the Commission previously rejected MERC's proposed leverage adjustment in MERC's most recent rate case, Docket No. G007,011/GR-10-977, and MERC has provided no new arguments in the current proceeding to support its proposed adjustment.[47]

~~33.~~32. ~~The~~ MERC argues that the Department's criticism does not apply because the leverage adjustment is a risk adjustment.[48] MERC's adjustment deals with the risk difference between the common equity ratio using market capitalization, the sole consideration of investors, and the book value common equity ratio used in utility rate cases. ~~The Department's failure to compute a leverage adjustment in its DCF and CAPM analyses in this case understates the return on common equity that should be authorized for MERC.~~[49] MERC simply failed to recognize that investors already account for the risk difference via the stock prices.[50]

~~34.~~33. The OAG-AUD also rejected MERC's leverage adjustment. The OAG-AUD argued that the leverage adjustment proposed by MERC would encourage the stock price to deviate away from the book value, at the expense of retail customers and to the advantage of investors. The OAG-AUD concluded that MERC's proposed leverage adjustment emanates from the differences in the market price and the book value of a stock, fair value and the carrying value of debt, and the fair value and the carrying value of a preferred stock, respectively. According to the OAG-AUD, MERC's leverage adjustment is largely driven by the difference in the market-to-book ratio of common stock and the fair-to-carry ratio of debt.[51]

~~35. MERC's leverage adjustment does not depend on establishing or targeting any particular ratio of price to book value. The adjustment reflects the risk related to financial leverage and does not address the difference between expected return and opportunity cost rates, if any. MERC's leverage adjustment adds stability to the DCF return because the adjustment will increase or decrease as the dividend yield changes. MERC's adjustment is not a market-to-book ratio adjustment and does not alter the use of book values of common equity, preferred stock, and long-term debt in calculating the weighted average cost of capital. MERC's adjustment does not address any of the factors that would cause market prices to deviate from book value because it does not provide a return that supports any particular market-to-book ratio, high or low. MERC's adjustment solely addresses variations in financial risk, and is based on book values that are usually used in the rate setting process. The fact that the rate setting process uses the book value capital structure to calculate the weighted cost of capital, and the fact that investors understand that a utility's earnings are based in part on the allowed returns set in the rate case process, provides no basis to disregard MERC's leverage adjustment. MERC's leverage adjustment does not alter the procedure to calculate the weighted cost of capital, and the fact that sophisticated investors understand the rate setting process. Moreover, the market value~~

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[47] Ex. 200 at 65-68 (E. Amit Direct); Ex. 202 at 21 (E. Amit Surrebuttal).

[48] Ex. 18 at 12-13 (P. Moul Rebuttal).

[49] ~~Ex. 18 at 12-15 (P. Moul Rebuttal).~~

[50] DOC Ex. 200 at 15, 48, 65-67 (Amit Direct).

[51] Ex. 161 at 5, 19-21 and Appendix 1, Equation C (P. Chattopadhyay Direct); Ex. 165 at 37 (P. Chattopadhyay Surrebuttal).

~~of the capitalization can be accurately calculated and is not dependent on any other rate setting element. There is no market-to-book adjustment included in MERC's leverage adjustment.~~[52]

~~36.~~34. MERC also applied a size adjustment to the results of its CAPM. MERC's size adjustment is inappropriate and is not supported by extensive academic research that shows that a variety of factors explain the risk compensation required by investors that exceeds the risk-free rate of return (the yield on Treasury obligations).[53] A well-known study conducted by Fama and French identified size as a separate factor that helps explain returns.[54]

~~37.~~35. Relevant research on the issue has identified the size of a firm as a separate factor that must be recognized in addition to the beta measure of systematic risk in explaining investor returns. These studies found that as the size of a firm decreases, its risk, and hence its required return, increases.[55]

~~38.~~36. The research indicates that stocks in lower deciles had returns in excess of those shown by the simple CAPM. In the case of low-cap market capitalization, a size premium of 1.23 percent is indicated by the 2013 Classic Yearbook for Stocks, Bonds, Bills and Inflation ("SBBI") published by Ibbotson Associates that is part of Morningstar. MERC adopted a more conservative size adjustment of 1.12 percent, which represents the mid-cap adjustment. Without this adjustment the academic research has demonstrated that the CAPM would understate the required return.[56]

~~39.~~37. The Department agreed that there exists a size risk premium. ~~main point that the~~However, as the Department explained ~~made in defense of excluding the size adjustment is that~~ MERC's size is only one aspect of the Company's overall financial and business risk. The Department ~~took the position~~explained that it is inappropriate to choose only one specific factor of the overall investment risk and argue that, due to this specific risk factor, MERC's required rate of return is higher than the rate of return for the comparison group. A company by company detailed analysis of company's specific risk factor would leave an empty comparison group leaving the analyst no useful information. The Department noted that in MERC's most recent rate case, Docket No. G007,011/GR-10-977, the Commission rejected MERC's proposed size adjustment. ~~According to the Department,~~ MERC provided no new arguments in the current proceeding to support the proposed adjustment.[57]

~~40. The Fama and French study identifies size as a separate factor that helps explain returns and must be recognized in addition to the beta measure of systematic risk in explaining investor expected returns. The average size of the group covered by Value Line is the mid-cap group, which Value Line defines as companies with a market capitalization from $1 billion to~~

~~[52] Ex. 18 at 32-34 (P. Moul Rebuttal).~~

[53] DOC Ex. 200 at 64 (Amit Direct).

[54] Ex. 18 at 17-18 (P. Moul Rebuttal), citing "The Cross-Section of Expected Stock Returns," The Journal of Finance, June 1992.

[55] Ex. 17 at 40-41 (P. Moul Direct).

[56] Ex. 17 at 36, 40-41 and Schedule 12 (PRM-1) (P. Moul Direct); Ex. 18 at 18 (P. Moul Rebuttal).

[57] Ex. 200 at 64, 67-68 (E. Amit Direct); Ex. 202 at 21 (E. Amit Surrebuttal).

~~$5 billion. As established in MERC's Direct Testimony and shown by the Morningstar 2014 Classic Yearbook, additional compensation is required for companies that are below the large cap category (defined by Morningstar as having less than $9.1 billion of market capitalization). A size adjustment is clearly required for the companies Value Line classifies as natural gas utilities.~~[58]

~~41.~~38. The OAG-AUD declined to adopt the size adjustment in the CAPM. The OAG-AUD took the position that not only is the evidence on small-firm effect not sufficiently persuasive, but even the basis for an upward adjustment to the allowed ROE, given the relative size of the proxy's capitalization relative to Integrys' capitalization, is questionable.[59]

~~42. The OAG-AUD's position is not appropriate in this case. The CAPM is commonly used in rate cases and is based on widely-accepted portfolio theory. There has been extensive academic research that shows that a variety of factors explain the risk compensation required by investors for the risk associated with small size. The Wong article cited by the OAG-AUD was authored twenty-one (21) years ago, and utilized data back to the 1960s. Enormous changes have occurred in the industry since the 1960s that have fundamentally changed the utility business. The Wong article notes that betas for non-regulated companies were higher than the betas of utilities. Lower betas do not invalidate the additional risk associated with small size and beta is not the tool that should be employed to make a size determination.~~[60]

~~43.~~39. To determine the CAPM risk-free rate, MERC appeared to use~~d~~ the ~~historical~~ projected 30-year yields on Treasury notes and bonds. Specifically, MERC used a 3.75 percent risk-free rate of return for CAPM purposes, which considered not only Blue Chip forecasts, but also the recent trend in the yields on long-term Treasury bonds.[61]

~~44.~~40. The Department disagreed with MERC's risk free rate. The Department argued that the yield on 30-year Treasury bills includes significant interest risk premium and, therefore, does not represent a true risk-free yield. The Department further argued that current yields on long-term Treasury bills fully reflect current investors' expectations about the future economic and financial environment. Therefore, substituting Blue-Chip's forecast of future yields for current yields is inappropriate and simply introduces another element of uncertainty in the application of the CAPM. The Department proposed to account for MERC's risk-free yield by substituting the current September 2013 average yield on 20-year Treasury bonds (3.53 percent) for the 3.75 percent used by MERC.[62]

~~[58] Ex. 18 at 17-18 (P. Moul Rebuttal).~~

[59] Ex. 161 at 49-50 (P. Chattopadhyay Direct).

106. -The Department appropriately used a current 30-day average yield on 20-year treasury bonds as the risk-free rate, the average beta of its comparison group and a market estimated risk premium to arrive at an estimated CAPM-ROE of 9.79 percent.

~~[60] Ex. 18 at 35-36 (P. Moul Rebuttal).~~

[61] Ex. 17 at 38-39 (P. Moul Direct).

[62] Ex. 200 at 31, 57-58 (E. Amit Direct); Ex. 202 at 15 (E. Amit Surrebuttal).

~~45.~~41. The Department ~~in~~appropriately principally relied on ~~historical~~ current yields on 20-year Treasury bonds for its risk-free rate of return. Such a yield incorporates all investors' expectations regarding the future economic environment. ~~Just like all market models of the cost of equity, CAPM is exceptional. While the Department used a Treasury obligation with a more lengthy maturity (i.e., 20-year Treasury bonds), it failed to incorporate investor-expected yields in its analysis. The trend shows higher Treasury bond yields for the future that should be incorporated into the CAPM in order to conform to the specification of the model.~~[63]

~~46.~~42. The OAG-AUD argued that a 2.69 percent yield on ten-year Treasury notes should be used as the risk-free rate of return component of the CAPM. The OAG-AUD disagreed that the 30-year Treasury bond is an appropriate instrument to determine the risk free return and disagreed with MERC's reliance on forecasts as well as historical measures of yields to derive the risk free return. According to the OAG-AUD, the risk free return is best captured by short-term Treasury bills, but in recognition that utility rates are usually set for longer periods, longer-term bonds are used to capture the risk free rate when applying CAPM to estimate the cost of equity. The 10-year bond is the OAG-AUD's preferred metric for the risk free rate when conducting CAPM analysis for regulated companies because the OAG-AUD feels it strikes a reasonable balance between choosing a truly interest rate risk free instrument (like the shortest of the short term Treasury bills) and a consideration that regulated utility rates are usually set for longer terms than just a few months.[64]

~~47.~~43. MERC prefers to use longer term Treasury bond yields with a 30-year maturity. While the OAG-AUD may be correct that the 10-year Treasury note yield averaged 2.69 percent from January 30, 2014 to February 28, 2014, forecasts show that this rate is too low for the risk-free rate of return component of the CAPM for the 2014 test year and the rate effective period. Part of the increase can be attributed to the rise in yields, which in turn can be attributed to the tapering of the Federal Open Market Committee's last quantitative easing. It is for this reason that MERC used both a forecast and longer-term 30-year Treasury yield that produces a 4.50 percent risk-free rate of return in the update of its CAPM cost rate.[65]

~~48.~~44. With respect to MERC's derivation of the market-risk premium, the Department concluded that it was not appropriate. MERC used a combination of inappropriately calculated historical risk premium and inappropriately estimated current risk premium to estimate the risk premium. T~~t~~he OAG-AUD disagreed with MERC's reliance on historical data to determine the risk premium approach to measure the Value Line risk premium, as well as MERC's mixing of market risk premiums from two distinct sets of companies to derive a solitary measure of risk premium. The OAG-AUD's preferred approach is to rely only on the DCF based estimates of market risk premiums and individually estimate the returns on equity using Value Line and S&P information.[66] MERC does not object to the 9.08 percent market premium used by the OAG-

~~[63] Ex. 18 at 16 (P. Moul Rebuttal).~~

[64] Ex. 161 at 51 (P. Chattopadhyay Direct).

[65] Ex. 18 at 36-37 and Schedule 1 (PRM-2) (P. Moul Rebuttal).

[66] Ex. 161 at 46-53 (P. Chattopadhyay Direct).

AUD because the market premium result is higher than the market premium result from the procedures MERC used.[67]

~~49.~~45. The RP analysis determines the cost of equity by adding to corporate bond yields a premium to account for the fact that common equity capital is exposed to greater investment risk than debt capital. MERC's RP analysis utilized the Moody's index of A-rated Public Utility Bonds along with the forecast of interest rates provided in the Blue Chip Financial Forecast.[68] For an equity risk premium, MERC looked to the SBBI (i.e. Morningstar) Classic Yearbook to identify the equity risk premium that is aligned with the prospective level of interest rates.[69] The result of this methodology produced an updated ROE of 12.14 percent.[70]

~~50.~~46. The Department demonstrated~~took the position~~ that MERC used the wrong methodology to estimate the yield on A-rated utility bonds and, therefore, MERC's proposed yield was biased upward. The Department further ~~discounted~~ explained that MERC's RP analysis ~~because it~~ was ~~conducted~~ based ~~with~~ on historical data and used the wrong risk premium.[71] ~~MERC's risk premium was established with historical data. However, using this historical data, MERC obtained results that were positioned to account for conditions expected for the future. The data presented by MERC shows that the equity risk premium varies with the level of interest rates. In order to recognize the dynamic nature of the equity risk premium and to fit that premium to future market fundamentals, MERC performed an analysis to align the historically developed equity premium with the expected level of interest rates. In MERC's rebuttal update, MERC reduced the equity risk premium to recognize the increase in interest rates that has occurred since MERC's Direct Testimony was prepared. The value of MERC's method, which considers the level of interest rates, is that it allows the RP approach to conform to a forward-looking cost of equity.[72]~~

~~51.~~47. The OAG-AUD elected not to use the RP approach to determine the cost of equity. According to the OAG-AUD, the RP approach is inappropriate because RP is largely not forward-looking and reliance on historical data exposes the method to considerable subjective manipulation. Also, according to the OAG-AUD, RP is conceptually similar to the CAPM method as it also models a higher return for higher risk and purports to model the risk premium associated with equity capital over a risk-free debt instrument.[73] Although the OAG-AUD does not support the use of an RP analysis, it raises multiple concerns with the RP methodology used by MERC.[74]

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67 Ex. 18 at 37 (P. Moul Rebuttal).

68 Ex. 17 at 33-34 (P. Moul Direct).

69 Ex. 17 at 34-36 (P. Moul Direct).

70 Ex. 18 at 36 (P. Moul Rebuttal).

71 Ex. 200 at 52-55 (E. Amit Direct); Ex. 202 at 14-15 (E. Amit Surrebuttal).

~~72 Ex. 18 at 19 and Schedule 8 (PRM-2) (P. Moul Rebuttal).~~

73 Ex. 161 at 53 (P. Chattopadhyay Direct).

74 Ex. 161 at 53-55 (P. Chattopadhyay Direct).

~~52.~~48. The CE approach determines the equity return based upon results from non-regulated companies. Because regulation is a substitute for competitively determined prices, the returns realized by non-regulated firms with comparable risks to a public utility provide useful insight into a fair rate of return. In order to identify the appropriate return, it is necessary to analyze returns earned (or realized) by other firms within the context of the CE standard. The firms selected for the CE approach should be companies whose prices are not subject to cost-based price ceilings (i.e., non-regulated firms) so that circularity is avoided.[75]

~~53.~~49. To implement the CE approach, MERC selected non-regulated companies from the Value Line Investment Survey for Windows that have six categories of comparability designed to reflect the risk of the Delivery Group. These screening criteria were based upon the range as defined by the rankings of the companies in MERC's Delivery Group. MERC used both historical and realized returns and forecasted returns for non-utility companies. It is appropriate to consider a relatively long measurement period in the CE approach in order to cover conditions over an entire business cycle. A ten-year period (five historical years and five projected years) is sufficient to cover an average business cycle. Unlike the DCF and the CAPM, the results of the CE method can be applied directly to the book value capitalization. MERC calculated a CE result of 11.70 percent.[76]

~~54.~~50. The Department disagreed with MERC's CE analysis. While the Department ~~conceded~~ agreed that MERC used appropriate screens to select the comparison group, the Department concluded that the results of MERC's analysis clearly indicated that MERC's selected group includes many companies that are not risk comparable to the investment risks in MERC's Delivery Group. In particular MERC's average ROE of 48.9% and 17.9% for the historical and projected periods respectively do not survive the test of reasonableness.[77]

~~55.~~51. The OAG-AUD found MERC's CE proxy to be inappropriate. According to the OAG-AUD, the overly subjective nature of forming a proxy for a regulated company using non-regulated companies persuades it not to consider the CE approach. In the OAG-AUD's opinion, reliance on the DCF approach that carefully focuses on deriving a proxy for MERC in determining a forward looking estimate of the cost of equity is significantly superior to any implementation of the CE approach that relies not only on historical data from non-utility companies, but also bases its estimate on historical and forecasted accounting returns on common equity that are poor proxies for the true cost of equity.[78]

~~56. It is necessary to establish a company's relative risk position within its industry through a fundamental analysis of various quantitative and qualitative factors that bear upon an investor's assessment of overall risk.[79]~~

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[75] Ex. 17 at 42-43 (P. Moul Direct).

[76] Ex. 17 at 43-45 and Schedule 13 (PRM-1) (P. Moul Direct). The items considered were: Timeliness Rank, Safety Rank, Financial Strength, Price Stability, Value Line betas, and Technical Rank.

[77] Ex. 200 at 59 (E. Amit Direct).

[78] Ex. 161 at 55-56 (P. Chattopadhyay Direct).

~~[79] Ex. 17 at 12 (P. Moul Direct).~~

~~57. MERC faces risk factors that cannot be quantified but must be accounted for in order to provide a reasonable opportunity for MERC to achieve its cost of capital. These risks are: the risks that all gas utilities face arising from competition, economic regulation, the business cycle, and customer usage patterns; MERC's high construction expenditures; and MERC's approximately 79 percent total throughput to large volume customers that have the ability to bypass the Local Distribution Company ("LDC") system.[80]~~

~~58. MERC faces risk factors that can be quantified as compared to the S&P Public Utilities, an industry-wide proxy group including other regulated utilities, and MERC's proxy group.[81] While there were instances in which MERC did not have an increased risk, there were a number of counts in which MERC's risk was much higher than the Company's proxy group.~~

~~59. MERC is much smaller than the average size of the Company's proxy group and the average size of the S&P Public Utilities. All other things being equal, a smaller company is riskier than a larger company because a given change in revenue and expense has a proportionally greater impact on a smaller firm. MERC also experienced poor earned returns and higher variability than the S&P Public Utilities and the Company's proxy group, which signifies higher risk for MERC. The five-year operating ratios (the percentage of revenues consumed by operating expense, depreciation, and taxes other than income) for MERC is higher than the S&P Public Utilities and the Company's proxy group, which indicates greater risk. MERC had a lower level of interest coverage (the multiple by which available earnings cover fixed charges, such as interest expense) than the S&P Public Utilities and the Company's proxy group, which signifies higher credit risk for the company.[82]~~

~~60.~~52. MERC's cost of equity recommendation is ~~conservative~~ excessive due to ~~the higher risk characteristics of MERC~~ an inappropriate financial leverage adjustment and an inappropriate inclusion of small size risk-premium. Each of ~~these~~ leverage risk factors is already accounted for in the utilities' stock prices. Moreover it is inappropriate to single out the size factor without an in depth investigation of each utility specific and unique risk factors. Therefore, the ~~point to a~~ return for the Company ~~that~~ must not be greater than the results indicated by the proxy group analysis. That is to say, results taken from ~~MERC's~~ the Department's proxy group ~~will understate~~ reasonably estimate the required return for the Company~~because it has a higher risk~~.[83]

~~61.~~53. Based on an analysis of MERC's risk indicators, the Department concluded that there is not a valid basis to conclude that MERC's investment risk is greater than MERC's Delivery Group investment risk. The Department disagreed with the risk indictors used by MERC. The Department stated that, as a general matter, MERC should have used a macro, not micro, analysis.[84] Regarding the specific factors used by MERC, the Department concluded that: adjusting for risk based on the high percentage of revenue received by MERC from large volume

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~~80 Ex. 17 at 8-11 (P. Moul Direct).~~

~~81 Ex. 17 at 12 (P. Moul Direct).~~

~~82 Ex. 17 at 12-17 (P. Moul Direct).~~

~~83 Ex. 17 at 17 (P. Moul Direct); Ex. 18 at 3-5 (P. Moul Rebuttal).~~DOC Ex. 200 at 61-65 (Amit Direct).

84 Ex. 200 at 60-61 (E. Amit Direct).

customers is inappropriate; using the averages for the Delivery Group tends to mitigate the impact of weather and a more appropriate measure should be based on weather-normalized data; to the degree that the weak measures for MERC are the result of MERC's own inefficient operations, MERC should not be rewarded with a higher allowed ROE; and the historical values of the risk indicators used by MERC may not be good indicators of MERC's investment risk.[85]

~~62.~~54. ~~MERC maintains its position that the Company's cost of equity recommendation is conservative due to the higher risk characteristics of MERC and the fact that results taken from the Delivery Group will understate the required return for MERC. The Department has recognized that MERC has more financial risk than the NGCC used in the Department's cost of equity analysis.~~[86]

~~63.~~55. The opportunity to achieve a reasonable ROE represents a direct signal to the investment community whether to expect that regulatory oversight of the utility will result in the utility generating sufficient earnings to enable investors to earn a rate of return that is reasonable in light of other investment opportunities. To obtain new capital and retain existing capital the rate of return on common equity must be high enough to satisfy investors' requirements.[87]

~~64.~~56. Based on the analysis of returns established in other natural gas regulatory proceedings, the returns that investors expect gas utilities to achieve, and the general state of the capital markets, the Commission should ~~not~~ provide MERC with a~~n~~ reasonable equity return that is ~~lower than 10 percent~~appropriately recommended by the Department.[88] This would allow~~Anything lower may jeopardize~~ MERC~~'s ability~~ to attract capital under reasonable terms, and in turn, meet its service responsibilities to customers.[89]

~~65. MERC presented a thorough analysis that has used multiple financial models and numerous data based checks on the reasonableness of potential returns on common equity. MERC's analysis supports a ROE of 10.75 percent in this case, and also illustrates the ways that the Department and the OAG-AUD ignored key considerations that understate MERC's cost of equity. MERC's analysis, therefore, provides a better basis to determine a return on common equity for MERC.~~

~~66.~~57. The ALJ finds that MERC's authorized return on common equity should be~~10.75~~ 9.29 percent.[90]

2. Flotation Costs

~~67.~~58. In general, DCF results must be adjusted to allow for the cost of issuing new shares of common stock without causing dilution. Due to issuance costs, the price paid by an

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85 Ex. 200 at 61-63 (E. Amit Direct); Ex. 202 at 16-17 (E. Amit Surrebuttal).

~~86 Ex. 18 at 4-5 (P. Moul Rebuttal).~~

87 Ex. 18 at 6-8 (P. Moul Rebuttal).

88 ~~Ex. 18 at 7-8 (P. Moul Rebuttal).~~DOC Ex. 200 at 2 (Amit Direct); DOC Ex. 202 at 2 (Amit Surrebuttal).

89 DOC Ex. 202 at 2 (Amit Surrebuttal). Tr. at 200 (Amit).

90 DOC Ex. 202 at 2 (Amit Surrebuttal). Tr. at 200 (Amit).

investor for a new share of common stock is higher than the price per share received by the company. These issuance costs must be recognized by adjusting the required rate of return. This adjustment is appropriate even if no new issuances are planned in the near future because failure to allow such an adjustment may deny MERC the opportunity to earn its required rate of return in the future and such a denial is contradictory to the purpose of rate of return regulation.[91]

~~68.~~59. MERC proposed to include a flotation cost adjustment of 0.14 percent based on MERC's updated cost of equity analysis and based on a value of flotation costs of 3.9 percent.[92]

~~69.~~60. MERC and the Department agreed that a flotation cost must be included in the DCF analysis and the Department agreed with MERC's flotation cost calculation of 3.9 percent for the MERC Delivery Group. However, the Department disagreed with MERC's calculation of flotation cost adjustment.[93] In contrast to MERC's approach to determining flotation cost adjustment, the Department applied the 3.9 percent value of flotation costs to the dividend yield component of the DCF, resulting in 0.15 percent of return applicable to flotation costs.[94]

~~70.~~61. While the procedures used by MERC and the Department differ, the end result is remarkably similar. MERC's flotation cost adjustment adds fourteen basis points (i.e., 0.14%) to the cost of equity, while the Department's calculation adds fifteen basis points (i.e., 0.15%) to the cost of equity.[95]

~~71.~~62. The OAG-AUD objected to adjusting the ROE for flotation costs for two reasons: 1) when the market-to-book ratio is greater than one the DCF produces an upward biased ROE estimate and such ROE already accounts for flotation costs; and 2) investors buy new shares of stock, knowing that the price they pay is higher than the revenues per share received by MERC from the sale of new shares. Therefore, according to the OAG-AUD, by purchasing new shares, investors reveal that the return on book value is at least equal to investors' required return.[96]

~~72.~~63. The OAG-AUD's failure to modify its DCF results for flotation costs resulted in an understatement of the required rate of return on common equity. The OAG-AUD's position concerning flotation costs is inconsistent with the Value Line forecasts that show that natural gas companies will be issuing new common stock in the future. In addition, the OAG-AUD included external financing growth in its DCF analysis, which mandates a flotation cost adjustment. When utilities obtain new equity as represented by external financing growth factor, there are flotation costs associated with obtaining that new equity. Moreover, the industry has historically

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91 Ex. 200 at 26-27 (E. Amit Direct).

92 Ex. 17 at 31-32 and Schedule (PRM-1) (P. Moul Direct); Ex. 18 at 38 (P. Moul Rebuttal).

93 Ex. 18 at 38 (P. Moul Rebuttal); Ex. 200 at 50 and Schedule (EA-14) (E. Amit Direct); Ex. 202 at 14 (E. Amit Surrebuttal).

94 Ex. 200 at 26-27 and Schedules (EA-7 and EA-14) (E. Amit Direct); Ex. 201 at 24-26 (E. Amit Rebuttal).

95 Ex. 18 at 10, 38 and Schedule 1 (PRM-2) (P. Moul Rebuttal).

96 Ex. 161 at 43-45 (P. Chattopadhyay Direct); Ex. 164 at 25-27 (P. Chattopadhyay Rebuttal); Ex. 165 at 33-36, 38 (P. Chattopadhyay Surrebuttal); Ex. 200 at 24 (E. Amit Direct); Ex. 202 at 35-36 (E. Amit Surrebuttal); Evidentiary Hearing Transcript (May 13, 2014) at 182 (P. Chattopadhyay) and 202-204 (E. Amit) (Doc. ID No. 20145-99937-01).

issued significant quantities of new equity that had flotation costs. The OAG-AUD's argument that its proposed rate of return provides an adequate cushion to cover flotation costs is inaccurate. Flotation cost allowance is designed to account for the fact that the underwriter's discount/commission and the utility's out-of-pocket expense must be paid before the utility can invest the net proceeds from a common stock issuance into the rate base on which it earns a return. These costs exist regardless of the market-to-book ratio for any given company and are no different than the recovery of issuance expenses associated with selling long-term debt to investors. Moreover, the Commission has previously recognized a flotation cost adjustment when it has set a utility equity return. There is nothing unusual about including a flotation cost in the cost of equity in a rate case.[97]

~~73.~~64. The Department demonstrated ~~Because~~ that because the DCF analysis does not produce an upward biased ROE estimate, the DCF results must still be adjusted for flotation costs. Moreover, it would be inappropriate to disallow a legitimate cost to MERC to compensate for some other alleged excess revenue unrelated to flotation costs. To the degree that utilities are allowed to recover flotation cost, the allowed rates of return on book equity inherently reflect the flotation cost adjustment. Investors buying new shares of stock would buy them only if they expected to earn their required rate of return. However, absent allowance for flotation costs, existing shareholders would not be able to receive their required rate of return. Thus, the ROE must include a flotation cost adjustment and the OAG-AUD has provided no reasonable arguments to support disallowance of flotation costs.[98]

~~74.~~65. The Commission frequently approves cost of equity recommendations adjusted for flotation costs in rate cases. For example, the Commission recently approved the inclusion of a flotation cost adjustment of 16 basis points in the 2013 *Center Point Energy* natural gas rate case;[99] a flotation cost adjustment of 13 basis points in the 2012 *Northern States Power* electric service rate case;[100] a flotation cost adjustment of 15 basis points in the 2011 *Northern States Power* electric service rate case;[101] a flotation cost adjustment of 18 basis points in 2011

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97 Ex. 18 at 31, 38-39 and Schedule 6 (PRM-2) (P. Moul Rebuttal). The Commission recognized flotation cost adjustments of 0.23 percent in the rate case for Northern States Power (Docket No. G002/GR-09-1153), 0.20 percent in the rate case for CenterPoint Energy (Docket No. G008/GR-08-1075), and a 0.17 flotation cost adjustment in MERC's last rate case (Docket No. G007,011/GR-10-977) where the final surrebuttal evidence offered by the DOC showed flotation costs of 0.17 percent (i.e., 9.41% - 9.24%).

98 Ex. 200 at 25 and Schedule (EA-14) (E. Amit Direct); DOC Ex. 201 at 25 (Amit Rebuttal); DOC Ex. 202 at 35-36 (Amit Surrebuttal).

99 *In the Matter of an Application by CenterPoint Energy Resources Corp. d/b/a CenterPoint Energy Minnesota Gas For Authority to Increase Natural Gas Rates in Minnesota*, Docket No. G-008/GR-13-316, FINDINGS OF FACT, CONCLUSIONS, AND ORDER at 31-32 (June 9, 2014) (Doc. ID No. 20146-100252-01).

100 *In the Matter of the Application of Northern States Power Company for Authority to Increase Rates for Electric Service in the State of Minnesota*, Docket No. E-002/GR-12-961, FINDINGS OF FACT, CONCLUSIONS, AND ORDER at 11-12 (Sept. 3, 2013) (concurring with the ALJ findings regarding ROE, which included the basis points finding in paragraph 365 of the July 3, 2013 order) (Doc. ID No. 20139-90902-01).

101 *In the Matter of the Application of Northern States Power Company d/b/a Xcel Energy for Authority to Increase Rates for Electric Service in Minnesota*, Docket No. E-002/GR-10-971, FINDINGS OF FACT, CONCLUSIONS, AND ORDER at 10-11 (May 14, 2012) (adopting the settlement regarding basis points as described in paragraphs 87 and 88 of the Feb. 22, 2012 ALJ order) (Doc. ID No. 20125-74691-01).

Interstate Power & Light electric service rate case;[102] a flotation cost adjustment of 20 basis points in the 2011 *Otter Tail Power Company* electric service rate case;[103] a flotation cost adjustment of 23 basis points in the 2009 *Northern States Power* natural gas rate case;[104] and a flotation cost adjustment of 20 basis points in the 2008 *Center Point Energy* natural gas rate case.[105]

~~75.~~66. MERC and the Department have demonstrated that a flotation cost adjustment is necessary for MERC to have a reasonable opportunity to earn its required rate of return.

~~76.~~ The ALJ finds that the Department's~~MERC's~~ cost of equity should be adjusted by ~~14~~15 basis points to account for flotation costs.[106]

~~B.~~67. ~~e by the end of the test year and affected only the community of Cannon Falls.~~

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[102] *In the Matter of the Application of Interstate Power and Light Company for Authority to Increase Rates for Electric Service in Minnesota*, Docket No. E-001/GR-10-276, FINDINGS OF FACT, CONCLUSIONS, AND ORDER at 8-12 (Aug. 12, 2011) (Doc. ID No. 20118-65311-01).

[103] *In the Matter of the Application of Otter Tail Power Company for Authority to Increase Rates for Electric Utility Service in Minnesota*, Docket No. E-017/GR-10-239, FINDINGS OF FACT, CONCLUSIONS, AND ORDER at 42-43 (Apr. 25, 2011) (concurring with the ALJ findings regarding ROE, which included the basis points finding in paragraph 388 of the Feb. 14, 2011 order) (Doc. ID No. 20114-61715-01).

[104] *In the Matter of the Application of Northern States Power Company for Authority to Increase Rates for Natural Gas Service in Minnesota*, Docket No. G002/GR-09-1153, FINDINGS OF FACT, CONCLUSIONS OF LAW, AND ORDER at 27 (Dec. 6, 2010) (Doc. ID. No. 201012-57199-01).

[105] *In the Matter of an Application by CenterPoint Energy for Authority to Increase Natural Gas Rate in Minnesota*, Docket No. G008/GR-08-1075, FINDINGS OF FACT, CONCLUSIONS OF LAW, AND ORDER (Jan. 11, 2010) (Doc. ID No. 20101-45867-01).

[106] *See* DOC Ex. 200 at 25-26, 50-51 (Amit Direct).