

**UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION**

Eastern Shore Natural Gas Company)

Docket No. RP07-__-000

**PREPARED DIRECT TESTIMONY OF
MICHAEL P. McMASTERS**

1 **Q. Please state your name, occupation and business address.**

2 A. My name is Michael P. McMasters. I am the Senior Vice President and Chief
3 Financial Officer of Eastern Shore Natural Gas Company (“Eastern Shore” or
4 “the Company”) and its parent, Chesapeake Utilities Corporation
5 (“Chesapeake”). My business address is 909 Silver Lake Boulevard, Dover,
6 Delaware 19904.

7

8 **Q. Describe briefly your education and relevant professional background.**

9 A. I received a Bachelor of Arts in Business Administration with a major in
10 Accounting from Salisbury University in Salisbury, Maryland. I was hired by
11 Chesapeake Utilities Corporation in 1980. From 1980 to 1992, I held various
12 positions in the Accounting and Rate Departments, including Manager of Rates
13 and Controller. Additionally, I served as Vice President of Financial Services at
14 Currin and Associates, Inc., a subsidiary of Chesapeake. In 1992, I joined
15 Equitable Gas Company as the Director of Operations Planning. I rejoined
16 Chesapeake in 1994 as Director of Natural Gas Accounting and Rates and was

1 later promoted to Vice President and General Manager of Eastern Shore Natural
2 Gas Company. In 1997, I was elected Vice President, Treasurer and Chief
3 Financial Officer of Chesapeake and Eastern Shore and, in 2004, I was
4 promoted to Senior Vice President.

5
6 **Q. Please describe the scope of your present responsibilities.**

7 A. In my capacity as Senior Vice President and Chief Financial Officer, I am
8 responsible for all Treasury and Accounting functions for Chesapeake Utilities
9 Corporation and its subsidiaries, including Eastern Shore. These responsibilities
10 include raising capital to fund operations and growth, preparation and issuance
11 of all publicly reported financial information, establishing internal controls,
12 accounting policies and operating procedures for Chesapeake and subsidiaries.

13
14 **Q. Have you previously been a witness in proceedings before the Federal**
15 **Energy Regulatory Commission (“FERC”) or before State Regulatory**
16 **Commissions?**

17 A. I have previously submitted pre-filed testimony in five Eastern Shore rate
18 proceedings over the past twenty-two years, including RP84-72-000, RP87-61-
19 000, RP89-164-000, RP97-32-000 and RP97-231-000.

20
21 **Q. What is the purpose of your direct testimony in this proceeding?**

1 A. As noted above, I have overall responsibility for ensuring that Chesapeake and
2 Eastern Shore have adequate capital to finance ongoing operations and
3 expansion. My testimony consists of a description of Eastern Shore's and
4 Chesapeake's capital structure, their cost of debt financing, cost of equity capital
5 and investor expectations. I will also describe Chesapeake's accounting for post-
6 retirement benefits other than pensions.

7

8 **Q. Do you sponsor any statements in this filing?**

9 A. I sponsor Statements F-1 through F-4; however, Eastern Shore Witness Paul R.
10 Moul testifies as to the appropriate cost of capital included in these Statements.

11

12 **Q. Please describe the capital structure of Eastern Shore at the end of the base**
13 **period and at the end of the test period.**

14 A. Eastern Shore's capital structure at June 30, 2006 consists of approximately
15 \$40.0 million of common equity. Eastern Shore does not have any long-term
16 debt outstanding. Eastern Shore's remaining capital comes from its parent
17 company, Chesapeake. For the purposes of this proceeding, Eastern Shore is
18 proposing to use the capital structure of its parent company.

19

20 **Q. How was the capital structure of Chesapeake at the end of the base period**
21 **and at the end of the test period determined?**

1 A. The proposed test period capital structure is based upon the long-term debt
2 balance and the common equity balance as of June 30, 2006 for Chesapeake
3 Utilities Corporation. The long-term debt balance excludes a \$100,000 loan
4 payable by an unregulated affiliate company and any principal repayments due
5 within one year. Additionally, the equity balance was adjusted to exclude
6 accumulated other comprehensive income. The June 30, 2006 capital structure
7 of Chesapeake, as adjusted, consists of 61% equity and 39% debt. In my
8 opinion, this is a reasonable estimate of the Company's capital structure as of
9 March 31, 2007. The forecasted March 31, 2007 capital structure will be
10 adjusted as more information becomes available. Chesapeake does not currently
11 have any preferred equity outstanding and does not expect to issue any before
12 March 31, 2007.

13

14 **Q. Why is Eastern Shore imputing Chesapeake's capital structure?**

15 A. Eastern Shore is a wholly owned subsidiary of Chesapeake, not a publicly traded
16 company. Eastern Shore does not raise its own capital, but rather relies on
17 Chesapeake as its source of financing.

18

19 **Q. What is the cost of debt financing for Chesapeake and Eastern Shore**
20 **through the end of the test period?**

1 A. The cost of debt financing through the end of the test period is forecasted to be
2 6.73%. At June 30, 2006, Chesapeake had outstanding \$57,728,364 of long-
3 term debt. This amount excludes the current portion of long-term debt and
4 excludes \$100,000 of unregulated subsidiary debt. The weighted average cost
5 of debt at June 30, 2006 was 7.24%. The forecasted changes between June 30,
6 2006 and March 31, 2007 result from the normal principal repayments
7 scheduled during that period and from the issuance of a new senior note.
8 Chesapeake entered into an agreement with three institutional investors to
9 borrow \$20 million in principal at an interest rate of 5.5%. The estimated debt
10 issuance costs are \$75,000. As a result of the forecasted changes, the cost of
11 debt at March 31, 2007 is expected to be 6.73%.

12

13 **Q. What is Eastern Shore's proposed overall rate of return in this proceeding?**

14 A. As shown on the below, Eastern Shore proposes an overall rate of return of
15 11.72% for the test period.

	<u>Ratio</u>	<u>Cost Rate</u>	<u>Cost of Capital</u>
17 Long-Term Debt	39%	6.730%	2.61%
18 Common Equity	<u>61%</u>	<u>14.875%</u>	<u>9.11%</u>
19 Total Cost of Capital	<u>100.00%</u>		<u>11.72%</u>

20

1 Eastern Shore Witness Paul R. Moul testifies that the appropriate cost of
2 common equity for Eastern Shore in this proceeding is 14.875%. The long-term
3 debt effective cost rate utilized for this filing is the forecasted long-term debt
4 effective cost rate for Chesapeake Utilities Corporation at March 31, 2007.

5
6 **Q. How do Eastern Shore's earnings influence Chesapeake's investors and**
7 **investors analysts?**

8 A. Investors in Chesapeake ("the Consolidated Group") and Investor analysts that
9 follow Chesapeake look very carefully at earnings per share growth and
10 dividends, and they consider the regulatory climate and historical data as part of
11 their investment decisions. They are aware that Eastern Shore has invested
12 consistently and substantially in new infrastructure, and they consider factors
13 such as the Consolidated Group's historical ROE. Eastern Shore represents 34
14 percent of the plant assets of the Consolidated Group and, over the past five
15 years, 30% to 42% of Operating Income. A change of 1% in Eastern Shore's
16 ROE impacts the Consolidated Group's earnings per share by 4.6%, or
17 approximately \$0.08 per share.

18
19 **Q. How would Eastern Shore's allowed ROE affect Chesapeake's decisions to**
20 **invest in Eastern Shore's expansions vs. other regulated and unregulated**
21 **investment opportunities?**

1 A. Eastern Shore and Chesapeake review capital expenditure projects based upon
2 the forecasted amount of capital required for the project, the risk associated with
3 the project and the expected returns. Chesapeake expects higher returns from
4 riskier projects. Typically, the unregulated operations have higher risk and are
5 expected to earn higher returns. Over the last several years, Chesapeake has
6 invested a significant amount of capital in its regulated businesses, including
7 particularly Eastern Shore. As Eastern Shore Witness Elaine B. Bittner testifies,
8 the amount of capital that Chesapeake has invested in recent years in new
9 Eastern Shore pipeline infrastructure is proportionately much larger than
10 infrastructure investment by other pipelines, large and small. The level of
11 Chesapeake's investment in its regulated businesses, including Eastern Shore,
12 could have the effect of reducing the company's expected return on equity if
13 Eastern Shore is not allowed an opportunity to earn a return on equity
14 commensurate with its level of risk, as discussed in the testimony of Eastern
15 Shore witnesses Bittner and Moul.

16

17 **Q. What treatment is requested by Eastern Shore for Post-Retirement Benefits**
18 **Other Than Pensions ("PBOP")?**

19 A. Eastern Shore is requesting the accrual treatment for PBOP. The cost of service
20 includes an annualized expense level for PBOP, which reflects rate recovery of
21 such costs on an accrual basis, as determined by an actuary. In accordance with

1 Generally Accepted Accounting Principles, Eastern Shore adopted the accrual
2 method of accounting for PBOP consistent with Financial Accounting Standards
3 Board SFAS No. 106.

4

5 **Q. Does this conclude your testimony at this time?**

6 A. Yes, it does.

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AFFIDAVIT OF MICHAEL P. McMASTERS

Michael P. McMasters, being duly sworn according to law, on oath deposes and says: that he is the witness whose testimony appears on the preceding pages entitled "PREPARED DIRECT TESTIMONY OF MICHAEL P. McMASTERS" in this proceeding; that, if asked the questions which appear in the text of the aforesaid testimony, affiant would give the answers that are therein set forth; and that affiant adopts the aforesaid testimony as his sworn testimony in these proceedings.

Michael P. McMasters

Subscribed and sworn to before me this _____ day of October, 2006.

Notary Public