both Southern Union on a  
14 consolidated basis and to Panhandle on a stand-alone basis. This essentially indicates  
15 that S&P now views the Panhandle operations and Southern Union's natural gas  
16 distribution divisions as having equivalent business risk. Before S&P's release of the  
17 research report on June 2, 2004, S&P had assigned a business position of a "4" to  
18 Southern Union. Before Southern Union had acquired Panhandle they were assigned a  
19 business position of "3," implying that the acquisition of Panhandle caused additional  
20 business risk for Southern Union on a consolidated basis.

21          Q.     What is the implication of S&P's assignment of a business profile of "3"  
22 to both Southern Union on a consolidated basis and Panhandle on a stand-alone basis?

1           A.     The implication is that the use of the consolidated capital structure for cost  
2 of capital purposes is appropriate. S&P's business profile assignment indicates that they  
3 don't view Southern Union's natural gas distribution divisions and Panhandle as being  
4 "entirely different." In fact the implication of each operation being assigned the same  
5 business profile is that the benchmark capital structures that S&P would compare  
6 Southern Union and Panhandle to would be the same.

7           Q.     What was the implication of S&P's previous decision to raise the business  
8 profile of Southern Union to a "4" from a "3" after it acquired Panhandle?

9           A.     Financial theory indicates that the higher the business risk of the  
10 operation, the less financial risk, i.e. increased leverage, the operation can endure. This is  
11 why S&P requires more stringent financial ratios for companies that have a higher  
12 business profile. Therefore, based on S&P's previous position on the business profile of  
13 Southern Union and Panhandle, if Southern Union had been adhering to financial theory  
14 regarding the assignment of capital, then Southern Union would have been allocating a  
15 larger percentage of its consolidated common equity balance to the Panhandle operations.  
16 However, because S&P now views each operation as having similar business risk, the use  
17 of the consolidated capital structure is even more appropriate. This refutes Mr. Dunn's  
18 claim that this is a "complicated" company.

19          Q.     Did Mr. Dunn indicate anything in his deposition on May 6, 2004 that  
20 validates the use of the consolidated capital structure if the business risks of all of the  
21 company's operations are fairly similar?

22          A.     Yes. On page 21, beginning on lines 6, Mr. Dunn indicates the following:

23                   In a simple day, companies many years ago were relatively simple,  
24                   single lines of business and have maybe a tiny little subsidiary.

1 Water company has a water testing subsidiary, no problem. Or  
2 even somebody like American Waterworks, which has a number of  
3 water company subsidiaries, consolidated might work simply  
4 because they're comprised of 15 companies that are virtually  
5 identical and all probably capitalized at least similarly. The same  
6 for AT&T when it was the dominant telephone company.

7 Q. Has Mr. Dunn been consistent before with his position described above?

8 A. Yes. When Mr. Dunn represented the Platte County Intervenors in Case  
9 No. WR-95-205, *In the matter of Missouri-American Water Company's tariff revisions*  
10 *designed to increase rates for water service provided to customers in the Missouri*  
11 *service area of the company* and Case No. SR-95-206, *In the matter of Missouri-*  
12 *American Water Company's tariff revisions designed to increase rates for sewer service*  
13 *provided to customers in the Missouri service area of the company*, Mr. Dunn  
14 recommended American Water's consolidated capital structure because he maintained  
15 that the subsidiary capital structure contained "phantom equity."

16 Q. Is Mr. Dunn being consistent with this position now?

17 A. No. Because S&P now views Southern Union's pipeline operations and  
18 distribution operations as being equivalent in business risk, it would seem that if  
19 Mr. Dunn were to be consistent with his view expressed in his deposition and with the  
20 position he took in a previous case with this Commission, he would recommend the  
21 consolidated capital structure.

22 Q. Considering all of the discussion about what Southern Union's capital  
23 structure would be without the Panhandle operations, what do you conclude about  
24 recommending a capital structure other than the consolidated capital structure when  
25 recommending a rate of return for a utility that is a division of an operating company?

1           A.     The only capital structure that is truly known, measurable and identifiable  
2 is the consolidated capital structure. This is the only capital structure, other than a  
3 hypothetical capital structure, that the Commission should consider. If a hypothetical  
4 capital structure were to be considered by the Commission, then the Commission would  
5 have to consider adjustments to the various costs of capital that are applied to the  
6 hypothetical capital structure. For example, because Southern Union has always been an  
7 aggressively leveraged company, if one were to use some type of hypothetical capital  
8 structure for one of its natural gas distribution utilities, then one would need to adjust the  
9 cost of debt and common equity downward.

10          Q.     Do you consider Mr. Dunn's proposed capital structure in this case as a  
11 hypothetical one?

12          A.     Yes, because this capital structure bears no relationship to the capital  
13 structure that credit rating agencies evaluate to determine the creditworthiness of  
14 Southern Union. It also bears no relationship as to how MGE is actually capitalized.

15          Q.     Do you agree with Mr. Dunn that there was an attempt to insulate MGE  
16 from the Panhandle operations when it applied for approval to acquire Panhandle?

17          A.     Yes. I agree there was an attempt to insulate MGE from the Panhandle  
18 operations, but I do not believe that this attempt was successful.

19          Q.     What evidence did you rely on to conclude that MGE is not insulated from  
20 the Panhandle operations?

21          A.     As I stated previously, S&P is applying an equal credit rating on senior  
22 debt to Southern Union and its Panhandle subsidiary.

1           Q.     Would it have been possible for the Panhandle debt to be refinanced at  
2 such attractive interest rates if Mr. Dunn's assertion that Panhandle doesn't have any  
3 equity to support it were true?

4           A.     No. If Panhandle had only debt and no equity to support its operations, I  
5 don't believe creditors would have viewed Panhandle as a good credit risk.

6           Q.     Mr. Dunn claims that you didn't make an adjustment for the lower  
7 common equity ratio that you recommended for MGE versus the average common equity  
8 ratios for your comparable companies. Is this correct?

9           A.     No. I addressed this when I responded to Dr. Morin's rebuttal testimony  
10 about the same criticism. I made an upward adjustment of 32 basis points to consider the  
11 credit rating differential between my comparable companies and Southern Union.  
12 Southern Union's credit rating already contemplates the financial risk, i.e. a lower  
13 common equity ratio, when assigning a credit rating to Southern Union.

14          Q.     On page 13 of his rebuttal testimony, Mr. Dunn refers to S&P's Utility  
15 Group Financial Target benchmark ratios for companies with business profile of a "4" to  
16 test the reasonableness of your recommended capital structure in this case. Is it  
17 reasonable for Mr. Dunn to use a business profile of a "4" to test the reasonableness?

18          A.     No. I have already discussed that S&P has assigned a business profile of a  
19 "3" to all of Southern Union's operations as of June 2, 2004. In fairness to Mr. Dunn,  
20 this did not occur until after he wrote his rebuttal testimony. However, he should not  
21 have been reviewing the benchmarks for companies with a business risk profile of "4"  
22 because, previously, S&P had increased Southern Union's business profile to a "4"  
23 because of the Panhandle acquisition. Before the Panhandle acquisition when Southern

Surrebuttal Testimony of  
David Murray

1 Union only had natural gas distribution operations, Southern Union was assigned a  
2 business profile of a “3.”

3 Q. What is the current total debt to total capital benchmark for a company  
4 with a business position of a “3”?

5 A. It is from 55 to 65 percent total debt to total capital.

6 Q. Does your recommended capital structure fall within this benchmark?

7 A. No.

8 Q. How many times in the last ten years has Southern Union’s capital  
9 structure fallen within this guideline when TOPrS is included as debt (see attached  
10 Schedule 5)?

11 A. Four times.

12 Q. What was S&P’s previous benchmark for a company with a business  
13 profile of “3” before it changed the targets on June 2, 2004?

14 A. It was from 53 to 61 percent total debt to total capital.

15 Q. How many times in the last ten years has Southern Union’s capital  
16 structure fallen within the old guideline when TOPrS is included as debt?

17 A. Once.

18 Q. Why did you include TOPrS as debt in your calculation of total debt to  
19 total capital?

20 A. Because that is how S&P treats TOPrS. Please see the attached email  
21 labeled as Schedule 6.

22 Q. What do you conclude from your analysis of Southern Union’s capital  
23 structures over the last ten years?

1           A.     S&P has decided that Southern Union's capital structure, although it  
2 doesn't meet the benchmark, is appropriate for a BBB-rating when evaluated with other  
3 factors.

4           Q.     Are the financial benchmarks mentioned by Mr. Dunn intended to be rigid  
5 guidelines to use to determine if a capital structure is appropriate for a given credit  
6 rating?

7           A.     No. The S&P financial benchmarks indicated in Mr. Dunn's testimony  
8 are designed for purposes of assisting utilities, utility affiliates, and the investment  
9 community in assessing the relative financial strength of issuers. By no means are these  
10 benchmarks concrete numbers. As I have already discussed, Southern Union has only  
11 met the old benchmark one year in the last ten.

12          Q.     On page 15, lines 20 through 26 of his rebuttal testimony, Mr. Dunn  
13 indicates that the proceeds from Southern Union's planned common equity offering will  
14 not be used to invest in Panhandle Eastern. Even if this is true, isn't the reason that  
15 Southern Union has such a leveraged capital structure at this time is because of its  
16 acquisition of Panhandle?

17          A.     Yes. Although the proceeds from this issuance of common equity may not  
18 be used to invest in Panhandle, it is the effects of the Panhandle acquisition that has put  
19 Southern Union in a situation which requires it to issue additional common equity in  
20 order to improve its capital structure. Consequently, although the proceeds from this  
21 specific issuance may not be directly used to invest in Panhandle, it is the Panhandle  
22 acquisition that has caused the need for this issuance.

1           Q.     On page 41, lines 8 through 15 of his rebuttal testimony, Mr. Dunn  
2 explains how the issuance of this additional common equity will benefit MGE customers  
3 when he argues for an adjustment for flotation costs. Are you convinced by his  
4 explanation?

5           A.     No. Mr. Dunn indicates that the customers of MGE will benefit because  
6 “the bond rating of Southern Union will be preserved and because lower bond ratings  
7 lead to higher costs of debt, a savings will be realized.” Based on all of the information I  
8 have reviewed, which includes Southern Union’s 2003 Annual Report, and based on  
9 admissions from Mr. Dunn during his deposition, the reason Southern Union is having to  
10 issue additional common equity to preserve its bond rating is because of the leverage  
11 caused by the Panhandle acquisition. Of course, if Mr. Dunn’s position on Southern  
12 Union’s capital structure and the insulation of its natural gas distribution operations were  
13 true, then Southern Union wouldn’t have to issue additional common equity because of  
14 the Panhandle debt assumed by Southern Union.

15                 Mr. Dunn indicates that MGE customers will benefit from this offering  
16 because the “proceeds of the sale represent new capital available to Southern Union,  
17 some of which **may** be used to add facilities to MGE’s infrastructure to provide services  
18 to customers.” (emphasis added). As I indicated in my rebuttal testimony, Mr. Dunn has  
19 not provided any documented proof that any of these proceeds are because of MGE’s  
20 capital needs.

21           Q.     On page 17 of his rebuttal testimony, Mr. Dunn shows the capital structure  
22 that Mr. Gillen provided in his rebuttal testimony that removed the “impact of Panhandle

1 Eastern from the consolidated capital structure...” What impact of Panhandle Eastern  
2 was removed from the consolidated capital structure?

3 A. The only type of capital that was removed from the consolidated capital  
4 structure was the debt that supports Panhandle Eastern. Mr. Dunn indicated in his  
5 deposition testimony on page 29, line 13, “[t]he equity is essentially nonexistent.” He  
6 indicates on page 29, lines 20 through 21 of his deposition that “...the Panhandle equity  
7 is in the ground somewhere.” Mr. Dunn apparently believes this is justification for his  
8 position that no equity should be excluded from Southern Union’s capital structure to  
9 eliminate the capital that supports Panhandle because the equity is “nonexistent.”

10 Q. If Mr. Dunn’s position is that there is no Southern Union equity that  
11 supports the Panhandle operations that should be excluded from his recommended capital  
12 structure, then does this contradict one of his data request responses?

13 A. Yes. Staff Data Request No. 0345 asked the following question of Mr.  
14 Dunn:

15 On page 22, lines 19 through 22 of his rebuttal testimony Mr.  
16 Dunn indicates that Panhandle Eastern has a mix of capital that  
17 “stands behind” it. What are the various ratios, in percentage  
18 terms, for each type of capital in the mix that supports Panhandle  
19 Eastern?

20 Mr. Dunn’s response was “[n]o such study was performed.” I find it hard to reconcile  
21 that Mr. Dunn indicates in his direct testimony and his deposition that there is no  
22 Panhandle equity, but then he indicates that there is a “mix of capital” that supports all of  
23 Southern Union’s operations, but he did not perform a study to determine what that mix  
24 was for Panhandle.

25 Q. On page 19 through 21 of his rebuttal testimony, Mr. Dunn cites from a  
26 couple of sources to support his contention that the consolidated capital structure is

1 inappropriate. Are there any sources that you are familiar with that give some guidance  
2 as to when one might recommend the consolidated capital structure?

3 A. Yes. In David C. Parcell's book The Cost of Capital – A Practitioner's  
4 Guide the following guidance is given to help determine if a consolidated capital  
5 structure is appropriate or if a subsidiary capital structure is appropriate:

6 Subsidiary vs Consolidated Capital Structure

7 Many utilities are subsidiaries of other companies, which can be  
8 holding companies, other utilities, or diversified companies. When  
9 a utility is a subsidiary of another firm, the question frequently  
10 arises as to whether the proper ratemaking capital structure is  
11 represented by the utility or its parent.

12 Among the considerations which help determine whether the utility  
13 vs. parent capital structure is appropriate are:

- 14 1. Whether subsidiary utility obtains all of its capital from its  
15 parent, or issues its own debt and preferred stock.
- 16 2. Whether parent guarantees any of the securities issued by  
17 the subsidiary.
- 18 3. Whether subsidiary's capital structure is independent of its  
19 parent (i.e., existence of double leverage, absence of proper  
20 relationship between risk and leverage of utility and non-  
21 utility subsidiaries).
- 22 4. Whether parent (or consolidated enterprise) is diversified  
23 into non-utility operations.

24 Q. Isn't the above reference addressing whether to use a subsidiary capital  
25 structure or a consolidated capital structure rather than a capital structure for a division,  
26 such as MGE?

27 A. Yes. However, I believe this provides even stronger support for the use of  
28 the consolidated capital structure because divisions, unlike subsidiaries, aren't even  
29 separate legal entities that issue their own capital. This supports why Staff has applied

1 the consolidated capital structure when recommending a rate of return for the divisions of  
2 operating companies – as Staff has done for Aquila’s Missouri operating divisions in the  
3 past. The Commission adopted this approach in the Aquila case, Case No. ER-97-394, in  
4 which Mr. Stephen G. Hill was the Staff witness proposing such approach.

5 Q. Did Dr. Morin qualify Mr. Hill as an expert in his deposition on June 10,  
6 2004?

7 A. Yes. On page 45, lines 6 through 9, Dr. Morin qualified Mr. Hill as an  
8 expert.

9 Q. On page 24, lines 14 through 21 of his rebuttal testimony, Mr. Dunn  
10 indicates that you included the embedded cost of long-term debt held at Panhandle in  
11 your overall embedded cost of long-term debt for no other reason than to reduce the cost  
12 of debt. Is this a proper assessment?

13 A. No. Although I was surprised that the embedded cost of long-term debt  
14 held at Panhandle was lower than the embedded cost of long-term debt held at Southern  
15 Union, I later discovered that Southern Union refinanced much of the debt at Panhandle  
16 shortly after it acquired the operation from CMS Energy. Right before Southern Union  
17 acquired Panhandle from CMS Energy it had a credit rating that was below investment  
18 grade. Once Panhandle became a part of Southern Union it was able to take advantage of  
19 the better credit rating assigned to Southern Union’s consolidated operations and the low  
20 interest rate environment to refinance approximately \$512,757,000 of debt according to  
21 Southern Union’s Form 10-Q for the quarterly period ended, March 31, 2004. However,  
22 this is not why I included the Panhandle debt. I have explained in my rebuttal testimony  
23 why it is appropriate to include the Panhandle debt and costs in my recommended rate of

1 return. This is not a matter of being “opportunistic.” In fact in the last Aquila, Inc.  
2 electric and steam rate case, Case Nos. ER-2004-0034 and HR-2004-0024, I  
3 recommended a consolidated embedded cost of long-term debt of 7.633 percent for  
4 Missouri Public Service (MPS) based on all of Aquila’s debt, including its subsidiaries  
5 that still existed through the update period. Whereas, Aquila’s witness recommended an  
6 embedded cost of debt of 7.23 percent based on debt that Aquila assigned to the MPS  
7 division. Consequently, I am not treating MGE any differently than I treated Aquila in  
8 their rate case. This treatment is not a matter of “opportunism,” it is a matter of  
9 recommending the appropriate rate of return given the circumstances of the corporate  
10 structure.

11 Q. On page 25, line 16 through 26 of his rebuttal testimony, Mr. Dunn  
12 indicates a situation in which you indicated that you would recommend the capital  
13 structure of the utility for ratemaking purposes if the company raised its own long-term  
14 debt. Does this situation apply in this circumstance?

15 A. No. MGE is not a subsidiary and, therefore, cannot issue its own debt.

16 Q. Starting on page 26, line 10, Mr. Dunn presents his argument for  
17 excluding short-term debt from the capital structure. How do you respond?

18 A. Short-term debt in excess of construction work in progress (CWIP) is a  
19 source of capital that has been used by Southern Union consistently for at least the 18  
20 months leading up to the update period in this case. The average level of short-term debt  
21 in excess of CWIP for the twelve months leading up to the updated period can be seen in  
22 Travis Allen’s Schedule TA-4 attached to his direct testimony. This source of capital has  
23 a cost and this cost should be reflected in the weighted-average-cost-of-capital

1 recommendation for purposes of this case. If Southern Union is able to realize a lower  
2 cost of capital by its consistent use of lower-cost, short-term debt that is in excess of  
3 CWIP, then this lower cost of capital should be reflected in the rate-of-return  
4 recommendation through its inclusion in the recommended capital structure.

5 Q. What has happened to the level of short-term interest rates that may make  
6 the use of more short-term debt appealing?

7 A. The interest rates on short-term debt have come down considerably. This  
8 is evident from the 1.89 percent average cost of short-term debt that Southern Union  
9 incurred for the 12 months ending December 31, 2003. This compares to the average  
10 cost of short-term debt of 7.31 percent incurred for the 12 months ending December 31,  
11 2000, in MGE's last rate case, Case No. GR-2001-292

12 Q. Starting on page 27 of his rebuttal testimony, Mr. Dunn criticizes your  
13 analysis as being "contrived and mechanical." Do you have any authoritative support for  
14 your review of the growth rates of historical dividends per share, historical book values  
15 per share, historical earnings per share and projected earnings per share to recommend a  
16 proxy growth rate to use in your DCF recommendation?

17 A. Yes. The authoritative support is as follows:

18 In The Cost of Capital – A Practitioner's Guide, by David C. Parcell,  
19 pages 8-18 through 8-20 indicate the following:

20 *Financial Indicators of Growth*

21 There are a wide variety of acceptable methods for using historical  
22 growth to estimate future growth in the DCF model (Gordon,  
23 Gordon and Gould, 1989 50). The three most commonly-used  
24 financial indicators of growth are dividends per share (DPS),  
25 earnings per share (EPS), and book value per share (BVPS) (Howe  
26 & Rasmussen, 1982, 1333). Actually, DPS, EPS and BVPS can be  
27 defined in terms of each other, as  $DPS = EPS - \Delta BVPS$  (Patterson,

1971). Viewed this way, any of the three terms is dependent upon the others and each can be viewed as the investors' perceived growth rate.

#### Dividends Per Share

Past growth of DPS is the most direct link between historic dividend growth and projected dividend growth. However, in the long-run, dividends can grow at a rate no greater than that of earnings. If the dividends out-paced earnings for an extended period of time the company would deplete its equity capital. In the short-run, the two growth rates can diverge without causing financial harm to the company. The average of these growth rates may provide a better forecast of the long-run dividend growth rate than any of the individual forecasts, because in the long-run the dividend growth rate should equal the growth rate of the earnings since it is primarily earnings that are used to support the dividends.

#### Earnings Per Share

An investor's expectations concerning a company's cash flows include both dividends plus the eventual proceeds from the sale of the stock. Earnings provide the source of both the dividends paid to stockholders and the retained earnings, which increase the book value and ultimately the market price of the stock. As a result, EPS is often used as a substitute for DPS.

#### Book Value Per Share

The growth of BVPS is used as a proxy for DPS growth since BVPS growth principally reflects (in the absence of large stock sales at prices well above or below book value) the retention (i.e., not paying out all of earnings as dividends) of earnings. The purpose of earnings retention is to enhance the level of future EPS and DPS. In addition, a company's EPS is equal to the BVPS times return on equity (ROE). As a result, any factor that causes the BVPS to increase (decrease) will tend to cause the EPS to increase (decrease).

#### Relationship Among Growth Rates

Even though the DCF model assumes that EPS, DPS, BVPS and the market price all grow at the same rate, it is generally recognized that in practice this does not normally occur. However, what is important to recognize in using the simplified version of the DCF model is that the analyst has no basis to forecast different future rates of growth for each of these items.

1 Therefore, it is appropriate for the rate of return witness to evaluate a variety of possible  
2 indicators of future growth.

3 Q. Is it important to consider historical growth rates as well as analysts  
4 projected growth rates?

5 A. Yes. In Mr. Parcell's book, The Cost of Capital - A Practitioner's Guide, it  
6 is indicated that "investors, as a group, do not utilize a single growth estimate when they  
7 price a utility's stock. Thus rate of return analysts should consider multiple growth  
8 estimates in order to better capture the growth embodied in a utility's stock price." It is  
9 important to note that Mr. Parcell emphasizes that analysts should consider multiple  
10 growth estimates. This applies to projected as well as historical growth rates.  
11 Additionally, Mr. Parcell states: "Analysts should recognize that individual investors  
12 have different expectations regarding growth and therefore no single indicator captures  
13 the growth expectations of all investors." Therefore, it is important to not only give  
14 weight to multiple projected growth rates, but to also give weight to historical growth  
15 rates because that is in fact what investors as a group will do.

16 Q. Do you have authoritative support for averaging the five and ten year  
17 historical growth rates that are indicated in column (1) of Schedule 16 attached to your  
18 direct testimony?

19 A. Yes in Dr. Roger A. Morin's book, Regulatory Finance Utilities' Cost of  
20 Capital, 1994 the following is indicated:

21 Historical growth rates are customarily computed over the last 5  
22 and 10 years. An average of the 5-year and 10-year growth rates is  
23 a reasonable compromise between the conflicting requirements of  
24 representativity and statistical adequacy.

1           Q.     In considering Mr. Dunn's criticism that you "processed a series of  
2 numbers through a set of schedules, with no apparent comprehension of the meaning of  
3 the numbers or the implications of the data," are you aware of any sources that provide  
4 some context to test the reasonableness of your recommendation in this case?

5           A.     The experts include Warren Buffett, Jeremy Siegel and Cliff Asness.  
6 Warren Buffett is CEO of Berkshire Hathaway and is probably the most respected  
7 investor in the United States. On December 20, 2001, in an interview on CNBC,  
8 Mr. Warren Buffett indicated that "returns in the stock market should come in around an  
9 average 7-8 percent over the next ten years." He also said that he's "not finding"  
10 undervalued companies in this market, indicating that he remains watchful of valuation  
11 levels for stocks. As recently as the release of Berkshire Hathaway's 2003 Annual  
12 Report, Mr. Buffett stated that he still wasn't finding attractively-priced stocks, meaning  
13 that he believes that the price of stocks in general are higher translating into a lower cost  
14 of common equity for the market.

15                 The other two, Cliff Asness, University of Chicago Ph.D., who writes  
16 influential studies in academic journals while running the \$5 billion hedge fund AQR  
17 Capital Management, and Jeremy Siegel of The Wharton School of the University of  
18 Pennsylvania, whose book, *Stocks for the Long Run*, helped mold academic thinking on  
19 how equities perform over long periods, were featured in a recent June 16, 2003 article in  
20 *Fortune* magazine, "Can Stocks Defy Gravity? That's what Wall Street wants you to  
21 believe. Don't buy it. The best minds say the market will rise, but it won't soar."  
22 Although these are the two main academicians featured in the article, Kenneth French of  
23 Dartmouth also urges caution when investing in today's market. Kenneth French and

1 Eugene Fama have published many influential stock market studies in the past two  
2 decades.

3 All of the influential individuals featured in this article have come to the  
4 conclusion that the equity risk premium, which is the additional return that investors  
5 demand over risk-free government securities, is now lower. As a result of the lower  
6 equity risk premium, they predict that the stock market as a whole can only provide  
7 6 percent to 8 percent returns for the foreseeable future. Jeremy Siegel, when speaking  
8 about total market returns, specifically states: "Better-than-average earnings, if they  
9 happen, could get us perhaps 8%. But 10% assumes earnings growth that is just too big."  
10 It is obvious that well-respected investors and academicians are not predicting very high  
11 returns for the near future because of current stock valuation levels. This translates into a  
12 low cost of common equity environment.

13 Comparing my recommended cost of common equity of 8.52 percent to  
14 9.52 percent to the predictions of anywhere from 6 to 10 percent for the entire market by  
15 these well respected individuals offers a barometer to the reasonableness of my  
16 recommendation in this case. In light of the fact that regulated utilities are less risky than  
17 the market, and therefore investors would normally require less return than the market,  
18 my recommendation is generous considering the current stock market environment.

19 Q. Does Dr. Morin believe that Jeremy Siegel and Warren Buffett are  
20 influential individuals in the world of investing?

21 A. Yes. Dr. Morin indicated the following:

22 I certainly would consider Mr. Siegel very I influential more from  
23 an academic perspective, but I would consider Mr. Buffet as well  
24 influential in strategy and marketing and finding under-values or  
25 assets.

1 Q. Did Dr. Morin indicate that required returns in the broader market had an  
2 influence on required returns for utilities in his deposition?

3 A. Yes. Dr. Morin indicated the following:

4 Yes. Of course. Investors are always making comparisons  
5 between prospective returns from utility stocks versus returns from  
6 industrial stocks comparable in risk. And if they're not comparable  
7 in risk, they will make the required risk adjustment using  
8 something like beta, for example.

9 Q. Have you observed any information specific to the Company's securities  
10 that provides insight to the reasonableness of your recommendation?

11 A. Yes. As I discussed on page 14, line 3 through 10 of my rebuttal  
12 testimony, Southern Union recently issued traditional, non-cumulative preferred  
13 securities to refinance the Trust Originated Preferred Securities (TOPrS). I also  
14 discussed that, holding all else equal, the traditional preferred securities are riskier  
15 because preferred dividends are not guaranteed and are non-cumulative, whereas the  
16 preferred dividends were backed by the coupon on the debt that was issued by Southern  
17 Union to pay the dividends on the TOPrS. The stated coupon on the TOPrS issued back  
18 in 1995 was 9.48 percent. The stated dividend rate on the non-cumulative preferred stock  
19 was 7.55 percent when it was issued and as of June 8, 2004 was trading at a yield of 7.10  
20 percent. The spread between the current yield on Southern Union's non-cumulative  
21 preferred stock and the stated coupon rate on the TOPrS that was issued in 1995 is 238  
22 basis points. It is logical to conclude that because, holding all else equal, TOPrS carries  
23 less risk than traditional, non-cumulative preferred stock, that if Southern Union had  
24 issued TOPrS again that the yield would have been lower than the stated dividend rate for  
25 the traditional preferred stock recently issued. This would translate into a lower cost of

1 capital of more than the 238 basis point spread between the stated coupon on TOPrS and  
2 the current yield on Southern Union's current non-cumulative preferred stock.

3 Q. What was Staff's recommend cost of common equity for MGE in Case  
4 No. GR-96-285, which was shortly after Southern Union issued TOPrS?

5 A. 11.80 percent applied to a common equity ratio of 32.74 percent.

6 Q. What was Southern Union's witness', Dr. Bruce H. Fairchild,  
7 recommended cost of common equity in that case?

8 A. 12.25 percent applied to a common equity ratio of 29.88 percent.

9 Q. What is Staff's recommended cost of common equity in this case?

10 A. 9.02 percent applied to a common equity ratio of 25.91 percent.

11 Q. How much of a decrease in cost of common equity is reflected in Staff's  
12 recommendation in this case versus Staff's recommendation in the 1996 MGE rate case?

13 A. 278 basis points.

14 Q. What is Southern Union's recommended cost of common equity in this  
15 case?

16 A. Mr. Dunn's recommended cost of common equity is 12.00 percent applied  
17 to a common equity ratio of 43.34 percent.

18 Q. How much of a decrease in cost of common equity is reflected in Southern  
19 Union's recommendation in this case versus Southern Union's recommendation in the  
20 1996 MGE rate case?

21 A. 25 basis points.

22 Q. What was the yield on BBB utility bonds in May 1995, which is the month  
23 that Southern Union issued its TOPrS?

Surrebuttal Testimony of  
David Murray

1           A.     It was 8.30 percent.

2           Q.     What was the yield on BBB utility bonds for the most recent month  
3 available in the Mergent Bond Record?

4           A.     It was 6.46 percent as of April 2004.

5           Q.     What is the difference in these yields?

6           A.     184 basis points.

7           Q.     What conclusion do you draw from the information above?

8           A.     Staff's recommendation clearly is consistent with the current low cost of  
9 capital environment. Southern Union's recommendation has barely changed to reflect the  
10 low cost of capital environment. In addition to not recognizing the lower cost of capital  
11 available to MGE, Mr. Dunn wants to pretend that Southern Union has stand-alone  
12 common equity ratio of 43.34 percent.

13          Q.     What capital structure did Dr. Bruce H. Fairchild use in his recommended  
14 rate of return in Case No. GR-96-285?

15          A.     He based his capital structure recommendation on the actual consolidated  
16 capital structure of Southern Union at the time.

17          Q.     What was Dr. Fairchild's rationale for using the actual consolidated  
18 capital structure?

19          A.     Dr. Fairchild cited the following reasons for his use of Southern Union's  
20 actual capital structure to determine MGE's cost of capital:

- 21                   • These ratios reflect the mix of capital currently employed to  
22                    finance MGE's investment in assets used to provide gas service in  
23                    Missouri;

- 1                   • Although this capital structure deviates from industry standards for
- 2                   local gas distribution companies (LDCs), it is consistent with
- 3                   Southern Union's entrepreneurial spirit, acquisition orientation, and
- 4                   earnings retention practices; and
- 5                   • While Southern Union's higher debt ratio, and lower common
- 6                   equity ratio, impart additional financial risks, these are offset by
- 7                   the greater use of cheaper debt and preferred stock capital, and less
- 8                   use of significantly more expensive common equity capital.

9                   Although not verbatim, Mr. Fairchild states essentially the same reasons  
10                  for the use of Southern Union's capital structure in Case No. GR-98-140. It should be  
11                  noted that Mr. Fairchild felt that Southern Union was more risky than his comparable  
12                  group because of the bond rating of Southern Union compared to the comparable group.  
13                  Therefore, in both cases he recommended an additional 60 basis points be added to his  
14                  cost of common equity recommendation to take this risk into consideration. In Case No.  
15                  GR-98-140 the Commission determined that Southern Union's capital structure did not  
16                  merit a risk premium adjustment because "MGE's risk level decreased in April 1998  
17                  when its ratings improved to BBB+. Further, management determines the capital  
18                  structure." Based on that determination, the Commission adopted Staff's midpoint of  
19                  10.93 percent in the last MGE rate case.

20                Q.       Did Dr. Morin qualify Dr. Fairchild as an expert in his deposition on page  
21                  46, line 24 through page 47, line 1?

22                A.       Yes.

1 Q. However, didn't you recommend an adjustment to your cost of common  
2 equity to consider the bond rating differential between Southern Union and your  
3 comparable group?

4 A. Yes. I believe it was the appropriate thing to do in this case.

5 Q. Mr. Dunn indicates that you disregarded your CAPM and Risk Premium  
6 analysis. Did Mr. Dunn use any other models other than the DCF model in his  
7 recommendation?

8 A. No.

9 Q. Beginning on page 35, line 13 of his rebuttal testimony, Mr. Dunn  
10 indicates that you used the wrong form of the DCF Model. Do you agree?

11 A. No, while I indicated in my direct testimony that I used the continuous  
12 growth form of the DCF model, this is not how I executed the model. I executed the  
13 model based on the assumption of annual compounding of the dividend and on the  
14 constant growth of that dividend. This model is consistent with the model contained in  
15 the textbook used in the Investments class that I took while attending the University of  
16 Missouri, Columbia in which I graduated with a B.S.B.A. with an emphasis in Finance  
17 and Banking, and Real Estate with a GPA of 3.5. The textbook was the Essentials of  
18 Investments, Bodie, Zvi; Kane, Alex; Marcus, Alan J. (1992). This form of the DCF  
19 model is also consistent with the annual compounding model shown in Mr. Dunn's  
20 Schedule JCD-2, which is the same model that Mr. Dunn used.

21 Q. Beginning on page 42, line 4 of his rebuttal testimony, Mr. Dunn criticizes  
22 your criteria as not being true risk criteria. How do you respond?

1           A.     The most important aspect of any comparable company analysis to  
2 evaluate the cost of capital is to select companies whose operations are as confined to the  
3 subject company's operations as much as possible. This is exactly why this type of  
4 analysis is often referred to as a "pure play" analysis. As I demonstrated in my rebuttal  
5 testimony, Mr. Dunn has a few comparable companies in his proxy group that don't meet  
6 this criterion. In order to select companies that have comparable business risks to the  
7 natural gas distribution business, it is essential to pick companies that are predominately  
8 in the natural gas distribution business.

9           Q.     Starting on page 43, line 10 of his rebuttal testimony, Mr. Dunn compares  
10 certain DCF cost of common equity results produced by Staff and OPC. How do you  
11 respond?

12           A.     This is the one area where I agree with Mr. Dunn that these are  
13 "mechanical" calculations. The results for each individual company indicated in column  
14 (5) of Schedule 18 attached to my direct testimony are not intended to be refined  
15 estimates of the cost of common equity for my final estimated cost of common equity.  
16 As shown in my final estimated cost of common equity for my proxy group of 8.20  
17 percent to 9.20 percent with a midpoint of 8.70 percent, I did not recommend the average  
18 of 8.35 percent indicated at the bottom of column (5). After reviewing all of the growth  
19 rates, I determined that some additional weight should be given to the projected growth  
20 rates indicated on Schedule 16 of my direct testimony. It is not the individual DCF  
21 results that should be compared to test the reasonableness of Staff's and OPC's  
22 recommendation, it is the overall recommendation that should be compared and this  
23 validates Staff's recommendation in this case.

**Response to Mr. Allen's Rebuttal Testimony**

Q. Do you agree with Mr. Allen's position that because the debt held at Panhandle is non-recourse it should not be included in the recommended embedded cost of long-term debt for MGE?

A. No. Whether debt is recourse or not does not drive the availability of funds for general corporate use. A corporation can assign certain debt issuances to its divisions and claim that this is the proper embedded cost of long-term debt to apply to those divisions and at the same time refinance other debt issuances within the corporation. The refinancing of other debt will drive the cost of capital down for the company, but because a division has specific debt issuances assigned to it at some higher historical embedded cost, it would not recognize the lower cost of debt that the company has achieved. This is the reason why all of Southern Union's debt should be considered in the embedded cost of long-term debt recommendation.

Q. How do you respond to Mr. Allen's criticism about your approach to determining the short-term debt balance to include in the capital structure?

A. I believe that the fact that our short-term debt balances are fairly similar shows that, in this case, both approaches are representative of Southern Union's recent utilization of short-term debt.

**Summary and Conclusions**

Q. Please summarize the conclusions of your surrebuttal testimony.

A. My conclusions regarding the capital structure, embedded cost of long-term debt and cost of common equity are listed below:

- 1                   1.     The use of the capital structure proposed by MGE is inappropriate.  
2                         Although he eliminated debt held at Panhandle, Mr. Dunn did not  
3                         subtract any equity that is associated with Panhandle from his  
4                         capital structure. Regardless, it is more appropriate to use the  
5                         consolidated capital structure of Southern Union. OPC used this  
6                         capital structure with some minor differences from Staff.  
7                         However, the calculation of the cost of capital for MGE should be  
8                         based on Southern Union's actual consolidated capital structure as  
9                         of December 31, 2003, as shown on my revised Schedule 9  
10                         attached to my rebuttal testimony;
- 11                   2.     Mr. Allen's use of the consolidated capital structure without the  
12                         inclusion of the costs of debt associated with this capital structure  
13                         is inappropriate and inconsistent with Commission precedent. My  
14                         embedded cost of long-term debt which reflects all of Southern  
15                         Union's debt is the appropriate cost of debt to use in the  
16                         recommended rate of return;
- 17                   3.     My cost of common equity stated in revised Schedule 25 attached  
18                         to my rebuttal testimony, which is 8.52 percent to 9.52 percent,  
19                         would produce a fair and reasonable rate of return of 6.70 percent  
20                         to 6.96 percent for the Missouri jurisdictional natural gas utility  
21                         rate base for MGE.

22           Q.     Does this conclude your surrebuttal testimony?

23           A.     Yes, it does.