

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

In the Matter of Missouri Gas Energy's)	
Tariffs to Implement a General Rate)	Case No. GR-2004-0209
Increase for Natural Gas Service)	

**RESPONSE OF MISSOURI GAS ENERGY IN OPPOSITION TO
OFFICE OF THE PUBLIC COUNSEL'S MOTION TO
EXCLUDE PORTIONS OF JOHN DUNN'S TESTIMONY**

COMES NOW Missouri Gas Energy, a division of Southern Union Company ("MGE"), by and through counsel, and for its response in opposition to the Office of the Public Counsel's motion to exclude portions of John C. Dunn's testimony, respectfully states as follows to the Missouri Public Service Commission ("Commission"):

A. Background

1. At the hearing on June 21, 2004, the Office of the Public Counsel ("Public Counsel"), objected to the admission of Exhibit 1 and the inclusion of portions of the direct testimony and opinions of MGE witness John C. Dunn regarding a calculated rate of return for MGE.¹
2. Public Counsel asserts that admission of Mr. Dunn's testimony is impermissible pursuant to RSMo. §490.065(3) for the reason that the information relied upon by Mr. Dunn "is not the type of information reasonably relied upon by experts in the field."² Public Counsel also asserts that Mr. Dunn's reliance on the discounted cash flow ("DCF") model "renders his opinions unreliable."³

¹ Transcript, Hearing - Volume 10, page 163, lines 19-25.

² *Id.* at page 164, lines 2-12.

³ *Id.* at page 164, lines 12-14.

3. Judge Woodruff noted the objection and stated that it would be ruled upon after hearing all evidence.⁴ Judge Woodruff later stated that Exhibit 1 would be received into evidence subject to the objection of Public Counsel.⁵

B. Standard for Admission of Expert Testimony

4. Pursuant to *State Board of Registration for the Healing Arts v. McDonagh*, 123 S.W.3d 146 (Mo. banc 2003), the standards for admissibility of expert testimony in civil cases in Missouri are those set out in RSMo. §490.065. Reaffirming its decision in *Lasky v. Union Electric Co.*,⁶ the Missouri Supreme Court clearly stated in *McDonagh* that the standard for the admission of expert testimony in civil cases is that set forth in section 490.065.⁷ The Court also stated that the same standard should be applied in administrative cases such as proceedings before the Commission.⁸

5. Pursuant to the statute, if specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education may testify. The statutory standard is similar to the standard adopted in *Daubert v. Merrill Dow Pharmaceuticals* and set out in FRE 702,⁹ but RSMo. §490.065 also requires a showing that the facts and data upon which an expert relies are of a type reasonably relied upon by experts in the applicable field.¹⁰ The statute also requires the agency to

⁴ *Id.* at page 167, lines 20-25.

⁵ *Id.* at page 169, lines 21-23.

⁶ 963 S.W.2d 797 (Mo. banc 1997).

⁷ *State Board of Registration for the Healing Arts v. McDonagh*, 123 S.W.3d 146, 149 (Mo. banc 2003).

⁸ *Id.* at 155.

⁹ *Id.*

¹⁰ *Id.* at 156.

make an independent assessment as to whether the methodology is otherwise reasonably reliable.¹¹

C. John Dunn is Qualified as an Expert

6. Pursuant to RSMo. §490.065, Mr. Dunn is qualified as an expert by knowledge, skill, experience, training, and education.

7. As outlined in Appendix A to his direct testimony, Mr. Dunn has a Bachelor's Degree in Economics with a Minor in Mathematics and a Master of Arts Degree in Economics. Mr. Dunn has been an economic consultant for over 30 years, specializing in the general area of public utility economics and corporate finance with a special emphasis in the area of cost of capital and rate of return. Prior to becoming a consultant, Mr. Dunn was chief of Economic Research for the Missouri Public Service Commission. He received the designation of "Certified Rate of Return Analyst" after successfully completing a comprehensive examination on the body of knowledge involved in evaluation and determination of rate of return, capital structure and related matters.

8. Additionally, with regard to the issues at hand, Mr. Dunn has published various works, has lectured numerous times, belongs to many associations, and has testified before state and federal courts and various administrative bodies.¹²

D. The Facts and Data Relied Upon and the Method used by John Dunn are Reliable

9. Mr. Dunn used the DCF model to make his "initial calculations and establish a benchmark, industry cost of capital."¹³ In so doing, and in conformity with RSMo. §490.065(3), Mr. Dunn

¹¹ *Id.*

¹² See Exhibit 1, Direct Testimony of John C. Dunn, Appendix A, pages 2-5.

¹³ Exhibit 1, Direct Testimony of John C. Dunn, page 31, lines 9-10.

replied upon facts and data of a type reasonably relied upon by experts in the field. He calculated the cost of long term debt and common equity, considered the impact of industry changes, determined the proper growth rate and dividend yield, reviewed recent rate decisions, and looked at MGE's specific risks. After the DCF calculations were completed, Mr. Dunn used that data and judgment in finalizing his recommendations.¹⁴

10. Before cross examining Mr. Dunn on June 21, Public Counsel argued that "sole reliance" on the DCF method to determine a proper return on equity could lead to unreliability.¹⁵ Public Counsel, however, did not assert that use of the DCF method itself would be unreliable or otherwise contrary to methods employed by experts in the field. Public Counsel, of course, could not make such an assertion. The DCF model is used by numerous regulatory finance experts and is continually relied upon by this Commission in determining a proper return on equity.¹⁶

11. When the DCF model is used to determine a return on common equity, the result may be "checked" by employing another method such as the cost of capital asset pricing method ("CAPM") or a risk premium method. Failure to do so, however, does not render the results of applying the DCF model unsound.

12. This Commission has historically placed heavy reliance on the DCF model and has placed little to no reliance on other methods, including CAPM and risk premium. The Commission once

¹⁴ *Id.* at page 31, lines 13-14.

¹⁵ Transcript, Hearing - Volume 10, page 164, lines 9-14.

¹⁶ Incidentally, it should be noted that MGE disputes the *application* of the DCF model by certain witnesses in this proceeding (i.e. Travis Allen and David Murray being generally unqualified as experts, using improper inputs, etc.).

stated that it “has for many years judged the DCF method to be the most reliable for calculating a utility’s cost of equity.”¹⁷ The Commission continued by saying:

The Commission has consistently found Discounted Cash Flow (DCF) analyses to be appropriate for determining a rate of return on equity. . . . This is because it is relatively simple to apply and measures investor expectations for a specific company. . . . The DCF analysis is considerably more systematic and allows this Commission to treat all utilities it regulates in a consistent manner.¹⁸

13. Public Counsel, pointing to testimony of its own witness, asserts that “(a)ny analyst who doesn’t perform a check on their DCF analysis . . . really undermines reliability of the analysis.”¹⁹ Assuming for the moment that this is true, this assertion would go only to the weight to be given to Mr. Dunn’s testimony – not to its admissibility.

14. The DCF model is commonly used by regulatory finance experts and has historically been accepted by this Commission. In fact, the witnesses offered by Staff and Public Counsel in this proceeding used the DCF model. Further, Public Counsel failed to present any evidence to show that Mr. Dunn’s reliance on the DCF model rendered his recommendation unreasonable.

15. Public Counsel does not allege that the DCF model is unsound, that Mr. Dunn’s mathematical calculations were incorrect,²⁰ or that performing a “check” would have resulted in a different return on equity recommendation by Mr. Dunn. Additionally, these “checks” are many times ignored both by the offering party and by the Commission. For example, Public Counsel

¹⁷ *In the Matter of St. Louis County Water Company for Authority to File Tariffs Reflecting Increased Rates for Water Service*, 2001 Mo. PSC Lexis 314, 10 Mo. PSC3d 255, Case No. WR-2000-844 (May 3, 2001).

¹⁸ *Id.*, citing *In the Matter of the Joint Application of Missouri Cities Water Company*, 26 Mo. PSC (N.S.) 1, 26-27 (1983).

¹⁹ Transcript, Hearing - Volume 10, page 166, lines 13-15.

²⁰ It should be noted, however, that Public Counsel does assert that Mr. Dunn’s resulting calculations are incorrect, particularly with regard to growth rate. *See* Rebuttal Testimony of Travis Allen, pages 6-7.

witness Travis Allen performed only a CAPM check on his DCF analysis,²¹ admitted that he is “not really familiar” with application of the risk premium method,²² criticized the CAPM,²³ and relied on the results of his DCF analysis.²⁴

16. Public Counsel may disagree with Mr. Dunn’s recommendation, but Public Counsel failed to demonstrate that Mr. Dunn’s method – use of the DCF model to render a return on equity recommendation – is not a method or a type of method reasonably relied upon by experts or is otherwise not reasonably reliable. Public Counsel’s mere assertions in this regard are insufficient.

E. Conclusion

17. Mr. Dunn’s testimony satisfies the requirements of RSMo. §490.065. He is an expert – qualified by knowledge, skill, experience, training, and education. Further, the facts and data he relies upon are of a type reasonably relied upon by experts in the field of cost of capital and regulatory finance, and Mr. Dunn’s testimony is otherwise reasonably reliable. Thus, Exhibit 1 should be admitted into evidence in these proceedings. There appears to be no dispute with subsections (1), (2), or (4) of the statute, and the requirements of subsection (3) have also been satisfied.

18. Again, there has been no showing that Mr. Dunn’s sole reliance on the DCF model led to an unreasonable result, and Mr. Dunn’s own testimony demonstrated, as required by RSMo. §490.065, that he relied upon “facts or data . . . of a type reasonably relied upon by experts in the

²¹ Direct Testimony of Travis Allen, page 2, lines 11-14.

²² Deposition of Travis Allen, June 16, 2004, page 95, lines 3-7.

²³ Direct Testimony of Travis Allen, pages 17-18.

²⁴ *Id.* at page 2, lines 20-21; page 19, lines 3-8.

Respectfully submitted,

/s/ Diana C. Farr

ATTORNEYS FOR MISSOURI GAS ENERGY

CERTIFICATE OF SERVICE

The undersigned certifies that a true and correct copy of the foregoing document was hand-delivered, mailed by U.S. mail, or electronically transmitted on this 13th day of July, 2004, to all parties of record.

/s/ Diana C. Farr