STATE OF INDIANA

INDIANA UTILITY REGULATORY COMMISSION

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| VERIFIED PETITION OF WESTFIELD GAS CORPORATION, D/B/A CITIZENS GAS OF WESTFIELD FOR (1) AUTHORITY TO INCREASE RATES AND CHARGES FOR GAS UTILITY SERVICE AND APPROVAL OF A NEW SCHEDULE OF RATES AND CHARGES AND TERMS AND CONDITIONS APPLICABLE TO GAS UTILITY SERVICE, INCLUDING APPROVAL PURSUANT TO RULE 5-1-27(F) OF THE COMMISSION'S RULES OF A FIVE-YEAR NON-GAS REVENUE TEST TO DETERMINE WHEN DEPOSITS ARE REQUIRED FOR FACILITIES EXTENSIONS; (2) APPROVAL PURSUANT TO INDIANA CODE SECTION 8-1-2.5-6 OF AN ALTERNATIVE REGULATORY PLAN AND AUTHORITY TO IMPLEMENT AN ENERGY EFFICIENCY ADJUSTMENT RIDER; (3) APPROVAL TO AMORTIZE AND RECOVER CERTAIN DEFERRED ENERGY EFFICIENCY REBATE COSTS; (4) AUTHORITY TO RECOVER UNACCOUNTED FOR GAS COSTS AND A PORTION OF THE GAS COST COMPONENT OF NET-WRITE OFFS THROUGH PETITIONER'S GAS COST ADJUSTMENT CHARGE; (5) APPROVAL OF NEW DEPRECIATION ACCRUAL RATES; AND (6) APPROVAL OF A SERVICE LEVEL AGREEMENT BETWEEN PETITIONER AND CITIZENS ENERGY GROUP. | CAUSE NO. 43624 |

FILED
MAY 29 2009
INDIANA UTILITY
REGULATORY COMMISSION

PREFILED TESTIMONY OF

BRADLEY E. LORTON – PUBLIC'S EXHIBIT BEL-1

ON BEHALF OF

THE INDIANA OFFICE OF

UTILITY CONSUMER COUNSELOR

May 29, 2009

**TESTIMONY OF WITNESS BRADLEY E. LORTON**
**CAUSE NO. 43624**
**CITIZENS GAS OF WESTFIELD**

**Q: Please state your name and business address.**

A: My name is Bradley E. Lorton, and my business address is 115 W. Washington Street, Suite 1500 South, Indianapolis, Indiana, 46204.

**Q: How are you currently employed?**

A: I am a Utility Analyst in the Natural Gas Division of the Indiana Office of Utility Consumer Counselor (OUCC).

**Q: Please describe your qualifications.**

A: My expertise is in economics and public utility regulation. I hold Bachelor of Science and Master of Science degrees in Economics from Indiana State University. I also completed additional courses at Indiana University-Purdue University at Indianapolis in Economics, Mathematics and Labor Studies. I have completed both week-long segments of the NARUC Annual Regulatory Studies program at Michigan State University.

I have over thirty years experience in government and private industry. My career in public utility regulation began in 2001 when I accepted my current position with the OUCC. Prior to that time I served in management and business analyst positions for the U. S. Department of the Navy at the Naval Air Warfare Center in Indianapolis, and its privatized successor organizations. I also served as a Producer Price Index Economist at the Bureau of Labor Statistics, United States Department of Labor, and as a Statistician for the Indiana Division of Labor.

**Q: Have you provided testimony in other cases before the Indiana Utility Regulatory Commission?**

A: Yes. I have testified before this Commission on several occasions over the past six years on issues ranging from cost of equity to energy efficiency to alternative regulatory proposals.

**Q: What have you done to prepare to testify in this Cause?**

A: I reviewed the Petition of Citizens Gas of Westfield (Petitioner), Petitioner's Case-in-Chief, and Petitioner's existing and proposed gas tariffs. I researched several previous cases before the Commission that dealt with fair value and acquisition adjustments. I researched data from Value Line, and other financial sources in order to produce Discounted Cash Flow (DCF) and Capital Asset Pricing Model (CAPM) calculations.

I reviewed additional information relevant to cost of equity capital (i.e. the appropriate return on equity) including interest rate data from the Federal Reserve, economic growth data from the U.S. Bureau of Economic Analysis, and inflation data from the U.S. Bureau of Labor Statistics, and Morningstar, Inc. (formerly Ibbotson Associates).

**Q: What is the purpose of your testimony?**

A: I testify regarding Petitioner's proposed rate increase, fair value rate base and fair return. The OUCC believes that Petitioner's fair value rate base includes a *de facto* acquisition adjustment that in the past the Commission has not allowed. Petitioner appears to equate "fair value" with "market value." The OUCC disagrees and believes that such an equation is neither the long-term consistent

position of the Commission, nor a requirement of the Indiana statute. The inclusion of this *de facto* adjustment sets Petitioner's fair value rate base roughly $3.76 million above its original cost rate base, and would add substantially to the burden that customers would shoulder. The OUCC believes that Petitioner's fair value rate base should be recalculated so as to eliminate the *de facto* acquisition adjustment.

I also testify in regard to the cost of equity capital (sometimes referred to as the authorized return on equity "ROE"). The OUCC believes Petitioner's proposed 10.57% ROE is too high, particularly in light of Petitioner now being able to use the Normal Temperature Adjustment, and the fact that Petitioner has zero long term debt in its capital structure. (The only debt in Petitioner's capital structure is in the form of customer deposits). Based on the results of the Discounted Cash Flow (DCF) method and the Capital Asset Pricing Model (CAPM), I conclude that a cost of equity of 9.75% for Petitioner would be very reasonable. I also analyze the macroeconomic and capital market situation to demonstrate that the U.S. economy remains in a low cost of capital environment.

## CURRENT VERSUS PROPOSED DISTRIBUTION RATES

**Q: Mr. Lorton, have you compared Petitioner's proposed rates with the rates currently in place?**

A: Yes.

**Q: What (if any) conclusions have you drawn from that comparison?**

A: Petitioner seeks very aggressive increases in both the fixed customer charge and the per-unit, volumetric rates. Petitioner proposes a 19% across-the-board

increase in the customer charges applicable to each rate class. However, the increases in volumetric rates are much larger. For instance, for a residential customer who purchases 120 therms or less in one month, the proposed volumetric delivery rate is 55.7% higher than the current rate. Public's Exhibit BEL-2 compares Petitioner's current and proposed rates by rate class.

**Q: What appears to be the cause of these dramatic increases?**

A: The largest contributing factor appears to be Petitioner's calculation of its fair value rate base. Although presented as a proposal for fair value only, the methodology used by Petitioner includes both a return on and return (recovery) of the acquisition adjustment associated with the 2004 purchase of Westfield Gas.

## FAIR VALUE AND ACQUISITION ADJUSTMENT

**Q: Petitioner's Witness Brehm points to previous cases in which the standard of "what a willing buyer would pay a willing seller in an arm's length transaction" is cited as an appropriate measure of "fair value." Shouldn't this be taken into account?**

A: Yes, but it is only one consideration among many, and has to be weighed accordingly. Willing participants and arm's length transactions don't necessarily guarantee a reasonable price outcome. Petitioner appears to believe that "fair value" and "market value" are synonymous. The OUCC disagrees. The Commission has consistently avoided equating the two, and acquisition adjustments have rarely been allowed for ratemaking purposes. Moreover, the statute does not define "fair value" as equating to "market value." In fact, IC 8-1-2-6 gives the Commission wide latitude for arriving at a fair value determination:

> The commission shall value all property of every public utility actually used and useful for the

> convenience of the public at its fair value, giving such consideration as it deems appropriate in each case to all bases of valuation which may be presented or which the commission is authorized to consider by the following provisions of this section. IC 8-1-2-6, Section 6(a).

**Q: Mr. Lorton, does Petitioner effectively propose to earn a return on and return (recovery) of an acquisition adjustment based on the purchase price paid by CESCO in September 2004?**

A: Yes. Line 2 Petitioner's Exhibit JRB-2 enters a "Gas Plant Acquisition Adjustment" of $3,629,021. Petitioner's Witness Brehm defines this adjustment as "the difference between the acquisition cost of the gas plant and its net original cost," (Petitioner's Exhibit JRB, p. 10, lines 9 – 10). However, Mr. Brehm quickly argues that Petitioner is not including this acquisition adjustment in its proposed rate base in this proceeding. Rather, he states that, "Petitioner is seeking to have its property valued for ratemaking purposes at its fair value . . ." (Id., lines 14 - 15). According to Mr. Brehm, Petitioner records an acquisition adjustment, but does not use it for ratemaking purposes.

**Q: Do you accept Mr. Brehm's contention that the acquisition adjustment is not being included in the rate base?**

A: No. The acquisition adjustment amount may not be isolated as a specific rate base adjustment. But Petitioner's methodology to arrive at its fair value rate base includes the amount of the acquisition adjustment (according to the definition used by Mr. Brehm) for ratemaking purposes, and drives the proposed fair value rate base to roughly $3.76 million above its proposed original cost rate base of $5,989,306 (see Public's Exhibit MHG-2, Schedule 4, page 1).

**Q: Please explain your understanding of Petitioner's proposed fair value rate base.**

A: Petitioner's proposed fair value rate base is $9,755,084. According to Petitioner's Witness Scott Miller, the ". . . the best and most appropriate assessment of the true worth of Petitioner's utility property" is "$9,248,151" (Petitioner's Exhibit SAM, p. 10, lines 5 through 13. See also Petitioner's Exhibit SAM-7, p. 1). This was the result of Mr. Miller's "methodology 2" to arrive at the fair value of Petitioner's utility property. Methodology 2 combines the Depreciated Purchase Cost (DPC) of Westfield Gas Corporation at the time of its acquisition by Citizens Energy Services Corporation (CESCO) with the Depreciated Replacement Cost (DRC) of assets added after the acquisition. In Petitioner' Exhibit JRB-13, Mr. Brehm arrives at the proposed fair value rate base of $9,755,084 by adding the "13 Month Average Inventory" of $506,933 to the result of Mr. Miller's methodology 2.

In his direct testimony, Mr. Miller used two other methodologies to calculate Petitioner's fair value. "Methodology 3" is a standard "replacement cost new less depreciation" (RCNLD) analysis, which arrived at a fair value of plant of $7,329,167. Mr. Miller stated that this was "not the preferred methodology" because it failed "to take into account actual arms-length market transaction information between a willing buyer and seller." (Petitioner's Exhibit SAM, p. 8, lines 1-3). Mr. Miller's "methodology 2" includes the full purchase price paid by CESCO in its acquisition of Westfield Gas Corporation.

Methodology 1, which Mr. Miller described as "Depreciated Replacement Cost of Purchase Price and New Assets," resulted in a value of $10,398,682. However, Mr. Miller admitted that it "may include value that was already reflected in the purchase price of the assets." (Petitioner's Exhibit SAM, p. 11, lines 5 – 6).

**Q: What price did CESCO pay for Westfield Gas Corporation?**

A: According to Mr. Miller's testimony, the purchase price was $5,882,593. (Id., p. 9, line 18, and Petitioner's Exhibit SAM-7).

**Q: What was the book value of Westfield Gas Corporation at the time of the acquisition?**

A: Public's Exhibit BEL-3 is Petitioner's response to OUCC data request question Q-58. It states that Net Utility Plant per books of Petitioner was $2,367,766. This was the book value that Mr. Brehm used to calculate the acquisition adjustment.

**Q: What was Petitioner's market-to-book ratio in the acquisition?**

A: The price CESCO paid for Westfield Gas was 2.48 times the book value.

**Q: What is the Commission's historical position on acquisition adjustments?**

A: Acquisition adjustments have been allowed only under limited circumstances. The circumstances under which acquisition adjustments have been allowed by the Commission were stated in Cause No. 42029, as follows:

> It is the established policy of this Commission to allow an acquisition adjustment in rates in only two events, namely:
>
> 1. As a result of the acquisition, are there significant and demonstrable benefits flowing to the ratepayers, e.g. better service and/or lower rates?
> 2. Does the acquisition result in correction or salvage of an entity identified by this Commission as a

"troubled" utility"? (Cause No. 42029, Order of November 6, 2002, p.5).

**Q: Mr. Lorton, doesn't Petitioner's Witness Braun present evidence that the utility has achieved commodity cost savings in excess of $1.6 million over the period 2005 through 2008 that have benefitted ratepayers?**

A: Mr. Braun's estimate of the commodity cost savings realized by Petitioner's customers is erroneous. This conclusion is borne out by the method he used in Petitioner's Exhibit CHB-3 in reaching such estimate. Also, the figure of $1.6 million of "savings in reduced gas commodity costs as a result of Citizens' gas procurement practices" was referenced in a letter from Mr. Lindsay Lindgren of Citizens Gas of Westfield to the utility's customers. This letter was filed as the "customer notice" in this case, on May 13, 2009 (see Public's Exhibit BEL-4).

First, Mr. Braun uses the Commission's annually published residential gas bill comparisons as the source data for his calculations. Those are <u>not</u> comparisons of commodity costs, but are total bill comparisons.

Second, Mr. Braun estimates the so-called "commodity savings" measured against the "industry average." This "industry average" is simply an overall average of gas utilities listed in the Commission's annual bill comparisons. These savings are not estimated by comparing the utility's own performance before and after the acquisition, or against actual natural gas market data. Consequently, the only claim that can be made is that Petitioner has improved its ranking compared to other Indiana gas utilities. Merely improving this ranking does not establish the existence of any measurable benefits to Petitioner's customers. Since the data Mr. Braun presents includes the total bill, rather than commodity cost only, *it is*

*possible that the only reason for this improvement is that most of the other utilities have had one or more rate cases since Petitioner's current rates went into effect.* Intuitively, this relative improvement will likely be watered-down or eliminated by increases resulting from this case.

Third, the Commission comparisons Mr. Braun uses are based on a level of consumption of 200 therms for one *monthly* bill. Mr. Braun's estimates are based on an *annual* consumption of 850 therms, or roughly an average of 71 therms per monthly bill. Consumption of 200 therms in one month appears to be more in line with a winter month, and not consistent with a monthly average yielding 850 therms consumed in a year. Mr. Braun's calculation on Petitioner's Exhibit CHB-3 ignores the fact that the fixed monthly charge and distribution charge is a higher percentage of the total monthly bill in warmer, lower usage months. Mr. Braun's claim of "gas commodity savings" is skewed when he uses a commodity cost/distribution charge bill ratio from a winter month as being representative of an entire year's estimated usage. Mr. Braun's calculation of "gas cost savings" is also flawed by including the fixed monthly charge and distribution charges in the calculation.

Fourth, even Mr. Braun's own calculations show that Petitioner's average bill at 200 therms consumption rose from an $192.63 in the 2001-04 timeframe to $227.95 in 2005-08. (See Petitioner's Exhibit CHB-3). The ratepayers have not seen their bills drop, nor do the comparisons used by Mr. Braun imply any improvement in commodity cost performance by Petitioner.

Based on these facts, I do not believe that Petitioner has demonstrated any significant or measurable benefit to its customers that would justify a *de facto* acquisition adjustment for ratemaking purposes.

**Q: Has Petitioner presented any evidence that Westfield Gas was a "troubled utility" at the time of the acquisition?**

A: No. It has presented no evidence of "troubled utility" status in its case-in-chief, nor even made such a contention.

**Q: Mr. Lorton, you mentioned earlier that the market-to-book ratio associated with the acquisition was 2.48. Does this appear to be reasonable?**

A: No. In Cause No. 41968, Aqua Source was allowed an acquisition adjustment on its purchase of Utility Center water utility. In that case, Utility Center was found to be a "troubled utility" but the Commission held that the acquisition adjustment should allow a market-to-book of no more than 2.09. Without convincing evidence as to the benefits to ratepayers resulting from the acquisition of Westfield Gas, and no evidence presented (nor even the contention raised) that Westfield Gas was a "troubled utility," treating Petitioner as if a 2.48 market-to-book ratio is reasonable for rate making purposes is both unrealistic and excessive.

**Q: In your opinion, what has been the historical regulatory treatment given to acquisition premiums?**

A: Acquisition premiums have historically not been included in rate base or given above the line treatment for ratemaking purposes.

**Q: In your opinion, what basis is used to support this historical treatment?**

A: Abuses from the 1920's and 1930's created the need to adopt the "original cost" concept in setting rates. In the 1920's and 1930's, utilities were acquiring other utility properties for amounts in excess of net book value. As a result, inflated rate bases were created through transactions that lacked any economic substance. When included for ratemaking treatment, this meant customers would be paying a premium through higher rates for the same property that had been providing them utility service. Regulators noticed that if utilities were allowed to earn a return on investment in excess of original cost, investors would realize unreasonably high profits. Accordingly, regulators determined that it was not reasonable to charge customers higher rates for the same utility property simply because the utility providing service was acquired by another company. (Hahne & Aliff, Accounting for Public Utilities (Matthew Bender) 4.04[2], p. 4-9, 4-10.)

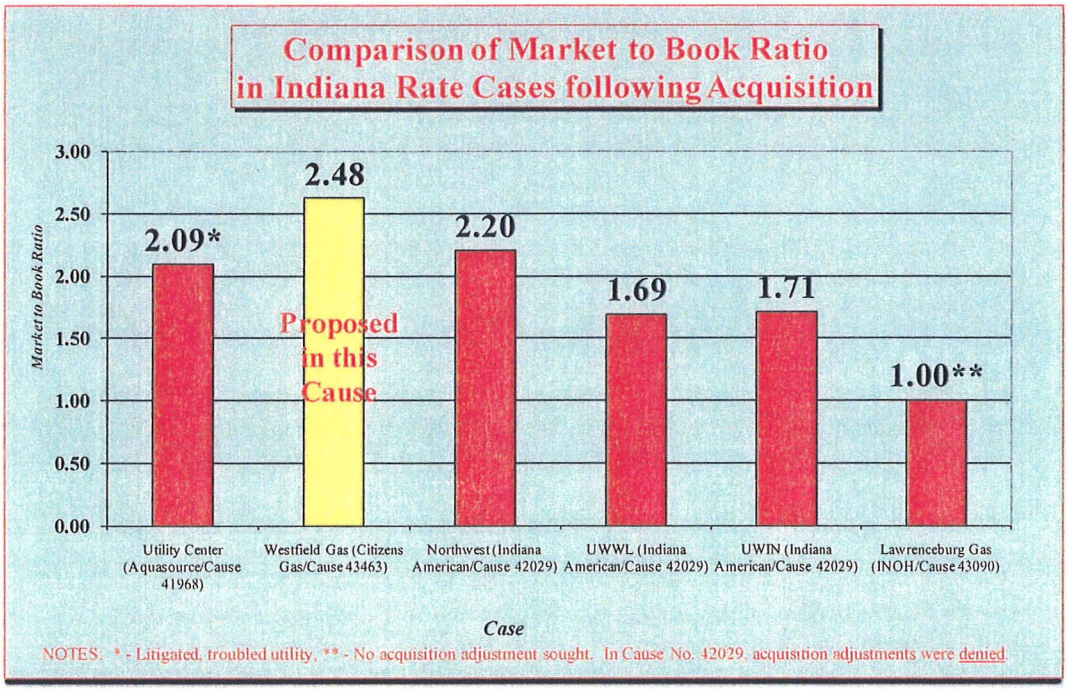
**Q: Why, in your opinion, did regulators determine it was not reasonable to charge customers higher rates for the same utility property?**

A: Regulators have granted public utilities a monopoly for their services. Under this status, a regulatory compact was formed providing public utility companies certain privileges in exchange for certain obligations, which are not afforded to non-regulated, competitive businesses. The utility's obligations include the provision of safe and reliable utility service at non-discriminatory, reasonable rates. Privileges given to the public utility include exclusive service territory and the opportunity to recover all reasonably and prudently incurred costs and to receive a fair return on prudent investment. In return for this protection, utilities have generally been prohibited from earning unreasonably high profits.

**Q: Have you found other cases in which acquisition adjustments were denied on similar bases to what you have described?**

A: Yes. In Cause No. 42029, Indiana-American Water Company requested acquisition adjustments for ratemaking purposes on three smaller utilities, (Northwest Indiana Water Company, United Water West Lafayette Inc., and United Water Indiana, Inc.) that Indiana-American had acquired since its last rate case. The market-to-book ratios on these utilities were 1.69, 1.71 and 2.20. However, the Commission denied the requested adjustments because Indiana-American had not presented evidence that the acquired utilities were troubled, nor that significant benefits were received by ratepayers as a result of the acquisition. Graph 1 compares the market-to-book ratios in these cases compared to the proposal from Petitioner in this case.

**Graph 1**



**Q: Do you agree with Petitioner's Witness Scott Miller that the Lawrenceburg Gas rate case (Cause No. 43090) "provides a compelling argument" for the fair value methodology that Petitioner has employed in this case?**

A: No. I was involved in the Lawrenceburg Gas rate case as an analyst and witness. My recollection of that case is that there were several issues, most notably in Lawrenceburg's capital structure, that made it an unusual case, and not a good comparison.

Mr. Miller cites an opinion stated by Lawrenceburg Gas witness Duane Mercer that the fair value of that utility was $16,804,760. However, the Lawrenceburg final order does not address fair value. The words "fair value" are not to be found in that final order. Mr. Mercer proposed an original cost rate base of $15,239,260, (Cause No. 43090, Order, p. 7). The Commission accepted a rate base very close to that proposed by Public's witness Mark Grosskopf in that case, and determined a rate base of $15,224,621 (Id., p. 8).

The purchase price of Lawrenceburg Gas in 2004 was very close to book value. The current owners purchased Lawrenceburg for $15,165,199 (Cause No. 43090, Petitioner's Exhibit DCM, p.11) on February 27, 2004. An examination of Lawrenceburg's "Class A-B Private Gas Utility Annual Report" for the year ending December 31, 2003 reveals a book value of $15,141,111 (Net Utility Plant in Service less Property Held for Future Use and Construction Work in Progress). Lawrenceburg did not seek a return on or of an acquisition adjustment in its rates.

Finally, Mr. Miller states that the dollars per foot of mains in the Lawrenceburg "fair value" estimate "shows the price CESCO paid to acquire

Petitioner was reasonable given the market forces in effect since both acquisitions were conducted as arms-length transactions between unaffiliated parties at approximately the same time and yielded very comparable results." (Petitioner's Exhibit SAM, p. 12, lines 12 - 15). But Mr. Miller's calculation of the Lawrenceburg "dollars per foot of mains" is based on a fair value estimate that the Commission never approved, and that was not even addressed in the final order. This is not a convincing argument for the reasonableness of the price CESCO paid for Westfield Gas.

**Q: What is your recommendation on fair value of Petitioner's rate base?**

A: The fair value rate base recommendation of over $9.75 million is far too high. To reach that level, Petitioner must include a *de facto* $3.6 million acquisition adjustment, that Petitioner otherwise seems to disavow. As a result, Petitioner asks for a rate base $3.76 million higher than the original cost rate base. Petitioner's fair value should be $5,989,306 (see Public's Exhibit MHG-2, Schedule 4, page 1), which is calculated without the *de facto* acquisition adjustment.

## FAIR RETURN

**Q: Did Petitioner propose an amount of fair return on rate base?**

A: Yes. Petitioner's Witness Brehm proposes a fair dollar return of $856,258.

**Q: Do you agree with Mr. Brehm's proposed amount of fair return?**

A: No.

**Q: Please explain.**

A: Mr. Brehm's proposal suffers from three distinct problems. First, his fair return includes $79,753 for "economic less book depreciation." Mr. Brehm proposes that Petitioner be compensated for "economic depreciation," and that such compensation be realized via Petitioner's return. Depreciation normally reduces the rate base over time. But under Mr. Brehm's proposal the future rate base would not be reduced. Also, the resulting increase in return would increase Petitioner's tax liabilities that would be passed on to ratepayers. If allowed to collect economic depreciation, Petitioner would collect any appreciation of assets due to inflation without regard to actual costs. In effect, Mr. Brehm proposes that Petitioner be allowed to collect a return on an unrealized gain in the value of assets.

Second, Mr. Brehm's fair return estimate is calculated against Petitioner's proposed fair value rate base of $9,755,084 which is far too high for reasons discussed earlier.

Third, Mr. Brehm used over ten pages of his direct testimony (See Petitioner's Exhibit JRB, pp. 30-41) elaborating on a methodology to calculate the "correct fair return." He presents a hypothetical model to demonstrate the mathematical correctness of his methodology (see Petitioner's Exhibit JRB-9). However, Mr. Brehm fails to apply Petitioner's actual data to the model he spends ten pages of testimony elaborating. Public's Exhibit BEL-5 is a copy of Petitioner's response to OUCC data request question Q-55. It clearly states that Mr. Brehm did not apply Petitioner's actual data to the model he presented.

**Q: Mr. Lorton, given Petitioner's proposed fair dollar return amount of $856,258, what costs of capital and equity are implied using Petitioner's original cost rate base?**

A: Petitioner's current original cost rate base is $5,989,306. (Public's Exhibit MHG-2, Schedule 4, page 1). The fair dollar return amount proposed by Mr. Brehm would produce a 14.30% cost of capital for Petitioner. Given Petitioner's proposed capital structure, the implied return on equity would be 14.46%.

**Q: Do you have any recommendations for calculating fair return for Petitioner?**

A: Yes. Use the fair dollar return of $578,197 as shown by the testimony of Public's witness Mark Grosskopf (Id.). This fair return calculation eliminates both the *de facto* acquisition adjustment described earlier and the $79,753 addition for "economic less book depreciation."

## COST OF EQUITY

**Q: What is Petitioner's current authorized return on equity (ROE)?**

A: It is currently 12.0% This ROE resulted from the Westfield Gas rate case in 2002, (Cause No. 42095-U) in which the revenue requirement was changed from its 1997 rate case (Cause No. 40793), but not the rate schedules. However, the final order in Cause No. 42095-U approved a 9.31% weighted cost of capital which included a 12.0% ROE.

**Q: Do you recommend reducing the authorized ROE?**

A: Yes.

**Q: Please explain why?**

A: The Normal Temperature Adjustment mechanism (NTA), approved on February 28, 2007 in Cause No. 43202 has considerably reduced Petitioner's risk. The

NTA was not in place at the time of Petitioner's last rate case. Moreover, common equity accounted for only about 50% of the approved capital structure in Cause No. 42095-U. The capital structure proposed in this Cause includes no debt. With less risk, ROE should be reduced. Interest rates in a relatively low range, Petitioner's low risk due to the NTA and 100% equity financing, demonstrate that an authorized ROE in the range of 12.0% is too high.

**Q: What is Petitioner's proposed ROE?**

A: Petitioner's witness Mr. Brehm proposes a 10.57% ROE.

## THE PROXY GROUP FOR DCF AND CAPM ANALYSES

**Q: Please describe your approach to establishing a cost of equity estimate for Petitioner.**

A: I relied primarily on the DCF and CAPM models to estimate the cost of equity.

**Q: Can you apply the DCF and CAPM models directly to Petitioner?**

A: No. Petitioner's stock is not publicly traded, and consequently much of the data that would be available for publicly traded companies is not available for Petitioner. This fact makes it impractical to apply the DCF and CAPM directly to Petitioner.

I calculated cost of equity for Petitioner based on a proxy group of publicly traded companies. This is an established approach.

**Q: Please describe how you derived the proxy group for your DCF and CAPM studies.**

A: I used the same proxy group Mr. Brehm did in his CAPM calculation.

**Q: What companies are in this proxy group?**

A: Mr. Brehm chose eight (8) companies from the Standard edition of Value Line. These companies include AGL Resources, Inc., Atmos Energy Corp., Laclede Group Inc., Northwest Natural Gas Co., Piedmont Natural Gas Company, Inc., South Jersey Industries, Inc., and WGL Holdings, Inc.

## DISCOUNTED CASH FLOW ANALYSIS

**Q: Mr. Lorton, do you agree with Mr. Brehm's Discounted Cash Flow (DCF) result of 13.61% cost of equity for Petitioner?**

A: No. Mr. Brehm's methodology to calculate a DCF result appears to add an expected rate of inflation of 2.54% to a growth rate of 11.07%. Mr. Brehm has substituted the expected rate of inflation for the dividend yield portion of the DCF equation (see below) on the assumption that Petitioner's current dividend is zero and will remain so. He uses a growth rate for the number of residential services as a proxy for constant growth in stock prices (see Petitioner's Exhibit JRB, pp. 25-26, and Petitioner's Exhibit JRB-7). He states that a DCF peer group analysis is problematic for this utility. I disagree. Proxy group dividend yields and growth rates are key information used by investors to develop expectations on return on equity (ROE). A proxy group provides an approximation of such expectations. Moreover, in his CAPM analysis, Mr. Brehm selected a proxy group which he felt applicable for comparison to Petitioner. Mr. Brehm's DCF methodology is unique at best, and highly questionable. Moreover, 13.61% is not a reasonable ROE, as it is out of line with findings in recent rate cases, and even Mr. Brehm backs away from using it as his final recommendation.

**Q: Please describe Discounted Cash Flow (DCF) Analysis in general.**

A: DCF analysis helps investors determine the appropriate price to pay for particular assets, such as utility stocks. The model has been adapted for regulatory proceedings in order to determine the cost of utility equity capital. The DCF model holds that the price of an asset today should equal the sum of all the cash flows that the asset will generate, discounted by the appropriate rate back to the present. This discount rate equals the cost of capital. With utility stocks, dividends are the relevant cash flows.

**Q: Please describe the "Constant Growth" DCF Model.**

A: The underlying principle of the "Constant Growth" DCF Model is that the price of a firm's stock reflects the *expected* cash flows (i.e. dividends) associated with that stock, discounted at a rate equal to the cost of equity capital. This can be expressed mathematically by the following equation:

$$P_0 = D_1/(K - g)$$

In this equation, the current price, $P_0$, can be calculated by dividing the expected annual dividend for the next year, $D_1$, by the term $K - g$ where $K$ represents the cost of equity capital and $g$ equals the expected, long-run annual growth rate in dividends per share (DPS). This model relies on the assumption that investors *expect* earnings per share (EPS), book value per share (BPS), and stock price per share to also grow at a constant long-run rate ($g$).

By rearranging the algebraic terms, it becomes possible to solve for the cost of equity capital. The resulting formula is the DCF model most familiar in utility regulation:

$$K = (D_1/P_0) + g$$

Here, the cost of equity capital, $K$, equals the "forward dividend yield," $D_1/P_0$, plus the expected growth rate in dividends per share, $g$. The DCF model, therefore, requires estimates of the forward dividend yield and the expected growth rate.

**Q: Is the "Constant Growth" DCF Model considered a reliable method to estimate cost of equity for public utilities?**

A: Yes. This model, when combined with reasonable judgment, provides a realistic and reliable method to estimate a utility's cost of equity. It also formulates the cost of equity as "yield plus growth," which accurately defines the incentive for investors to purchase stocks.

The DCF model is also relatively simple in that it states cost of equity in terms of just two components, and only one of these involves any significant controversy. The calculation of dividend yield generally involves few disputes. Most of the controversy in DCF calculations focuses on the growth rate $g$. This should not be surprising since the growth rate projects into the future, and disagreements will always arise regarding such projections. However, a reasonable estimate for $g$ can be developed by evaluating variables such as dividends, earnings, and book value per share. (Note: for the balance of my testimony, the "Constant Growth DCF Model" will simply be referred to as the "DCF model").

**Q: What is the difference between the current and forward dividend yields?**

A: The current yield, $D_0/P_0$, equals the current annual dividend rate, $D_0$, divided by the current stock price, $P_0$. The current annual dividend rate, $D_0$, equals the most recent quarterly dividend multiplied by four -- it does not include any projection into the next year. Dividend yields published by *The Wall Street Journal* and *AUS Utility Reports* are current dividend yields $D_0/P_0$.

The forward yield, $D_1/P_0$, adjusts the current yield $D_0/P_0$ to reflect likely dividend growth in the subsequent year. The forward yield replaces the current dividend rate, $D_0$, with a prospective dividend rate, $D_1$. $D_1$ is the rate expected during the following year, and the forward yield will then be calculated by dividing $D_1$ by the current price, $P_0$. Financial analysts frequently accomplish this adjustment by increasing the current dividend yield for one-half of a year's growth in dividends. This method is often referred to as the "half-year method." I utilize this method in my DCF analysis to convert current dividend yields ($D_0/P_0$) into forward dividend yields ($D_1/P_0$).

**Q: What is the result of your forward dividend yield calculation?**

A: My calculations resulted in a 4.2% forward dividend yield for the Gas Utility Proxy Group. This calculation applies the "half year method" to the average current yield calculated from *AUS Utility Reports* data. Page 2 of Public's Exhibit BEL-6 shows my calculations. However, I did not use this calculation as my final dividend yield recommendation, as recent Value Line data produced a result more favorable to the utility.

**Q: Did you compare your forward dividend yield calculation with any other published data?**

A: Yes. I compared the results to an average of the Value Line dividend yields for the Gas Utility Proxy Group. Value Line publishes forward dividend yield estimates that reflect anticipated dividend growth in the coming year. My calculations and the Value Line forward yields are shown in Public's Exhibit BEL-6. For purposes of this DCF analysis, I am using the Value Line forward yield of 4.8% for the Gas Utility Proxy Group. I concluded this to be reasonable and more favorable to Petitioner.

**Q: Please describe the estimate of the growth term *"g"* that you utilized in your DCF analysis.**

A: I relied on Value Line growth rates in EPS, DPS and BPS for companies in the Gas Utility Proxy Group.

**Q: Please describe the results of your growth calculations.**

A: I have concluded that 5.1% is a very reasonable growth rate for the Gas Utility Proxy Group (see page 5 of Public's Exhibit BEL-6 for Value Line Growth Rate data and averages). This rate results from analyzing EPS, DPS and BPS growth rates for the Gas Utility Proxy Group.

**Q: What have you concluded based on your DCF analysis?**

A: My DCF calculations result in a cost of equity of 9.9%. This combines the 4.8% forward yield and the 5.1% growth rate.

## CAPITAL ASSET PRICING MODEL

**Q: Mr. Lorton, do you agree with Mr. Brehm's Capital Asset Pricing Model (CAPM) result of 14.22% cost of equity for Petitioner?**

A: No. Mr. Brehm's calculation depends on the addition of a small company premium of 365 basis points, along with a much larger risk-free rate and beta than current data can reasonably justify. An additional premium for company size is a questionable adjustment when analyzing public utilities. Annie Wong of Western Connecticut State University writes:

> . . . given firm size, utility stocks are consistently less risky than industrial stocks. Second, industrial betas tend to decrease with firm size but utility betas do not. These findings may be attributed to the fact that all public utilities operate in an environment with regional monopolistic power and regulated finance structure. As a result, the business and financial risks are very similar among the utilities regardless of their sizes. (Annie Wong, "Utility Stock and the Size Effect: An Empirical Analysis," Journal of the Midwest Finance Association, 1993, p. 98).

Moreover, Michael Paschall and George B. Hawkins state that:

> A size premium does not automatically apply in every case. Each privately held company should be analyzed to determine if a size premium is appropriate in its particular case. There can be unusual circumstances where a small company has risk characteristics that make it far less risky than the average company, warranting the use of a very low risk premium. One possible example of this is a private water utility (monopoly situation, very low risk, near-guarantee of payments). (Paschall and Hawkins, Do Smaller Companies Warrant a Higher Discount Rate for Risk?: The "Size Effect" Debate, CCH Business Valuation Alert, December, 1999).

**Q: Please describe the Capital Asset Pricing Model (CAPM).**

A: The underlying assumption of CAPM is that the stock market compensates investors for risk that cannot be eliminated by means of a diversified stock portfolio. In CAPM, the required return on a stock equals the sum of a risk free rate of return ($R_f$) plus a risk premium [$\beta*(R_m - R_f)$] which is proportional to the level of "market risk," which cannot be eliminated through diversification. The CAPM formula is:

$K = R_f + \beta*(R_m - R_f)$

where,

$\beta$ = Beta, a measure of risk for the company,

K = Required return (i.e. cost of equity) on the stock of the company,

$R_f$ = Risk-free rate of return,

$R_m$ = Market equity return,

$(R_m - R_f)$ = Market equity risk premium.

The "beta" is considered the measure of risk most relevant in CAPM. A stock with a beta below 1.0 is considered less volatile and less risky than the stock market. Above a 1.0 beta the stock is considered more volatile and more risky than the stock market. By definition, the stock market has a beta of 1.0. The market is usually represented by a large and highly diversified portfolio of stocks such as the Standard & Poor's 500.

**Q: Were you able to perform a CAPM analysis directly for Petitioner?**

A: No. As Petitioner's stock is not publicly traded, the necessary data does not exist to perform CAPM analysis directly for Petitioner. Therefore, I have used the Gas Utility Proxy Group to perform a CAPM analysis.

**Q: How did you estimate "beta" term used in your CAPM model?**

A: I used betas from the Value Line Investment Survey, Standard Edition for the companies in the Gas Utility Proxy Group. However, as Public's Exhibit BEL-7 shows, I considered betas from Smart Money, Yahoo Finance, NASDAQ and Zack's. For this analysis I used the average of the Value Line adjusted betas. The Value Line adjusted betas calculated to the highest average of the data series that I

considered. Therefore, I will utilize 0.65 as the beta estimate in my CAPM analysis.

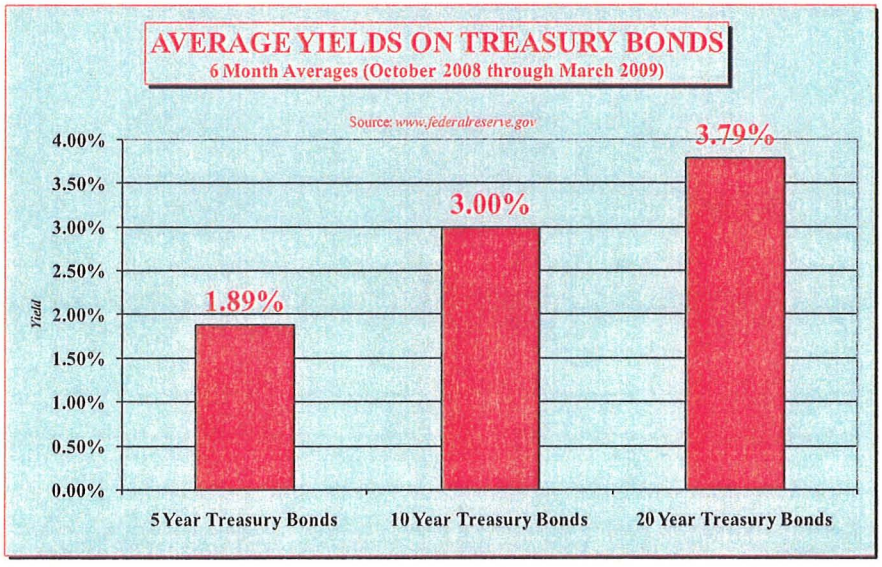
**Q: What risk free rate ($R_f$) are you using for your CAPM calculations?**

A: I used 4.8% for my risk free rate.

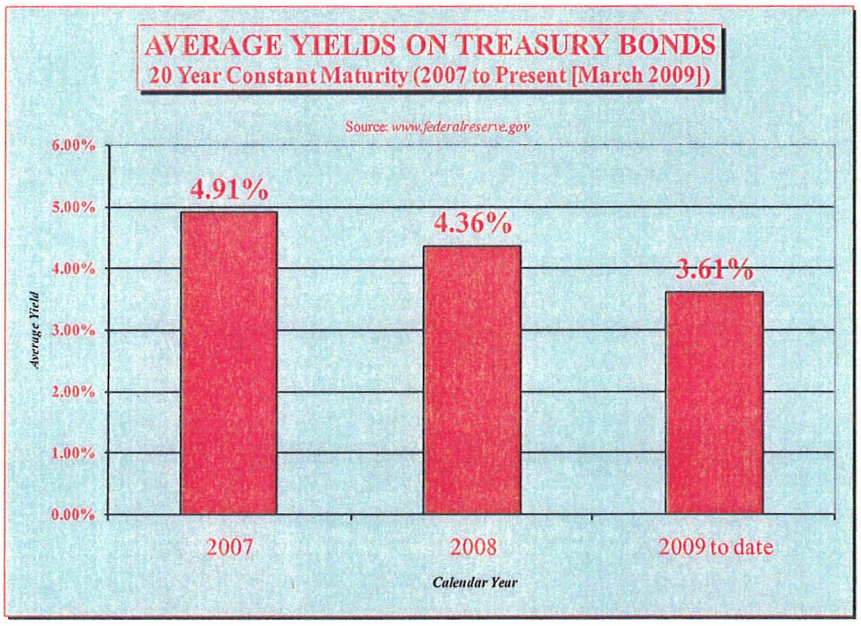
**Q: Please describe how you determined the risk free rate of 4.8%.**

A: I use 4.8% because it is near the top of my reasonable range. I examined recent and long term trends in yields on 5-year, 10-year and 20-year Treasury securities from data available from the Federal Reserve (www.federalreserve.gov). I calculated averages for the latest 6 months and for Calendar Years 2007, 2008 and 2009 to date (through March). Graph 2 illustrates the average rates on 5, 10, and 20 year Treasuries for the period between October, 2008 and March, 2009. Graph 3 shows the average rates on 20 Year Constant Maturity U.S. Treasuries from Calendar Years 2007, 2008 and 2009 to date.

**Graph 2**



**Graph 3**




Bond yields have slumped over the last two years as the economic downturn and recession made debt assets more attractive than equity. Monthly average yields on 20 year bonds bottomed out in December 2008 at 3.18%, and by March 2009 averaged only 3.78%. While a stronger economy will likely push yields above 4% a discernable economic recovery has yet to materialize.

I also examined the preliminary economic projections from the Congressional Budget Office (CBO) in *The Budget and Economic Outlook: Fiscal Years 2009 to 2019* (http://www.cbo.gov/doc.cfm?index=10014). The latest CBO projections for 10-year Treasuries are 2.9% in 2009, and 3.4% in 2010. Yields on 10 year Treasuries are not expected to exceed 4.0% on average until 2012 (Id.).

However, Graph 3 shows that 20 year Treasuries averaged 4.91% in 2007, prior to the heavy impact of the current recession. I have made every effort to afford a reasonable return for Petitioner. My research leads me to conclude that 4.8% is a

very reasonable risk-free rate. It considers both recent experience and projections, and filters out most of the slump in rates due to the current economic downturn.

**Q: Do you agree with Mr. Brehm's contention that "With respect to the risk-free rate, the rate to be used in the analysis should reflect a full spectrum of possible future macroeconomic conditions . . ."?**

A: No. It is virtually impossible for any economist to know the "full spectrum of possible future macroeconomic conditions" let alone "reflect" them in an analysis. To do so would require a degree of clairvoyance that has so far eluded the economics community. From the timeframe employed in his analysis, Mr. Brehm confuses the concept of "full spectrum of possible macroeconomic conditions" with that of "historic performance over a complete business cycle." While examining history has some merit, it should also be kept in perspective. In my section on macroeconomic trends, I discuss long-term trends in various bond yields. Notice that in Graphs 4, 5 and 6 (pp. 31-32) that just measuring "peak-to-peak" or "trough-to-trough" of the bond yield trends displayed reveals very little about future ups-and-downs. Over the course of the last three decades, bond yields have trended down on a long-term basis. The movement of any particular cycle in those graphs would not be a good indicator of future movements. Moreover, current rates are themselves projections of future movements based on the information available.

My analysis includes over two years of bond yield data from the Federal Reserve. Moreover, I have tried to be as generous to the utility's position as I believe a reasonable analysis permits. Consequently, I do not believe that an average of 20-year bond yields over the course of one business cycle represents the most accurate projection of future "macroeconomic conditions."

**Q: How did you estimate the Market Risk Premium ($R_m$ - $R_f$)?**

A: I calculated long term market risk premiums based on historical data from Stocks, Bonds, Bills and Inflation, 2009 Classic Yearbook, by Morningstar, Inc. (formerly Ibbotson Associates). The Morningstar data base covers the period 1926 to 2008. There are two methods of calculating historical holding period returns: the geometric mean (or compound annual return) and the arithmetic mean, which is a simple average of one year holding period returns.

The geometric mean return measures the average compound annual rate of return from an investment over a period of more than one year. The arithmetic mean measures the average of one year holding period returns. The arithmetic mean rate of return *always* exceeds the geometric mean rate of return unless the investment provides a constant return year after year. The arithmetic mean approach also produces higher estimates of the market risk premium, and higher overall CAPM results.

As the Commission has expressed its preference for considering both the geometric mean and arithmetic mean approaches, the market risk premiums that I calculate give equal weight to both the geometric and arithmetic mean approaches. This yielded a 4.75% risk premium. [Public's Exhibit BEL-7, page 4 of 4].

**Q: Please describe the results of your CAPM analysis.**

A: Here again, I emphasize that my analysis provides a conservatively high estimate. I have used only the upwardly adjusted betas from Value Line and a risk free rate higher than recent performance of 20 year Treasury bonds might otherwise indicate. I have also balanced the weight given to the geometric mean and arithmetic mean

approaches. This results in a CAPM estimate of 7.9% for the Gas Utility Proxy Group.

**Q: How does this estimate compare with your DCF cost of equity estimate?**

A: It is well below my 9.9% DCF result. I am recommending a cost of equity for Petitioner of 9.75%, toward the upper end of the range between my DCF and CAPM models. I make my recommendation in order to afford Petitioner as reasonable a rate of return as my analysis justifies.

**Q: Did you make any downward adjustment for the fact that Petitioner has zero long term debt in the capital structure?**

A: No. However, such an adjustment could be justified. The proxy group companies employ very substantial amounts of debt, which increase risks to shareholders. However, in light of Petitioner's small size I have made no adjustments to reflect the absence of any risk associated with debt capital.

## MACROECONOMIC TRENDS

**Q: Do macroeconomic factors and trends influence the cost of equity?**

A: Yes. The most noteworthy of these factors are interest rates, economic growth, and inflation.

**Q: Do you have economic forecast data to support 9.75% as a reasonable ROE for Petitioner?**

A: Yes. Another indication of the reasonable nature of my recommendation comes from the March 2009, *CFO Magazine Business Outlook Survey*, from Duke University (See Public's Exhibit BEL-8). This survey of Chief Financial Officers from major corporations, observed: "On February 16, 2009 the annual yield on 10-yr treasury bonds was 2.9%" and posed the question, "Over the next 10 years,

I expect the average annual S&P 500 return will be: . . ." The mean expected return on the S&P 500 was 8.77% with a 95% Confidence Interval between 7.89% and 9.65%. This places my recommended ROE, of 9.75% for Petitioner, above the upper limit of the *CFO Magazine* survey's 95% Confidence Interval.

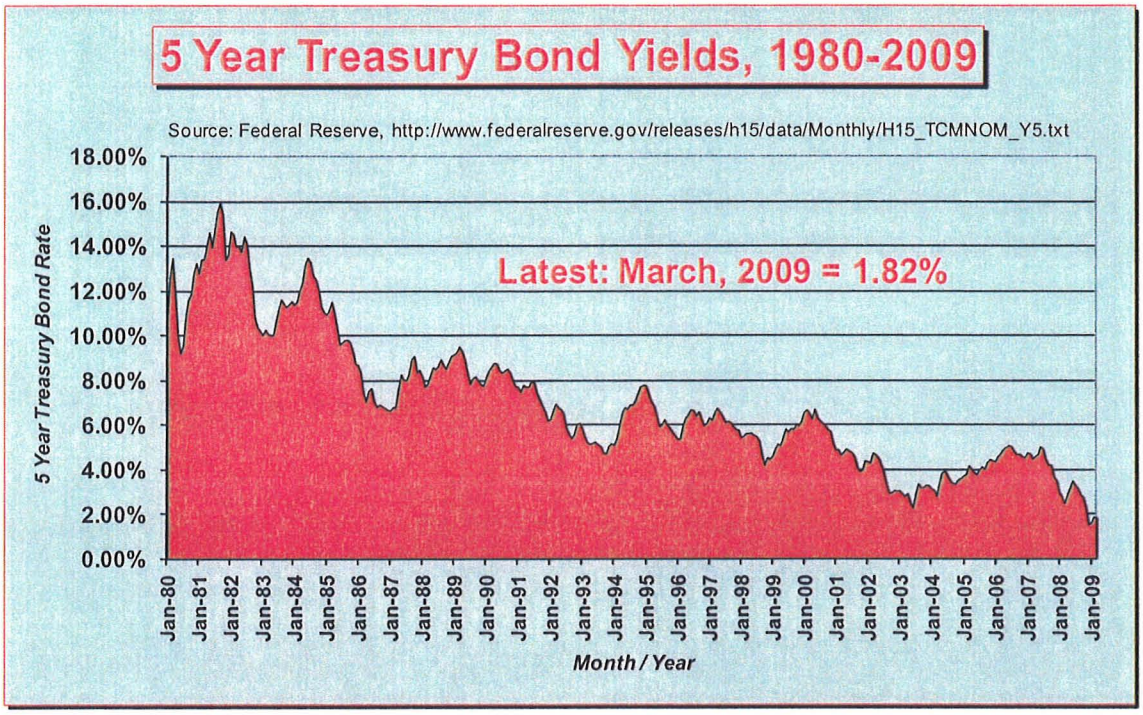
In contrast to the CFO Survey rate of return of 8.77% for S&P 500 companies, Mr. Brehm suggests that an 10.57% cost of equity should apply to a regulated public utility with zero debt. In today's capital market, Petitioner's proposal is too high and not realistic.

**Q: Please discuss interest rates as an influencing factor.**

A: Interest rates are one of the most important influencing factors. Yields on U.S. Treasury Bonds are commonly used to establish the risk-free rate of return in many analyses. Moreover, changes in interest rates have an impact on investor expectations.

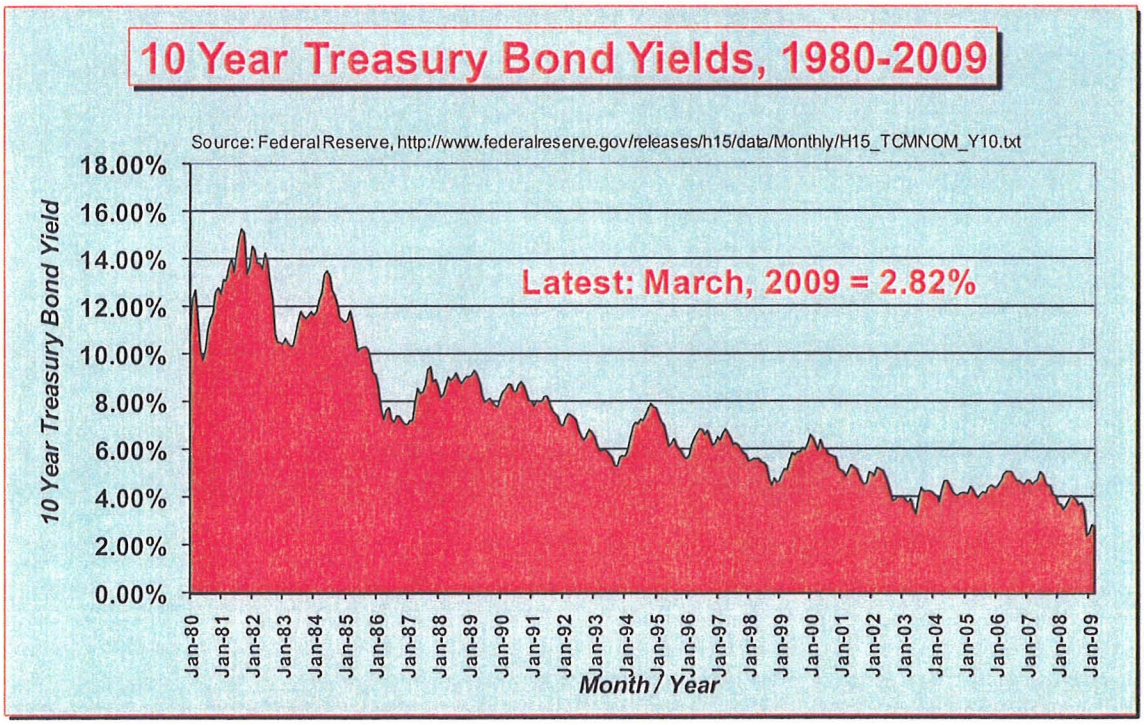
Recent years have been described as a period of "low cost capital." Lower interest rates and bond yields have been the main indicator of this trend. The trend toward low cost capital has taken place over two decades; it is a long run phenomenon. Graph 4 shows the monthly interest rate trend on 5-year constant maturity Treasury bonds, reported by the Federal Reserve. Graph 4 makes it obvious that we are in a period with rates well below the experience of the 1980s and 1990s.

**Graph 4**

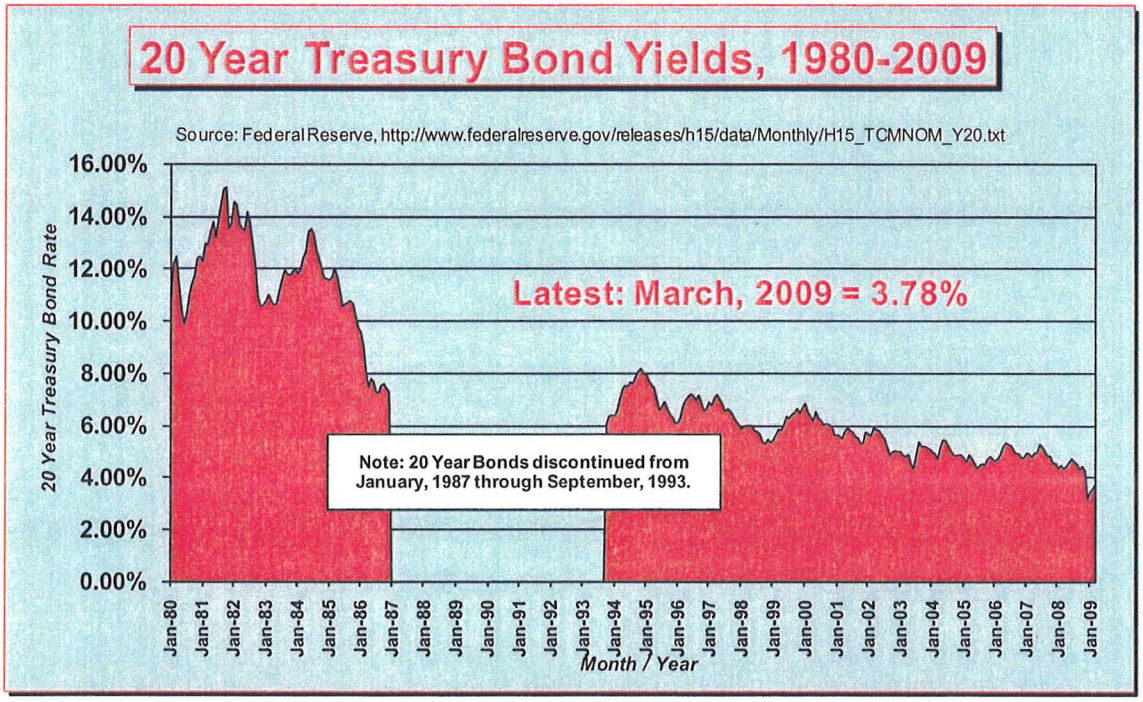



Graphs 5 and 6 reveal similar trends for 10-year and 20-year Treasuries.

**Graph 5**




**Graph 6**




**Q: Please discuss economic growth as an influencing factor.**

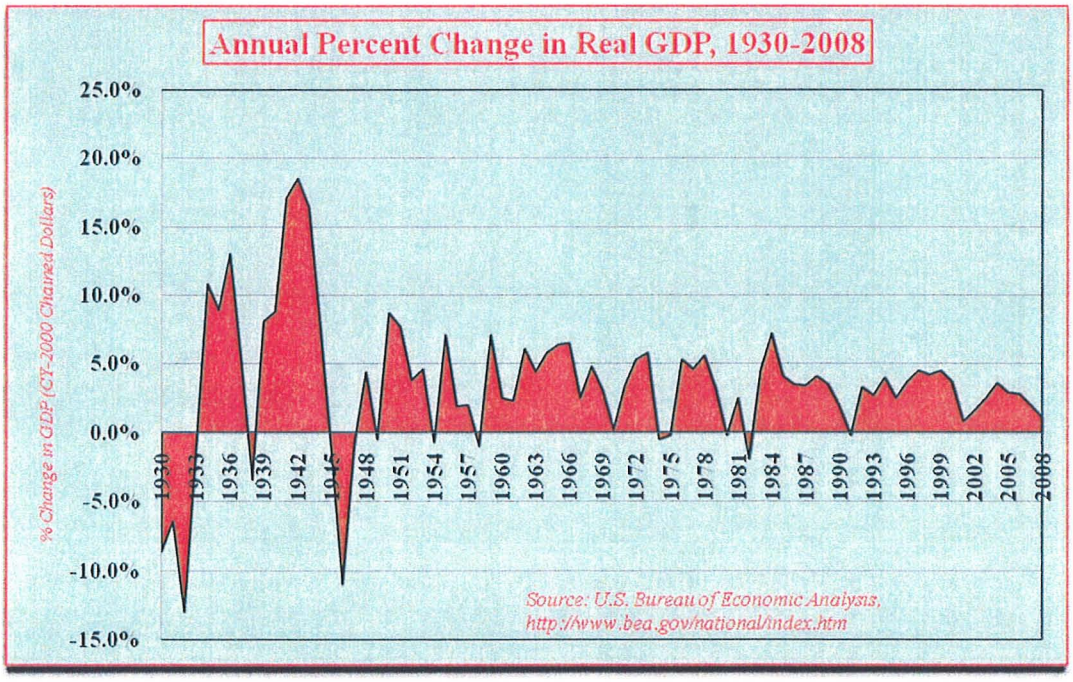
A: The most important influence that economic growth has on cost of equity is its potential impact on interest rates. A booming, high growth economy tends to put upward pressure on interest rates. A lackluster or recessionary economy tends to lead to stagnant or falling interest rates.

Graph 7 shows annual percent changes in real Gross Domestic Product (GDP) in the period 1930 through 2008, as published by BEA. The economic expansion that began in late 2001 proved somewhat less robust than earlier decades. Prior to the 1990's economic expansion periods included at least one or more years above 5% real growth. The U.S. economy has not experienced that level of real GDP growth on an annual basis since 1984. Moreover, CBO forecasts a 3.0% decline in real GDP in 2009, and only 2.9% growth in 2010.

Long term, the CBO forecasts 3.6% annually in the period 2012-2015, and 2.3% in 2016-2019. (Congressional Budget Office, *A Preliminary Analysis of the President's Budget and an Update of CBO's Budget and Economic Outlook*, Table 2-1, March, 2009. http://www.cbo.gov/doc.cfm?index=10014). Recent data reveals the impact of the current recession. The third quarter of 2008 saw a negative real growth rate of -0.6%. The recession then intensified with the GDP declining in both the fourth quarter of 2008 and the first quarter of 2009 at -6.3% and -6.1% respectively. (U.S. Department of Commerce, Bureau of Economic Analysis, http://www.bea.gov/national/index.htm).

In recent weeks, expectations have grown for the recession to end by late this year or early next. However, the current projections from the CBO and BEA continue to suggest somewhat restrained growth in the long term.

**Graph 7**



**Q: Have you taken current and projected inflation into account in your analysis?**

A: Yes.

**Q: Please describe the trends in the rate of inflation.**

A: The U.S. economy remains in a relatively low inflation period. In his testimony before the Congressional Joint Economic Committee on May 5, 2009, Federal Reserve Chairman Ben S. Bernanke observed that:

> As economic activity weakened during the second half of 2008 and prices of energy and other commodities began to fall rapidly, inflationary pressures diminished appreciably. Weakness in demand and reduced cost pressures have continued to keep inflation low so far this year. Although energy prices have recently risen some, the personal consumption expenditure (PCE) price index for energy goods and services in March remained more than 20 percent below its level a year earlier. Food price inflation has also continued to slow, as the moderation in crop and livestock prices has been passing through to the retail level. Core PCE inflation (prices excluding food and energy) dropped below an annual rate of 1 percent in the final quarter of 2008, when retailers and auto dealers marked down their prices significantly. In the first quarter of this year, core consumer price inflation moved back up, but to a still-low annual rate of 1.5 percent. (Federal Reserve, http://www.federalreserve.gov/newsevents/testimony/bernanke20090505a.htm).

Chairman Bernanke further stated the Fed's expectations on inflation:

> In this environment, we anticipate that inflation will remain low. Indeed, given the sizable margin of slack in resource utilization and diminished cost pressures from oil and other commodities, inflation is likely to move down some over the next year relative to its pace in 2008. However, inflation expectations, as measured by various household and business surveys, appear to have remained relatively stable, which should limit further declines in inflation (Id.).

CBO estimates are consistent with Chairman Bernanke's Congressional testimony. The CBO estimates the Consumer Price Index (CPI) in 2009 will decline by 0.7%, and increase to only 1.4% in 2010 and 1.2% in 2011. The CBO also estimates that the "Core Consumer Price Index" (which excludes the volatile prices in food and energy) will increase by 1.5% in 2009, and moderate to 1.1% in 2010 and 0.9% in 2011 (http://www.cbo.gov/doc.cfm?index=10014).

The Federal Reserve Bank of Philadelphia's *Survey of Professional Forecasters, First Quarter 2009,* projects core inflation at 1.2% in 2009, and 1.6% in 2010. This survey projects the overall CPI at 0.2% this year and 1.9% in 2010 with long run expectations of 2.4% during the period 2009 through 2018. (Federal Reserve Bank of Philadelphia Survey of Professional Forecasters, First Quarter, 2009, http://www.phil.frb.org/research-and-data/real-time-center/survey-of-professional-forecasters/2009/survq109.cfm). Low inflation rates tend to support lower interest rates and lower costs of financing capital investment, including investments in utility plant.

**Q: What are your conclusions about the macroeconomic trends that influence cost of equity?**

A: Recent trends in interest rates, inflation and economic growth do not reveal an over-heating economy, nor one in which the cost of capital trends toward significant increases. Moreover, the *CFO Magazine* survey demonstrates that Petitioner's proposed 10.57% cost of equity is well above market expectations, even for a much more risky stock portfolio like the S&P 500 containing many industrial companies. Consequently, my recommended ROE for Petitioner of

9.75% is much more in line with current economic conditions and very reasonable.

## SUMMARY AND RECOMMENDATIONS ON COST OF EQUITY

**Q: Please summarize your testimony on the proxy group selected to calculate cost of equity for Petitioner.**

A: I used the same proxy group used by Mr. Brehm, taken from the Standard Edition Value Line.

**Q: Please summarize your testimony on DCF calculations for the proxy group.**

A: I calculated a 4.8% forward dividend yield utilizing Value Line data, and comparing it to data from *AUS Utility Reports*. I also calculated a DCF growth rate, *g*, of 5.1%. Overall, my DCF calculations resulted in a 9.9% cost of equity.

**Q: Please summarize your testimony on CAPM calculations for the proxy group.**

A: Based on Value Line betas, I calculated an average beta for the proxy group of 0.65. As it is less than 1.0, it also describes a relatively low-risk industry. I estimated a risk-free rate of 4.8% based primarily on the recent and long term experience with rates on U.S. Treasury bonds (see Public's Exhibit BEL-7). Giving equal weight to both the geometric mean and arithmetic mean approaches, I calculated a market risk premium of 4.75%. This results in a CAPM cost of equity for the proxy group of 7.9%.

**Q: Please summarize your testimony on macroeconomic and capital market trends influencing cost of equity.**

A: In stark contrast to the market expectations described in CFO Magazine of an 8.77% anticipated return on the S&P 500, Mr. Brehm proposes a rate of 10.57%

for a regulated public utility with zero long term debt. Again, in today's capital market, this proposal is too high.

I examined three macroeconomic variables that can influence the cost of equity capital. First, I examined interest rates. There appears to be no decisive trend indicating a period of sustained higher interest rates. Interest rates on 5-year, 10-year and 20-year bonds have slumped in the past two years and the CBO forecasts that it will take until 2012 for yields on 10-year bonds to average more than 4.0%.

Inflation is also an important variable to consider. In spite of last year's run up in energy prices, the United States has continued an extended period of low inflation. Energy prices remain volatile and occasionally push "headline" (overall) inflation above core inflation. However, even with large swings in energy prices, both "headline" inflation and core inflation remain low compared to earlier periods. While inflation fears are always a policy consideration for the Federal Reserve, recent experience and projections by the CBO tend to indicate that inflation is under control in spite of recent run-ups in energy prices.

**Q: What is your recommendation for Petitioner's ROE?**

A: I recommend a 9.75% ROE for Petitioner. This recommendation reflects a risk premium of roughly 600 basis points over recent yields on 10-year Treasury bonds, which hover just above 3.0%.

Q: Does this complete your testimony?

A: Yes, it does.

## CITIZENS GAS OF WESTFIELD (Cause No. 43624)
### Comparison of Current and Proposed Base Rates

| | Current Base Rates * | Proposed Base Rates | $ Change | % Change |
|---|---|---|---|---|
| **Residential Delivery and Supply Service** | | | | |
| Customer Charge | $5.25 | $6.25 | $1.00 | 19.0% |
| *First 120 Therms* | $ 0.3447 | $ 0.5367 | $ 0.19200 | 55.7% |
| *121 - 500 Therms* | $ 0.1954 | $ 0.3590 | $ 0.16360 | 83.7% |
| *Over 500 Therms* | $ 0.1775 | $ 0.3377 | $ 0.16020 | 90.3% |
| **Commercial Delivery and Supply Service** | | | | |
| Customer Charge | $5.25 | $6.25 | $1.00 | 19.0% |
| *First 120 Therms* | $ 0.2826 | $ 0.4628 | $ 0.18020 | 63.8% |
| *121 - 500 Therms* | $ 0.1901 | $ 0.3527 | $ 0.16260 | 85.5% |
| *Over 500 Therms* | $ 0.1775 | $ 0.3377 | $ 0.16020 | 90.3% |
| **Industrial Delivery and Supply Service** | | | | |
| Customer Charge | $78.85 | $93.83 | $14.98 | 19.0% |
| First 500 Therms | $ 0.3184 | $ 0.5054 | $ 0.1870 | 58.7% |
| Over 500 Therms | $ 0.1228 | $ 0.2726 | $ 0.1498 | 122.0% |
| **Large Volume Interruptible Service** | | | | |
| Customer Charge | $150.00 | $178.50 | $28.50 | 19.0% |
| All Therms | $ 0.1184 | $ 0.2674 | $ 0.1490 | 125.8% |

* - Tariffed rates less $0.36 per therm for Base Cost of Gas.

Citizens Gas of Westfield
Response to OUCC DR Q-58

| | |
|---|---|
| Purchase Price of Property, Plant and Equipment of Westfield Gas Corporation | 5,882,593 |
| Net Utility Plant per books | 2,367,766 |
| Less Customer Advances for Construction | (114,194) |
| Acquisition Adjustment | 3,629,021 |

citizens energy group™

Citizens Gas | Citizens Thermal | Citizens Resources
2020 N. Meridian St. | Indianapolis, IN | 46202-1393
www.citizensenergygroup.com

Feb. 8, 2009

**Dear Westfield Customer:**

On December 31, 2008, Westfield Gas Corporation, doing business as Citizens Gas of Westfield (Citizens), filed a petition with the Indiana Utility Regulatory Commission (Commission) requesting approval to adjust its base rates and charges for gas utility service. This is the first base rate adjustment the utility has requested in over 11 years and the first since the utility was acquired by Citizens Energy Group in September 2004.

Westfield customers have realized substantial benefits as a result of the acquisition, including approximately $1.6 million of savings in reduced gas commodity costs as a result of Citizens' gas procurement practices. Other benefits realized by Westfield customers as a result of the acquisition include electronic bill payment, greater access to customer service representatives via a customer call center, improved system reliability and Internet access to free energy conservation tools.

Citizens estimates its request, if approved, would increase the average Westfield residential customer's bill about $15 per month or $184 per year. Any increase in base rates would not take effect for several months, pending review and approval by the Commission.

Citizens also is requesting other approvals in the petition, including authority to implement a rate structure that would decouple revenue collection from gas sales volumes, like other gas utilities in Indiana have done. The current rate structure, which ties the utility's revenue collection to gas sales volumes, penalizes the utility for encouraging customers to conserve energy. The new decoupled rate structure and requested funding for energy efficiency will help stabilize customer bills and allow the utility to implement an energy efficiency program that would provide customers incentives for conserving energy.

There is never a good time for a rate increase and we have worked diligently to hold down operating costs while also expanding the Westfield system and improving customer service and reliability. Since the acquisition, the utility has invested approximately $3.8 million in new facilities in the Westfield area and has also experienced annual increases in property taxes, insurance and other operating costs. Sound financial management now dictates that we seek an increase so we can continue to provide safe and reliable service and meet the growth in the Westfield area.

Please feel free to contact me with your comments and questions about our rate proposal. I can be reached at the address on this letter or by email at CustomerCare@CitizensEnergyGroup.com

**Sincerely,**

Lindsay Lindgren
President
Citizens Gas of Westfield

**Petitioner's Exhibit CHB-2**

Q-55. Please refer to Petitioner's Exhibit JRB-9.

a. Please indicate whether Mr. Brehm performed the calculations shown in this exhibit using actual data for Petitioner.

b. If the answer to a. is "yes", please provide a hardcopy (and an electronic copy if available) of those calculations.

c. If the answer to a. is "no", please explain why no such calculations were performed.

**Response:**

a. No.

b. Not applicable.

c. See Mr. Brehm's testimony on page 30, line 7 through page 41, line 34.

**Witness:** John Brehm

# Summary of
# Discounted Cash Flow Analysis (DCF)

*DCF formula:* $K = (D_1/P_0) + g$

**Gas Utility Proxy Group:**

| | | |
|---|---|---|
| **Dividend Yield ($D_1/P_0$):** | **4.8%** | **see page 2 and 3** |
| **Dividend Growth (g):** | **5.1%** | **see page 4 and 5** |
| **DCF Cost of Equity *(K)*:** | **9.9%** | |

# AUS and Value Line Dividend Yield Data

*(January 200 through February 2009 publication dates)*

| | Last 3 months Average | Last 6 months Average | Calendar Year 2008 | Last 12 months Average | Forward Yield $D_1/P_0$ |
|---|---|---|---|---|---|
| *Standard Edition Value Line Companies:* | | | | | |
| AGL Resources (ATG) | 5.6% | 5.7% | 5.0% | 5.3% | 6.7% |
| Atmos Energy (ATO) | 5.6% | 5.6% | 5.0% | 5.2% | 6.6% |
| Laclede Group (LG) | 3.5% | 3.3% | 3.8% | 3.5% | 4.1% |
| New Jersey Resources (NJR) | 3.1% | 3.2% | 3.3% | 3.3% | 3.8% |
| Northwest Natural Gas (NWN) | 3.7% | 3.4% | 3.3% | 3.4% | 4.2% |
| Piedmont Natural Gas (PNY) | 3.8% | 3.6% | 3.8% | 3.7% | 4.6% |
| South Jersey Industries (SJI) | 3.2% | 3.2% | 3.0% | 3.1% | 3.6% |
| WGL Holdings (WGL) | 4.5% | 4.7% | 4.4% | 4.4% | 5.0% |
| **Gas Utility Proxy Group Overall Average** | **4.1%** | **4.1%** | **3.9%** | **4.0%** | **4.8%** |

Forward Dividend Yields:

*Six Month Average Dividend Yield, adjusted for growth by (1 + 0.5g)*

$D_1/P_0 = D_0/P_0 * (1 + 0.5g) = 4.1\% * [1 + 0.5(0.051)] =$ **4.2%**

Value Line Forward Yield ($D_1/P_0$) = **4.8%**

| **Use for forward yield ($D_1/P_0$):** | **4.8%** |
|---|---|

# AUS Utility Reports Dividend Yield Data

*(January 2008 through March 2009 publication dates)*

| | Jan-08 | Feb-08 | Mar-08 | Apr-08 | May-08 | Jun-08 | Jul-08 | Aug-08 | Sep-08 | Oct-08 | Nov-08 | Dec-08 | Jan-09 | Feb-09 | Mar-09 | Last 3 months Average | Last 6 months Average | Calendar Year 2008 | Last 12 months Average |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| *Standard Edition Value Line Companies:* | | | | | | | | | | | | | | | | | | | |
| AGL Resources (ATG) | 4.6% | 4.4% | 4.6% | 4.9% | 4.7% | 4.6% | 4.9% | 5.0% | 5.1% | 5.0% | 6.0% | 6.0% | 5.7% | 5.5% | 5.7% | 5.6% | 5.7% | 5.0% | 5.3% |
| Atmos Energy (ATO) | 4.9% | 4.8% | 4.8% | 5.1% | 4.8% | 4.6% | 4.8% | 5.1% | 4.7% | 4.6% | 5.9% | 6.0% | 5.7% | 5.6% | 5.5% | 5.6% | 5.6% | 5.0% | 5.2% |
| Laclede Group (LG) | 4.5% | 4.4% | 4.5% | 4.2% | 4.1% | 3.6% | 3.7% | 3.9% | 3.2% | 3.0% | 3.1% | 3.1% | 3.4% | 3.6% | 3.6% | 3.5% | 3.3% | 3.8% | 3.5% |
| New Jersey Resources (NJR) | 3.3% | 3.3% | 3.4% | 3.6% | 3.4% | 3.3% | 3.3% | 3.5% | 3.1% | 2.9% | 3.5% | 3.5% | 3.0% | 3.0% | 3.3% | 3.1% | 3.2% | 3.3% | 3.3% |
| Northwest Natural Gas (NWN) | 3.2% | 3.0% | 3.3% | 3.6% | 3.3% | 3.4% | 3.2% | 3.4% | 3.1% | 2.8% | 3.5% | 3.3% | 3.5% | 3.8% | 3.7% | 3.7% | 3.4% | 3.3% | 3.4% |
| Piedmont Natural Gas (PNY) | 3.9% | 3.9% | 4.0% | 4.0% | 3.8% | 3.9% | 3.8% | 4.2% | 3.7% | 3.1% | 3.4% | 3.4% | 3.4% | 4.0% | 4.1% | 3.8% | 3.6% | 3.8% | 3.7% |
| South Jersey Industries (SJI) | 3.1% | 2.9% | 3.0% | 3.1% | 2.9% | 2.8% | 2.8% | 2.9% | 3.1% | 2.8% | 3.4% | 3.4% | 3.2% | 3.3% | 3.2% | 3.2% | 3.2% | 3.0% | 3.1% |
| WGL Holdings (WGL) | 4.3% | 4.1% | 4.2% | 4.4% | 4.2% | 4.0% | 4.0% | 4.2% | 4.3% | 4.0% | 5.3% | 5.3% | 4.5% | 4.5% | 4.4% | 4.5% | 4.7% | 4.4% | 4.4% |
| Gas Utility Proxy Group Overall Average | **4.0%** | **3.9%** | **4.0%** | **4.1%** | **3.9%** | **3.8%** | **3.8%** | **4.0%** | **3.8%** | **3.5%** | **4.3%** | **4.3%** | **4.1%** | **4.2%** | **4.2%** | **4.1%** | **4.1%** | **3.9%** | **4.0%** |

# Summary of
# Discounted Cash Flow Analysis (DCF)
# Growth Estimates

## Gas Utility Group:

*From Standard Edition Value Line:*

| | |
|---|---|
| Average of Value Line forecasted growth rates | 4.5% |
| Average of 5 year historical growth | 6.4% |
| Average 10 year historical growth: | 4.5% |
| Average Standard Edition Companies: | 5.1% |

| | |
|---|---|
| Use DCF Growth Rate | 5.1% |

*Averages are the average earnings, dividends, and book value per share growth for the applicable periods.*

# Value Line Growth Rates

*STANDARD VALUE LINE COMPANIES*

| | Annual Growth - Past 10 Years | | | Annual Growth - Past 5 Years | | | Annual Growth - Value Line Projected | | | Average Growth Rates | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Company Name | Earnings Per Share | Dividends Per Share | Book Value Per Share | Earnings Per Share | Dividends Per Share | Book Value Per Share | Earnings Per Share | Dividends Per Share | Book Value Per Share | Past 10 Years | Past 5 Years | Value Line Projected |
| AGL Resources (ATG) | 7.0% | 3.5% | 7.0% | 11.5% | 6.5% | 11.5% | 3.0% | 2.5% | 0.5% | 5.8% | 9.8% | 2.0% |
| Atmos Energy (ATO) | 2.5% | 2.5% | 6.5% | 5.0% | 1.5% | 7.5% | 4.0% | 1.5% | 4.0% | 3.8% | 4.7% | 3.2% |
| Laclede (LG) | 3.5% | 1.0% | 3.5% | 9.5% | 1.5% | 5.5% | 3.5% | 2.5% | 5.5% | 2.7% | 5.5% | 3.8% |
| New Jersey Resources (NJR) | 7.5% | 4.0% | 8.5% | 7.5% | 5.0% | 11.5% | 5.5% | 5.5% | 8.5% | 6.7% | 8.0% | 6.5% |
| Northwest Natural Gas (NWN) | 3.0% | 1.5% | 3.5% | 6.5% | 2.0% | 3.5% | 7.0% | 5.5% | 3.5% | 2.7% | 4.0% | 5.3% |
| Piedmont Natural Gas (PNY) | 4.5% | 5.0% | 5.5% | 6.5% | 4.5% | 6.0% | 7.5% | 3.5% | 5.0% | 5.0% | 5.7% | 5.3% |
| South Jersey Industries (SJI) | 9.5% | 2.5% | 7.5% | 12.5% | 4.5% | 12.5% | 5.5% | 7.0% | 4.5% | 6.5% | 9.8% | 5.7% |
| WGL Holdings (WGL) | 2.0% | 1.5% | 4.0% | 4.0% | 1.5% | 4.5% | 4.0% | 2.5% | 5.0% | 2.5% | 3.3% | 3.8% |
| **Group Average** | **4.9%** | **2.7%** | **5.8%** | **7.9%** | **3.4%** | **7.8%** | **5.0%** | **3.8%** | **4.6%** | **4.5%** | **6.4%** | **4.5%** |

*All data based on the March 13, 2009 Value Line Investment Survey, Standard Editions), Ratings and Reports -- www.valueline.com.*

# CAPM Cost of Equity Summary

CAPM Formula: $K = R_f + \beta(R_m - R_f)$

| | |
|---|---|
| Risk Free Rate $(R_f)$ | 4.8% |
| Beta $(\beta)$ | 0.65 |
| | |
| Risk Premium *(Geometric Approach - Long Term Bonds)* | 3.90% |
| Risk Premium *(Arithmetic Approach - Long Term Bonds)* | 5.60% |
| **Risk Premium** | **4.75%** |
| | |
| **Required Return (K)** | **7.9%** |

# Risk Free Rate ($R_f$)

## Yields on U.S. Treasury Securities

### Recent Months

| Month | 5 Year Treasury Bonds | 10 Year Treasury Bonds | 20 Year Treasury Bonds |
|---|---|---|---|
| January 2007 | 4.75% | 4.76% | 4.95% |
| February 2007 | 4.71% | 4.72% | 4.93% |
| March 2007 | 4.48% | 4.56% | 4.81% |
| April 2007 | 4.59% | 4.69% | 4.95% |
| May 2007 | 4.67% | 4.75% | 4.98% |
| June 2007 | 5.03% | 5.10% | 5.29% |
| July 2007 | 4.88% | 5.00% | 5.19% |
| August 2007 | 4.43% | 4.67% | 5.00% |
| September 2007 | 4.20% | 4.52% | 4.84% |
| October 2007 | 4.20% | 4.53% | 4.83% |
| November 2007 | 3.67% | 4.15% | 4.56% |
| December 2007 | 3.49% | 4.10% | 4.57% |
| January 2008 | 2.98% | 3.74% | 4.35% |
| February 2008 | 2.78% | 3.74% | 4.49% |
| March 2008 | 2.48% | 3.51% | 4.36% |
| April 2008 | 2.84% | 3.68% | 4.44% |
| May 2008 | 3.15% | 3.88% | 4.60% |
| June 2008 | 3.49% | 4.10% | 4.74% |
| July 2008 | 3.30% | 4.01% | 4.62% |
| August 2008 | 3.14% | 3.89% | 4.53% |
| September 2008 | 2.88% | 3.69% | 4.32% |
| October 2008 | 2.73% | 3.81% | 4.45% |
| November 2008 | 2.29% | 3.53% | 4.27% |
| December 2008 | 1.52% | 2.42% | 3.18% |
| January 2009 | 1.60% | 2.52% | 3.46% |
| February 2009 | 1.87% | 2.87% | 3.59% |
| March 2009 | 1.31% | 2.82% | 3.78% |
| Recent 3 Month Average *(January, February, March)* | 1.59% | 2.74% | 3.61% |
| Recent 6 Month Average *(October 2008 through March 2009)* | 1.89% | 3.00% | 3.79% |
| Recent 9 Month Average *(July 2008 through March 2009)* | 2.29% | 3.28% | 4.02% |
| Calendar Year 2007 | 4.43% | 4.63% | 4.91% |
| Calendar Year 2008 | 2.80% | 3.67% | 4.36% |
| date | 1.59% | 2.74% | 3.61% |

Source: Federal Reserve, *www.federalreserve.gov*

| | |
|---|---|
| **Risk Free Rate for CAPM Estimate *(Rf)*** | **4.8%** |

# Beta for Gas Utility Group

| Company | Value Line Adjusted | Smart Money | Yahoo Finance | NASDAQ | Zacks |
|---|---|---|---|---|---|
| AGL Resources (ATG) | 0.75 | 0.31 | 0.29 | 0.49 | 0.31 |
| Atmos Energy Corp. (ATO) | 0.60 | 0.51 | 0.49 | 0.51 | 0.51 |
| Laclede Group (LG) | 0.65 | 0.23 | 0.07 | 0.33 | **N/A** |
| New Jersey Resources (NJR) | 0.65 | 0.21 | 0.15 | 0.41 | 0.21 |
| Northwest Natural Gas (NWN) | 0.60 | 0.38 | 0.34 | 0.38 | 0.38 |
| Piedmont Natural Gas (PNY) | 0.65 | 0.34 | 0.29 | 0.44 | 0.34 |
| South Jersey Industries (SJI) | 0.65 | 0.30 | 0.27 | 0.38 | 0.30 |
| WGL Holdings (WGL) | 0.65 | 0.31 | 0.26 | 0.46 | 0.31 |
| **Average for Gas Utility Group** | **0.65** | **0.32** | **0.27** | **0.43** | **0.34** |
| | | | | | |
| **CAPM Beta Estimate ($\beta$)** | **0.65** | | | | |

*Note: Value Line data as of March 13, 2009, all other sources as of April 7, 2009.*

# Market Risk Premiums

## Total Returns, 1926-2008

| | Large Company Stocks | Long-term Bonds |
|---|---|---|
| **Geometric Mean** | 9.60% | 5.70% |
| **Arithmetic Mean** | 11.70% | 6.10% |

## Market Risk Premiums $(R_m - R_f)$

| | | Long-term Bonds |
|---|---|---|
| **Geometric Mean** | | 3.90% |
| **Arithmetic Mean** | | 5.60% |
| **Average Market Risk Premium** | | **4.75%** |

| | |
|---|---|
| **CAPM Market Risk Premium** | **4.75%** |

*Source: Morningstar, Inc., Stocks, Bonds, Bills and Inflation (Ibbotson SBBI), 2009 Classic Yearbook, Table 2-1, p. 32.*

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**Duke CFO Global Business Outlook survey - U.S. - First Quarter, 2009**

**17. On February 16, 2009 the annual yield on 10-yr treasury bonds was 2.9%. Please complete the following:**

| | Mean | SD | 95% CI | Median | Minimum | Maximum | Total |
|---|---|---|---|---|---|---|---|
| Over the next 10 years, I expect the average annual S&P 500 return will be: There is a 1-in-10 chance it will be less than: | 1.98 | 7.44 | 1.33 - 2.64 | 2 | -30 | 60 | 491 |
| Over the next 10 years, I expect the average annual S&P 500 return will be: Expected return: | 8.77 | 10.00 | 7.89 - 9.65 | 7 | -15 | 100 | 499 |
| Over the next 10 years, I expect the average annual S&P 500 return will be: There is a 1-in-10 chance it will be greater than: | 13.28 | 11.94 | 12.22 - 14.33 | 10 | 0 | 100 | 494 |
| Over the next year, I expect the average annual S&P 500 return will be: There is a 1-in-10 chance it will be less than: | -8.57 | 13.26 | -9.74 - -7.40 | -5 | -50 | 50 | 492 |
| Over the next year, I expect the average annual S&P 500 return will be: Expected return: | 2.18 | 9.04 | 1.38 - 2.97 | 2 | -50 | 70 | 499 |
| Over the next year, I expect the average annual S&P 500 return will be: There is a 1-in-10 chance it will be greater than: | 10.24 | 11.06 | 9.26 - 11.22 | 7 | -20 | 100 | 491 |

*Source: CFO Magazine, Business Outlook Survey, March, 2009, http://www.cfosurvey.org/ United States Topline survey, p. 48*

**VERIFICATION**

STATE OF INDIANA )
) ss:
COUNTY OF MARION )

The undersigned, Bradley E. Lorton, under penalties of perjury and being first duly sworn on his oath, says that he is a Employee for the Indiana Office of Utility Consumer Counselor; that he caused to be prepared and read the foregoing that the representations set forth therein are true and correct to the best of his knowledge, information and belief.

By: Bradley E. Lorton
Indiana Office of
Utility Consumer Counselor

Subscribed and sworn to before me, a Notary Public, this 29th day of May, 2009.

Signature

Kimberly D. Perry
Printed Name

My Commission Expires: October 22, 2010

My County of Residence: ~~Marion~~ Johnson

## CERTIFICATE OF SERVICE

This is to certify that a copy of the foregoing **OUCC TESTIMONY OF BRADLEY E. LORTON** has been served upon the following parties of record in the captioned proceeding by electronic service and/or by depositing a copy of same in the United States mail, first class postage prepaid, on May 29, 2009.

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