Exhibit No.:
Issue: Financial Integrity/Revenue Imputation
Witness: Robert B. Hevert
Sponsoring Party: Liberty Utilities
Case No.: GR-2014-0152
Date Testimony Prepared: July 30, 2014

MISSOURI PUBLIC SERVICE COMMISSION

Case No. GR-2014-0152

REBUTTAL TESTIMONY

OF

ROBERT B. HEVERT

SUSSEX ECONOMIC ADVISORS, LLC

Submitted on Behalf Of

LIBERTY UTILITIES (MIDSTATES NATURAL GAS) CORP.
d/b/a LIBERTY UTILITIES

July 30, 2014

**** Denotes Highly Confidential Information ****

*** Denotes Proprietary Information ***

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BEFORE THE

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I. INTRODUCTION

Q. Please state your name, affiliation and business address.

A. My name is Robert B. Hevert. I am Managing Partner of Sussex Economic Advisors, LLC ("Sussex"). My business address is 161 Worcester Road, Suite 503, Framingham, Massachusetts 01701.

Q. Are you the Robert B. Hevert who submitted Direct and Rebuttal Testimony in this proceeding?

A. Yes, I filed Direct Testimony on behalf of Liberty Utilities (Midstates Natural Gas) Corp., d/b/a Liberty Utilities ("Liberty Utilities" or the "Company"), an indirect wholly owned subsidiary of Algonquin Power & Utilities Corp.

Q. What is the purpose of your testimony?

A. The purpose of my testimony is to respond to the Staff of the Missouri Public Service Commission's ("Staff") recommendation to adjust Liberty Utilities' revenues by imputing certain additional revenues related to three special contracts with two industrial customers (General Mills, and Noranda Aluminum, Inc.), and one adjacent local distribution company, SourceGas Arkansas, Inc.[1]

Q. Are sponsoring Schedules related to this testimony?

A. Yes, I am sponsoring Schedule RBH-FI1HC through Schedule RBH-FI6HC.

Q. Please describe how the remainder of your testimony is organized.

A. The remainder of my testimony consists of the following three sections:

II. Overview of Staff's revenue imputation recommendation

III. Analysis of Staff's revenue imputation recommendation

IV. Conclusions

II. OVERVIEW OF STAFF'S REVENUE IMPUTATION RECOMMENDATION

Q. Please briefly summarize Staff's proposed revenue imputation.

A. Staff proposes to impute a total of ** __________ ** in revenue related to three special contracts between Liberty Utilities' and, respectively, SourceGas Arkansas, Inc., Noranda Aluminum Inc., and General Mills (those agreements are referred to collectively as the "Special Contracts").[2] The specific amounts of imputed revenue recommended by Staff for each contract are provided in Table 1(below).

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[1] Staff Workpaper "Special Contracts_SourceGas_Noranda_General Mills.xls," Tab "Adjustment in Text Year," cells J10-J14. I note that there appears to be a slight discrepancy between Staff's Workpapers and Staff's Cost of Service Report. My analyses rely on the information contained in Staff's Workpapers

[2] Ibid.

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Table 1: Staff's Revenue Imputation Adjustments

Special Contract Counterparty	Revenue Imputation
General Mills	** ________[3] **
SourceGas Arkansas, Inc	** ________[4] **
Noranda Aluminum, Inc.	** ________[5] **
Total	** ________ **

The regulatory policy issues arising from Staff's recommended adjustments are addressed in the Rebuttal Testimony of Company Witness Christopher D. Krygier. Below, I provide my analysis and conclusions regarding the likely financial implications associated with Staff's recommendation.

III. <u>ANALYSIS OF STAFF'S REVENUE IMPUTATION RECOMMENDATION</u>

Q. Please summarize the specific financial implications associated with Staff's recommended revenue imputations.

A. Fundamentally, Liberty Utilities' revenues under the Special Contracts are constrained by the rates specified within the respective contracts. That is, despite Staff's position that Liberty Utilities should charge these customers a higher rate, the Company is unable to unilaterally increase the rates it charges the three customers under the Special Contracts. As a result, the revenue that Staff imputes is strictly hypothetical and, does not result in additional cash flow to the Company. Rather, the adjustment reduces the Company's revenue deficiency and, therefore, the cash flow it would be able to generate after rates are in effect. That cash flow dilution will challenge the Company's ability to maintain its

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3 Ibid at cell J14

4 Ibid at cell J10.

5 Ibid at cell J12.

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financial integrity and, as discussed below, would eliminate its opportunity to earn a reasonable Return on Equity.

Q. Please explain how the revenue imputation would challenge the Company's financial integrity.

A. In order to cover its expenses and service its debt, the Company must generate sufficient operating cash flow. Staff's proposed adjustment, however, not only reduces Liberty Utilities' revenue deficiency in the context of its cost of service, it also reduces the Company's earnings and cash flow. In particular, the new customer rates calculated following the revenue imputation adjustment would generate approximately **_______ _______** less in earnings and cash flow than the Company requires to adequately cover its expenses, service its debts and earn a reasonable Return on Equity. As such, that cash flow and earnings dilution would substantially diminish the Company's financial integrity.

Q. Have you analyzed the financial impact of Staff's revenue imputations?

A. Yes, I have. I relied on the cost of service model that Liberty Utilities filed as part of its direct case in this docket. Using that model, I included Staff's proposed revenue imputation adjustments both individually and collectively. I then calculated the likely Return on Equity that the Company would earn on its equity capital. In addition, I analyzed four cash flow or coverage ratios that are relied upon by Standard & Poor's to assess the cash flow of rated entities ("S&P"):

(1) Funds From Operations to Long-Term Debt ("FFO/Debt");

(2) Debt to EBITDA[6] ("DEBT to EBITDA");

(3) Funds From Operations to Interest ("FFO/Interest"); and

(4) EBITDA to Interest ("EBITDA/Interest").

Those ratios are summarized in Table 2 (below).[7] As discussed below (*see* also Schedule RBH-FI1HC), Staff's proposed revenue imputation adjustment would likely substantially and negatively affect those four ratings metrics.[8]

Table 2: S&P Financial Risk Ratios

Cash Flow/Leverage Analysis Ratios--Standard Volatility							
	Core ratios		Supplementary coverage ratios		Supplementary payback ratios		
	FFO/debt (%)	Debt/EBITDA (x)	FFO/cash interest(x)	EBITDA/interest (x)	CFO/debt (%)	FOCF/debt (%)	DCF/debt (%)
Minimal	60+	Less than 1.5	More than 13	More than 15	More than 50	40+	25+
Modest	45-60	1.5-2	9-13	10-15	35-50	25-40	15-25
Intermediate	30-45	2-3	6-9	6-10	25-35	15-25	10-15
Significant	20-30	3-4	4-6	3-6	15-25	10-15	5-10
Aggressive	12-20	4-5	2-4	2-3	10-15	5-10	2-5
Highly leveraged	Less than 12	Greater than 5	Less than 2	Less than 2	Less than 10	Less than 5	Less than 2

Cash Flow/Leverage Analysis Ratios--Medial Volatility							
	Core ratios		Supplementary coverage ratios		Supplementary payback ratios		
	FFO/debt (%)	Debt/EBITDA (x)	FFO/cash interest (x)	EBITDA/interest (x)	CFO/debt (%)	FOCF/debt (%)	DCF/debt (%)
Minimal	50+	less than 1.75	10.5+	14+	40+	30+	18+
Modest	35-50	1.75-2.5	7.5-10.5	9-14	27.5-40	17.5-30	11-18
Intermediate	23-35	2.5-3.5	5-7.5	5-9	18.5-27.5	9.5-17.5	6.5-11
Significant	13-23	3.5-4.5	3-5	2.75-5	10.5-18.5	5-9.5	2.5-6.5
Aggressive	9-13	4.5-5.5	1.75-3	1.75-2.75	7-10.5	0-5	(11)-2.5
Highly leveraged	Less than 9	Greater than 5.5	Less than 1.75	Less than 1.75	Less than 7	Less than 0	Less than (11)

Cash Flow/Leverage Analysis Ratios--Low Volatility							
	Core ratios		Supplementary coverage ratios		Supplementary payback ratios		
	FFO/debt (%)	Debt/EBITDA (x)	FFO/cash interest (x)	EBITDA/interest (x)	CFO/debt (%)	FOCF/debt (%)	DCF/debt (%)
Minimal	35+	Less than 2	More than 8	More than 13	More than 30	20+	11+
Modest	23-35	2-3	5-8	7-13	20-30	10-20	7-11
Intermediate	13-23	3-4	3-5	4-7	12-20	4-10	3-7
Significant	9-13	4-5	2-3	2.5-4	8-12	0-4	0-3
Aggressive	6-9	5-6	1.5-2	1.5-2.5	5-8	(10)-0	(20)-0
Highly leveraged	Less than 6	Greater than 6	Less than 1.5	Less than 1.5	Less than 5	Less than (10)	Less than (20)

As Schedule RBH-FI1HC demonstrates, the individual and cumulative effect of each adjustment materially diminishes the Company's ability to earn a reasonable Return on Equity. For example, Staff's revenue imputation related to the SourceGas Arkansas,

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6 Earnings Before Interest, Taxes, Depreciation and Amortization.

7 *Corporate Methodology*, Standard & Poor's Ratings Services, Ratings Direct, November 19, 2013, at 35.

8 As shown in Table 1, S&P considers other 'supplementary payback ratios' that I have not considered in my analysis due to my focus on financial coverage.

Inc. contract would reduce the Company's earned Return on Equity by approximately ** ____** basis points, and the revenue imputation adjustment related to the Noranda Aluminum, Inc. contract would reduce the earned Return on Equity by approximately ** ___ ** basis points. The aggregate effect of Staff's proposed revenue imputation adjustments is to reduce the Company's expected Return on Equity to just ** ____ ** percent.

Similarly, the Company's ratio of FFO/Debt would fall from approximately ** _____ ** percent to approximately ** _____ ** percent; Debt/EBITDA would increase from ** _____ ** to ** ______ **; FFO/Interest would decline from approximately ** ______** to approximately ** ____ **; and EBITDA/Interest would decline from ** _____ ** to ** _____ **.

As noted above, S&P relies on these ratios in assessing financial risk. In doing so, S&P first determining the subject company's volatility level (*i.e.*, standard, medial, or low), then relies on the established guidelines shown in Table 2 (above) to determine the financial risk profile. The guidelines for determining the volatility for utility companies is provided in Table 3 (below).

Table 3: Regulated Utility Volatility[9]

	Standard	Medial	Low
Cash Flows	A vast majority of operating cash flows come from regulated operations that are predominantly at the low end of the utility risk spectrum (*e.g.*, a "network," or distribution/ transmission business unexposed to commodity risk and with very low operating risk).	A majority of operating cash flows from regulated activities with an "adequate" or better regulatory advantage assessment.	About one-third or less of its operating cash flow comes from regulated utility activities, regardless of its regulatory advantage assessment; or
Regulatory Assessment	A "strong" regulatory advantage assessment.	About one-third or more of consolidated operating cash flow comes from regulated utility activities with a "strong" regulatory advantage and where the average of its remaining activities have a competitive position assessment of '3' or better.	A regulatory advantage assessment of "adequate/weak" or "weak."
Credit	An established track record of normally stable credit measures that is expected to continue.		
Funding Cost	A demonstrated long-term track record of low funding costs (credit spread) for long-term debt that is expected to continue.		
Unregulated Activities	Non-utility activities that are in a separate part of the group (as defined in our group rating methodology) that we consider to have "nonstrategic" group status and are not deemed high risk and/or volatile.		

9 *Key Credit Factors for the Regulated Utilities Industry,* Standard & Poor's Rating Services, Ratings Direct, November 19, 2013, at 18-19.

Assuming that Liberty Utilities is placed in the medial volatility category, the likely decline in its financial profile resulting from Staff's revenue imputation adjustment would apply downward pressure on its financial risk profile. Although FFO/Debt remains within the ** ____________ ** category, it would fall to the lower end of the range for that grade. More importantly, the resulting decline in the remaining three metrics would likely correspond to one category below the previously assessed category. For example, both the Debt/EBITDA and EBITDA/Interest ratios fall from the ** ________ ** category to the ** ______________ ** category. Overall, these changes likely would have a significant effect on the Company's financial risk profile (and potentially its parent company), and could increase the cost and complicate the terms at which it could raise external capital.

A similar analysis is presented in Schedule RBH-FI2HC, which analyzes the effect of Staff's revenue imputation adjustment, but does not update the cash income tax calculation to reflect the changes in the Company's earnings that resulted from Staff's revenue imputation adjustment. As shown on Schedule RBH-FI2HC, the effects of Staff's adjustment remain essentially the same with one notable exception (*i.e.*,. FFO/Debt). In this scenario, the higher cash income taxes results in a decline in the FFO/Debt from ** ______________ ** category to the ** _____________ ** category.

Q. Has Staff also made recommendations related to the capital structure and Return on Equity to be used in calculating Liberty Utilities' revised rates?

A. Yes, as Table 4 notes Staff proposes changes to both.

Table 4: Revenue Imputation, Capital Structure and Return on Equity Recommendations

Category	Liberty Utilities Direct Testimony	Staff Recommendation
Revenue Imputation	$0	** ____ [10] **
Return on Equity (Midpoint)	10.50%	* [11] *
Capital Structure	41.66% Debt 58.34% Equity	* * **Debt** * * **Equity**[12]

While I address Staff's positions regarding the Company's rate of return and capital structure in my Rebuttal Testimony, I note here that the combined effects of Staff's proposed revenue imputation adjustments become even more acute in light of its Return on Equity and capital structure recommendations. As a result, I analyzed the potential combined effects of Staff's revenue imputation, Return on Equity, and capital structure recommendations on Liberty Utilities' financial integrity.

Q. Please describe your analysis of Staff's proposed revenue imputation adjustments, Return on Equity, and capital structure as they relate to the Company's financial integrity.

A. Similar to the analysis described above, I began with the cost of service model filed by Liberty Utilities in its direct case in this proceeding. I then made certain adjustments to reflect Staff's proposed revenue imputation adjustment, Return on Equity, and capital structure. Schedule RBH-FI3HC presents the combined effects of Staff's proposed

10 Staff Workpaper "Special Contracts_SourceGas_Noranda_General Mills.xls," Tab "Adjustment in Text Year," cells J10-J14.

11 Staff Cost of Service Report, at 6.

12 Staff Cost of Service Report, at 19.

revenue imputation adjustment, and ROE recommendation. Schedule RBH-FI4HC, presents the combined effects Staff's proposed revenue imputation adjustment, and capital structure recommendation. Lastly, Schedule RBH-FI5HC presents the combined effects of Staff's proposed revenue imputation adjustment, Return on Equity, and capital structure.

As Schedules RBH-FI3HC through RBH-FI5HC demonstrate, the combined effect of Staff's recommendations would be to substantially reduce the cash flow metrics discussed earlier, and increase the Company's financial risk. For instance, the combined effect of Staff's revenue imputation adjustments, and Return on Equity and capital structure recommendations is to reduce the Company's FFO/Debt ratio to just ** ______** percent, and its FFO/Interest to just ** _____ ** (*see* Schedule RBH-FI5HC*)*. In essence, Staff's proposed adjustments would decrease the Company's financial strength from the ** ________ ** and ** ______________ ** categories shown in Table 2 (above) to the ** ______________ ** (*i.e.*, Debt/EBITDA and EBITDA/Interest) and ** ____________ ** (*i.e.*, FFO/Debt and FFO/Interest) categories.

In addition, Staff's proposals would prevent the Company from earning a reasonable Return on Equity. As shown on Schedule RBH-FI5HC, the expected earned Return on Equity would decline from 10.50 percent to approximately ** ____ ** percent, a reduction of ** ___ ** basis points. Such an outcome, which suggests a Return on Equity below the Cost of Debt, clearly is not reasonable and should not be deemed in the public interest by the Commission.

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Q. Did you perform any additional analyses of the Company's financial integrity in the context of Staff's recommended adjustments?

A. Yes, I did. In Schedule RBH-FI6HC I developed a *pro forma* analysis that includes Staff's proposed revenue imputation adjustment, recommended Return on Equity, and recommended capital structure. I then used Staff's proposed capital structure to calculate the *pro forma* interest expense and calculate the coverage ratios discussed above. As shown on Schedule RBH-FI6HC, that scenario indicates substantially diminished credit metrics. For example, the Company's earned Return on Equity in this scenario would be just ** ____ ** percent, which is below the Cost of Debt. In addition, the Company's financial risk would correspond with the ** ___________ ** category for three out of the four coverage metrics (*i.e.*, FFO/Debt, FFO/Interest, and EBITDA/Interest). As to the remaining measure (*i.e.,* Debt/EBITDA), the *pro forma* metrics correspond to an ** _____________ ** risk by just two one hundredths of a percent. Based on that analysis, it is apparent that Staff's recommendations in this proceeding would not support a financially healthy utility and should not be considered as being in the public interest.

IV. <u>CONCLUSIONS</u>

Q. Please summarize your analyses and conclusions regarding the financial implications of Staff's proposed revenue imputation adjustments.

A. Staff has proposed revenue imputation adjustments of approximately ** ______ ** million associated with the Special Contracts. Because the Company is unable to unilaterally increase the rates charged pursuant to the Special Contracts, Staff's revenue imputation adjustments would diminish the Company's earnings and cash flow, and put significant downward pressure on cash flow-related measures of financial integrity. For example, Staff's revenue imputation adjustments would reduce the Company's earned return on common equity to just ** ____ ** percent; when combined with Staff's Return on Equity and capital structure recommendations, the revenue imputation adjustments would reduce the Company's earned return on common equity to approximately ** ____ ** percent. The effect, therefore, would be to significantly deteriorate Liberty Utilities' financial integrity and materially increase its financial risk.

Q. Does that conclude your testimony?

A. Yes, it does.

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Liberty Utilities (Midstates Natural Gas) Corp. d/b/a Liberty Utilities' Tariff Revisions Designed To Implement a General Rate Increase For Natural Gas Service in the Missouri Service Areas of the Company.	))))))	Case No. GR-2014-0152

AFFIDAVIT OF ROBERT B. HEVERT

COMMONWEALTH OF MASSACHUSETTS)
) ss
COUNTY OF MIDDLESEX)

Robert B. Hevert, being first duly sworn on his oath, states:

1. My name is Robert B. Hevert. I am Managing Partner of Sussex Economic Advisors, LLC and my business address is 161 Worcester Road, Suite 503, Framingham, Massachusetts 01701.

2. Attached hereto and made a part hereof for all purposes is my Rebuttal Testimony on behalf of Liberty Utilities (Midstates Natural Gas) Corp. d/b/a Liberty Utilities consisting of twelve (12) pages and Schedules RBH-FI1HC through RBH-FI6HC, all of which having been prepared in written form for introduction into evidence in the above-captioned docket.

3. I have knowledge of the matters set forth therein. I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded, including any attachments thereto, are true and accurate to the best of my knowledge, information and belief.

Robert B. Hevert

Subscribed and sworn before me this 30th day of July, 2014.

Notary Public

My commission expires: April 16, 2015

KIMBERLY H. DAO
Notary Public
Commonwealth of Massachusetts
My Commission Expires
April 16, 2015