BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of	)	
Summit Natural Gas of Missouri Inc.'s	)	**File No. GR-2014-0086**
Filing of Revised Tariffs to Increase Its	)	Tracking No. YG-2014-0285
Annual Revenues for Natural Gas Service	)	

STAFF'S REPLY BRIEF

COMES NOW the Staff of the Missouri Public Service Commission, by and through counsel, and hereby submits its *Reply Brief* in this matter:

I. Introduction

In its initial brief, the Office of The Public Counsel describes its concern about the size of the rate increase SNG has requested in this case. Staff shares OPC's concern, but cannot agree with its method. Rather, Staff recommended a rate of return and a revenue requirement that are more appropriate than what SNG requested. Staff's case appropriately protects ratepayers from the risks of SNG's expansion, while also establishing rates in a lawful manner based on SNG's actual cost of service.

The Commission should reject OPC's ratemaking methodology, and also continue its long-standing adherence to the net book value/net original cost rule. The Commission should accept the recommendations of Staff witness David Murray, whose testimony provides a reasonable return on SNG's investment in utility service while appropriately protecting ratepayers from the risks of SNG's expansion.

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II. Rate of Return

A. Introduction

The most important thing that utility regulatory commissions like the PSC do is to prevent monopoly utilities from taking unfair advantage of their captive customers. SNG is engaged in an aggressive and not-entirely-successful[1] effort to bring retail natural gas to communities that have long relied on propane. SNG is thus locked in costly competition with the propane industry in those communities. For this reason, SNG's incentive is very great to find a way for its retail gas customers to underwrite its speculative market-penetration efforts. Nowhere is that more apparent than in the Rate of Return issues.

At issue in this case are the capital structure, the cost of debt and the cost of equity; that is, everything in the Rate of Return area. SNG has proposed inflated values that will best support its ongoing competitive efforts. However, the numbers proposed by SNG **DO NOT REFLECT** its actual cost incurred in serving its existing customers.

Staff believes that it would be very unfair to those customers to require them to underwrite SNG's competitive efforts to penetrate new markets. It is for this reason that Staff's expert witness, David Murray, has proposed a hypothetical capital structure, a hypothetical cost of debt and a conservative cost-of-common equity developed using mainstream financial analytical data and methods.

[11] Even before the Lake of the Ozarks District expansion, earnings before interest, taxes, depreciation and amortization ("EBITDA") were only about 50 percent of projections. Ex. 103, p. 17.

B. Capital Structure

A review of the parties' recommendations (Table 1, below) reveals the truth of Staff's characterization. In the Capital Structure, SNG proposes 57% equity and 43% debt compared to Staff's recommendation of only 40% equity and 60% debt.

SUMMARY OF RECOMMENDATIONS			
CAPITAL STRUCTURE:			
Witness	**Party**	**Equity**	**Debt**
Anderson	SNG	**57%**[2]	**43%**[3]
Murray	Staff	**40%**[4]	**60%**[5]
COST OF DEBT:			
Anderson	SNG	**3.21%**[6]	
Murray	Staff	**5.00%**[7]	
COST OF EQUITY:			
Anderson	SNG	**12.00 to 17.60, 15.00**[8]	
Murray	Staff	**9.80 to 10.80**, **10.30**[9]	
Table 1.			

Equity is more expensive than debt, and so SNG's proposed capital structure necessarily will be significantly more expensive for the ratepayers than Staff's. Staff did

[2] Ex. 103, p. 3.
[3] *Id.*
[4] Ex. 103, p. 7.
[5] *Id.*
[6] *Id.,* p. 3.
[7] Ex. 103, , p. 20.
[8] Ex. 1, pp. 56-7. SNG has voluntarily reduced its requested ROE to 12.00% for competitive reasons. Ex. 4, *Moorman Direct,* p. 14.
[9] Ex. 130, *Murray Surrebuttal,* p. 8.

not create its proposed hypothetical capital structure from thin air, but found it in the financing plans **filed by SNG** with its application in Case No. GO-2012-0102.[10] Staff's proposed capital structure is exactly what SNG itself forecast before it began the Lake of the Ozarks ("LOO") District expansion.

Staff further provided evidence at the hearing that SNG's investor, the Infrastructure Investments Fund ("IIF") has a strategy of employing 60% leverage for its overall portfolio of infrastructure investments. Clearly, SNG's actual investor determines its required return based on its investment strategies.[11]

SNG cites ***In the Matter of Emerald Pointe Utility Company, Public Service Commission v. Office of the Public Counsel,***[12] ***McCloskey v. Koplar***[13] and ***White v. Director of Revenue***[14] for the proposition that "[o]nce a plaintiff has discharged his burden of production, the burden shifts to the other party 'to produce, if he desires, competent controverting evidence which, if believed, will offset the plaintiff's prima facie case.'"[15] SNG asserts that Staff has failed to meet this burden.[16] That, however, is for the Commission to decide. SNG also relies on ***State ex rel. Associated Natural Gas Co. v. Public Service Commission***[17] for the proposition that a regulatory commission may disregard a utility's actual capital structure in only two circumstances, neither of which a present here.[18] But that is not, in fact, what ***Associated Natural Gas*** stands for. In that case, the Court noted approvingly, "[i]t appears to be an accepted regulatory

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[10] Ex. 103, pp. 18-19.
[11] Tr. 11:202-204 (Murray)
[12] WL 3906156 (Mo. App., W.D. Aug. 12, 2014).
[13] 46 S.W.2d 557, 563 (Mo. banc 1932).
[14] 321 S.W.3d 298, 304-5 (Mo. banc 2010).
[15] ***Emerald Pointe,*** *supra,* quoting ***McCloskey,*** 46 S.W.2d at 563.
[16] *SNG Initial Brief,* p. 12.
[17] 706 S.W.2d 870, 878-9 (Mo. App., W.D. 1985).
[18] *SNG Initial Brief,* pp. 13-14.

practice to disregard the actual book capital structure of a utility when it is deemed to be in the public interest to do so."[19] This is exactly the course that Staff urges the Commission to take here.

C. Cost of Debt

Staff's cost-of-debt recommendation is aligned with its hypothetical capital structure recommendation. Staff proposes that the Commission use the embedded cost of debt from a debt issuance at SNG's affiliate, Colorado Natural Gas ("CNG"), as a proxy for SNG's cost of debt had the LOO expansion not occurred. Staff chose this debt issuance as a proxy because it occurred at approximately the same time as the debt SNG had initially proposed to issue in Case No. GO-2012-0102 when SNG's strategy was not to move forward with its build-out of the LOO system. Staff also provided an alternative overall embedded cost of debt for CNG of 5.37% for the Commission to consider as a proxy for SNG.

Yes, the cost of debt proposed by Staff *is higher* than that proposed by SNG,[20] but that is because SNG's cost of debt reflects a *variable rate* for short-term debt.[21] SNG's current $100 million financing with a maturity of only three years was incurred primarily to support its LOO expansion project.[22] Permanent, long-term financing would necessarily be more expensive. Therefore, CNG's debt cost is a reasonable proxy value.[23] In its *Initial Brief,* SNG argues that "SNGMO's case as filed is based on the use of its **actual, current cost of long-term debt at 3.21%**. . . . the Company believes it is appropriate to use this interest rate on long-term debt to calculate the company's

[19] 706 S.W.2d at 878.
[20] Table 1.
[21] Ex. 118, *Murray Rebuttal,* pp. 11-12.
[22] *Id.*
[23] *Id.*

weighted cost of capital because it correctly matches the cost of the Company's debt capital with all other test year expenses and revenues."[24] But this statement is absurd on its face **because the terms of SNG's current debt are not a function of the long-term assets of the districts subject to this rate case. The term of this debt was negotiated for purposes of further expansion in the LOO.*[25]***

Staff's position is that SNG's ratepayers should not have to pay for a higher revenue requirement because SNG needs to maintain more common equity to support its growth initiatives.[26] Staff believes that SNG's affiliate, CNG, which is not engaged in an expansion project, provides a fair and reasonable proxy for what SNG's capital structure and cost of debt would have been absent the LOO expansion.[27]

D. Cost of Equity

COST OF EQUITY:		
Anderson	SNG	**12.00 to 17.60, 15.00[28]**
Murray	Staff	**9.80 to 10.80**, **10.30**[29]
Table 2.		

SNG also proposes a significantly higher cost of common equity than Staff, 12.00% compared to 10.30%.[30] 12.00% is the lowest value recommended by SNG's

[24] *SNG Initial Brief,* p. 10 (emphasis added).
[25] Ex. 118, *Murray Rebuttal,* pp. 11-12.
[26] *Id.*
[27] *Id.,* pp. 3-4. SNG also suggests, that if the Commission is going to use a hypothetical cost of debt, it should use a value in the range 6.5% to 7.0%. *Id.,* at 11. The use of such a value would, of course, result in higher rates.
[28] Ex. 1, pp. 56-7. SNG has voluntarily reduced its requested ROE to 12.00% for competitive reasons. Ex. 4, *Moorman Direct,* p. 14.
[29] Ex. 130, *Murray Surrebuttal,* p. 8.
[30] Table 2.

expert witness, James M. Anderson, whose range extended up to 17.60%.[31] A higher authorized "return on equity," or "ROE" would necessarily be more costly for the ratepayers. The United States Supreme Court said long ago that a "public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties**; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures.**"[32] SNG is attempting to charge its captive ratepayers a speculative ROE exactly like that condemned by the Supreme Court in 1923. This is apparent from the testimony of Mr. Anderson:

> Q. (Mr. Thompson): "How did you calculate those risk factors?"
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> A. (Mr. Anderson): "Based on my experience and the fact that had the investors who purchased this system in 2008 simply invested in the Value Line gas distribution companies and reinvested those dividends, they would have received a 12 and a half percent return, which of course means their money doubles every 5.8 years.
>
> Here they've received no return. They hadn't received any dividends. The companies have lost money or made only small gains. The last full year of operations of Southern it lost 3 and a half million dollars.
>
> And in order to entice investors to invest in something like that when they can easily get 12 and a half percent on market securities which can be easily resold any time rather than a private security that cannot be resold, they're going to need a considerable inducement, over 12 and a half percent, to invest.
>
> So by looking at those factors, we can see that we easily need a 15 percent rate of return. Now, keep in mind, we're assigning a rate of return

[31] *Id.*

[32] ***Bluefield Water Works & Improvement Company v. Public Service Commission of West Virginia***, 262 U.S. 679, 692-93, 43 S.Ct. 675, 679, 67 L.Ed. 1176, 1182-83 (1923).

here for the risks that they take. As you've said and other counsel have said, the shareholders should bear the risk. What they're asking for is a commensurate rate of return for the risk that they bear. That commensurate rate of return should be 15 percent."[33]

Mr. Anderson, a very experienced securities broker, makes it abundantly clear in his testimony that SNG **is a speculative venture** and that its shareholders must be rewarded accordingly. However, that is exactly what the United States Supreme Court has forbidden.[34] Regardless, after Staff's persistence through discovery conferences and hearings with the Commission, Staff discovered information directly from SNG's investor ("The Infrastructure Investment Fund" or "IIF") that the risk of SNG was assigned an ** _______ ** cost of equity applied to a ** ________________________ ________________ **.[35] A cost of equity far below Mr. Anderson's estimates of what he things IIF requires.

Both experts used variants of the same analytical methods. Mr. Murray relied upon the Constant Growth Discounted Cash Flow ("DCF") method and checked his results using the Capital Asset Pricing Model ("CAPM") and a variant of the Risk Premium Analysis ("RPA") termed the "Rule of Thumb."[36] He also tested his results against average authorized returns as reported by Regulatory Research Associates ("RRA"). Mr. Anderson used the Constant Growth DCF, the CAPM, and the Total Return Method.[37] "The Total Return is the rate of return representing the actual price appreciation of a stock, with cash dividends reinvested on their payment date, over a

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[33] Tr. 10:141-42 (Anderson).
[34] ***Bluefield,*** *supra.*
[35] Ex. 130, *Murray Surrebuttal,* p. 10.
[36] Ex. 103, pp. 9, 22-33.
[37] Ex. 1, pp. 42-47.

given period."[38] The Total Return model uses dividends like the DCF model, but replaces the growth rate with the actual historic market price appreciation or decline for the common shares of the referenced companies for a selected period.[39] Mr. Anderson used the 69½ period from December 31, 2007, to October 15, 2013, for his Total Return analysis.[40]

CONSTANT GROWTH DCF RESULTS		
	Murray	**Anderson**
Dividend Yield	3.8[41]	3.6[42]
Growth Rate	4.0-5.0[43]	6.4[44]
Result	7.8-8.8[45]	10.2[46]
Table 3.		

A glance at Table 2 shows that Mr. Anderson's DCF results are significantly higher than Mr. Murray's, 10.2% compared to 7.8%-8.8%. The reason for the disparity is readily apparent: Although their market-based yield factors are almost identical, the two analysts used strikingly different growth rates.[47] Mr. Anderson's growth rate, 6.4%, is significantly higher than the high end of the range used by Mr. Murray, 4.0% to 5.0%.[48]

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[38] *Id.,* pp. 42-3.
[39] *Id.,* p. 46.
[40] *Id.,* p. 43.
[41] Ex. 103, p. 23.
[42] Ex. 1, p. 46, Table 3.
[43] Ex. 103, p. 23.
[44] Ex. 1, p. 46, Table 3.
[45] Ex. 103, p. 23.
[46] Ex. 1, 46, Table 3.
[47] Table 3.
[48] *Id.*

In this computer-reliant age, everyone is familiar with the modern proverb, "garbage in, garbage out."[49] Just like a computer program, the results produced by a mathematical formula, such as financial analysts use to calculate ROE, are entirely dependent on the inputs. If the inputs are flawed, the results will be as well – "garbage in, garbage out." Mr. Murray notes that "Mr. Anderson's constant-growth DCF analysis is inherently flawed in that it assumes some of his proxy companies' growth rates can grow in perpetuity at a rate that is in some situations over double the rate of growth that has been actually achieved by the natural gas distribution industry."[50] Additionally, "Staff requested the supporting calculations for Table 3 on page 46 of Mr. Anderson's testimony because the individual company cost of equity estimates did not equal the growth rate plus the dividend yield."[51] With respect to Mr. Anderson's growth rate, Mr. Murray testified:

> Mr. Anderson's DCF analysis assumes that his proxy group's dividends can grow at an annual compound growth rate of 6.4 percent into perpetuity. This is simply not possible and is not an assumption investors make for purposes of evaluating potential returns for natural gas utility stocks. While it is possible that the natural gas distribution industry may be able to grow its earnings and dividends at a rate higher than economic growth in the near term due to policy initiatives promoting the industry's replacement of gas distribution infrastructure because of safety concerns, these replacement programs will not last into perpetuity. It is reasonable to assume that the natural gas distribution industry's long-term growth rate will not be any higher than long-term historical experience. This is especially true considering these historical growth rates capture a period of economic growth that is not expected to be matched going forward.[52]

[49] *Wikipedia, q.v.,* accessed Sept. 25, 2014. The encyclopedia quotes Charles Babbage, *Passages From The Life Of A Philosopher* (1864)*:* "On two occasions I have been asked, "Pray, Mr. Babbage, if you put into the machine wrong figures, will the right answers come out?" ... I am not able rightly to apprehend the kind of confusion of ideas that could provoke such a question." Babbage designed the first programmable mechanical calculating machine, the Analytical Engine.
[50] Ex. 118, *Murray Rebuttal,* p. 19.
[51] *Id.,* pp. 19-20.
[52] *Id.,* p. 20.

The actual growth rate enjoyed by the natural gas industry over the past 40 years was 4.4%.[53]

The difference between the analysts' CAPM results is due to the same errors on Mr. Anderson's part as with the DCF. Mr. Murray's results, 7.31% and 8.55%, are both lower than Mr. Anderson's result, 9.1%.[54] This is entirely due to the different market risk

CAPITAL ASSET PRICING MODEL RESULTS		
	Murray	**Anderson**
Risk Free Rate	3.60[55]	3.78[56]
Market Risk Premium	4.64, 6.20[57]	7.60[58]
Beta (β)	0.80[59]	0.70[60]
Result	7.31, 8.55[61]	9.1[62]
Table 4.		

This is entirely due to the different market risk premium used by the analysts. In the CAPM, the cost of equity is determined by comparing the risk of a given investment to the risk of the market as a whole.[63] To a risk-free rate (Rf) is added the product of the market-risk premium (Rm – Rf) and β, where β is a measure of the divergence of the risk of the subject security from that of the market as a whole.[64] For the risk-free

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[53] *Id.*
[54] Table 4.
[55] *Id.,* p. 32.
[56] Ex. 1, p. 44.
[57] Ex. 103, pp. 32-33.
[58] Ex. 1, p. 44.
[59] Ex. 103, p. 32.
[60] Ex. 1, p. 45.
[61] Ex. 103, p. 33.
[62] Ex. 1, p. 45.
[63] Ex. 103, pp. 31-32; Ex. 1, pp. 42-45.
[64] *Id.*

rate, both Mr. Murray and Mr. Anderson stated that they used the yield on long-term (30 years) U.S. Treasury bonds.[65] But the figure used by Mr. Anderson – 7.60 – is markedly higher than the figures used by Mr. Murray, 4.64 and 6.20.[66]

Mr. Murray also expressed concern over the market-risk premium used by Mr. Anderson: "Mr. Anderson uses inflation-adjusted, i.e., real returns, as his proxy for the equity risk premium. I have never seen a rate of return expert estimate the market risk premium by simply using real returns achieved in the market."[67] Additionally, Mr. Anderson used inflated cost-of-equity estimates in his analysis.[68]

Mr. Anderson also committed a fundamental error by using different values for the risk-free rate in the two parts of the equation: "When employing the CAPM, it is important to use the same risk-free rate in both parts of the equation. . . . Mr. Anderson's CAPM analysis assumes a higher risk-free rate for the first "Rf'' variable (the 30-year Treasury bond), but then uses a lower risk-free rate for the second "Rf'' variable (the rate of inflation), which causes an upward bias to his CAPM analysis."[69] Mr. Anderson committed yet another fundamental error by using Value Line betas with his market-risk premium based on the spread between a small company stock index and the inflation rate.[70]

Mr. Murray commented, "It is inappropriate to apply betas derived from a measurement of the market risk premium of a broad index, to a risk premium measured by an index different from that in which the beta was determined. If Mr. Anderson

[65] Ex. 1, p. 45; Ex. 103, p. 32.
[66] Table 4.
[67] Ex. 118, *Murray Rebuttal,* pp. 24-5.
[68] *Id.,* p. 28.
[69] *Id.,* p. 25.
[70] *Id.*

believes a small size risk premium adjustment should be made to his CAPM analysis, he should have adjusted his initial CAPM cost of equity estimate by a small size risk premium."[71]

Each analyst employed one other method: Mr. Murray used a "Rule of Thumb" analysis that is a form of the familiar Risk Premium analysis.[72]

MR. MURRAY'S RULE OF THUMB[73]		
Risk Premium	3.0	4.0
"A" rated 30-year utility bonds	4.51	4.51
Result	7.51	8.51
Risk Premium	3.0	4.0
"Baa" rated 30-year utility bonds	5.28	5.28
Result	8.28	9.28
MR. ANDERSON'S TOTAL RETURN MODEL		
Total Return for Proxy Group, 12-31-07 – 10-15-13		12.5%[74]
Table 5.		

Mr. Anderson employed the Total Return Model. "The Total Return is the rate of return representing the actual price appreciation of a stock with cash dividends

[71] *Id.,* p. 26.
[72] Ex. 103, p. 33.
[73] *Id.*
[74] Ex. 1, p. 47.

reinvested on their payment date over a given period."[75] As usual, Mr. Anderson's result – 12.5% -- was significantly higher than Mr. Murray's at 7.51% - 9.28%.[76]

Mr. Murray expressed concern with Mr. Anderson's Total Return Model: "Mr. Anderson assumes that market returns achieved for the period December 2007 through October 2013 are driven by the fundamentals of the natural gas distribution industry." Mr. Murray points out that utility stocks behave like bonds and that as interest rates fall, utility stock prices rise as investors reduce the return they require to invest in utility stocks. In other words, the market returns relied on by Mr. Anderson are an artifact of the artificially low interest rate environment and does not reflect the fundamentals of the natural gas distribution industry.

The Total Return Model is further flawed by the total reinvestment hypothesis on which it relies. In fact, investors are attracted to utility stocks by dividends and not by growth. Thus, utilities typically pay out 60% to 70% of their earnings in dividends. As Mr. Murray points out, in reality, "the growth rate of a utility stock earning an ROE of 10 percent cannot be much higher than 3 percent to 4 percent." The capital gains should therefore be only 30% to 40% of the total return. Mr. Murray stated, "If one understands that changes in utility stock prices are primarily caused by changes in interest rates rather than changes in underlying growth rates, then it should be obvious that the growth in utility stock prices since 2007 has been due to a decline in the cost of capital for utilities."

In summary, it is Staff's position that SNG's Cost of Equity recommendation is unduly high because of bloated inputs employed by Mr. Anderson for exactly that

[75] *Id.,* p. 46.
[76] Table 5.

reason. While it may be true that IIF may use a higher return on equity for initial periods of expansion, such as is currently used for its expansion in Maine, this higher required return should not come off the backs of the customers of SNG's existing districts. The cost of equity passed on in rates to SNG's customers must be capped at a reasonable level, comparable to that of other Missouri gas utilities such as Laclede, MGE, Ameren, and Empire.

E. Risk Adjustments

RISK ADJUSTMENTS		
	Murray	**Anderson**
Risk Adjustment:	200[77]	440[78]
Table 6.		

Both Mr. Murray and Mr. Anderson applied an upward adjustment to their Cost of Equity results to reflect the fact that SNG is more risky than the proxy companies. Mr. Murray based his 200 basis point adjustment on the average spread between BB and BBB rated bond yields to that of the proxy group's average A rating because SNG's projected cost of debt of 5.50% in Case No. GO-2012-0102 falls between the two yields.[79] Mr. Anderson, by contrast, employed an entirely subjective laundry list of ten or eleven cumulative adjustments to arrive at his final figure of 440 basis points.[80] Further, Staff provided information from SNG's own investor, IIF, that shows its own

[77] Ex. 103, pp. 35-6.
[78] Ex. 1, pp. 47-56.
[79] Ex. 103, pp. 35-36.
[80] Ex. 1, pp. 47-56.

independent financial consultants develop aggregate risk premiums, not line-item adjustments as Mr. Anderson proposes.

The problem with Mr. Anderson's risk adjustment is that he simply made it up. He admits that his risk adjustment is entirely subjective.[81] Mr. Murray testified that it lacked any quantifiable basis.[82] Surely the Commission will not rely on an upward adjustment to the Cost of Equity that was plucked from thin air. SNG's ratepayers deserve better than that.

F. Conclusion

Staff's experienced and well-credentialed expert financial analyst, David Murray, has employed professional judgment and mainstream methods and data to produce reasonable rate of return recommendations in this case. In an effort to protect the ratepayers from being plundered in order to support the shareholders' drive to expand the company, Mr. Murray has proposed a hypothetical capital structure and cost of debt. This is entirely right and proper in a case like the present, where the public interest demands it. Mr. Murray has also carefully calculated the Cost of Common Equity and applied a well-conceived upward adjustment to reach a fair, just and reasonable recommendation for SNG. For all the reasons stated herein and in Staff's *Initial Brief* and testimony, Staff prays that the Commission will adopt Mr. Murray's recommendations.

[81] *Id.,* at p. 53; Tr. 10:142-43.
[82] Tr. 10:211.

III. Revenue Requirement

OPC's recommended ratemaking method—which involves imputing sales to SNG's revenue based on the Company's previous feasibility studies—would set low rates for current customers. However, because OPC's method is not based on the utility's cost of providing safe and adequate service, the relief for ratepayers will be only temporary. Eventually, SNG's customers will have to pay rates reasonably designed to cover the utility's operating costs, otherwise the company will not be able to provide safe and adequate service. OPC's method would shift the cost of utility service onto future customers, who would thus see rate increases of greater magnitude than the rate increase at issue here. It would not be just and reasonable to force such consequences on future customers so that today's customers may pay less than their current cost of service.

Staff agrees that the rate increase recommended in this case is greater than what OPC describes as "the average annual rate increase for other gas company rate cases,"[83] but the current state of SNG's business is not the same as other, more established gas companies in Missouri. For the foreseeable future, SNG plans to continue to aggressively construct new gas infrastructure or expand its current systems in rural areas of Missouri, where customers also have the alternative option to use propane for fuel.

A. Feasibility studies

OPC's argument focuses exclusively on the idea that SNG promised to insulate ratepayers from the risks associated with its expanding system. These promises were made in SNG's various CCN orders and agreements. In order to hold SNG to these

[83] *Initial Brief of the Office of the Public Counsel*, p. 1.

promises, OPC argues that the Commission in this case must abandon traditional cost-of-service ratemaking and set rates based on previous feasibility studies that the Company submitted in its CCN applications.

While OPC cites language from the CCN cases where SNG promised to bear the risk of its expansions, there is no language in any of these documents that bind the Commission to use the feasibility studies to impute sales in future rate cases. In fact, the documents generally include language expressly stating that the agreements do not constitute binding ratemaking treatment. For example, paragraph 23 in the Stipulation and Agreement resolving GO-2005-0120 (approved by the Commission on December 18, 2004) provides:

> This Stipulation and Agreement is being entered into for the purpose of disposing of all issues in this case. None of the Parties to this Stipulation and Agreement shall be deemed to have approved, accepted, agreed, consented, or acquiesced to any ratemaking principle or procedural principle, including, without limitation, any method of cost determination or cost allocation or revenue related methodology, and none of the signatories shall be prejudiced or bound in any manner by the terms of this Stipulation and Agreement in this or any other proceeding, whether this Stipulation and Agreement is approved or not, except as otherwise expressly specified herein.

This is for good reason—feasibility studies do not provide minimum levels of sales, but rather the studies represent projections about the future made on the best information available at the time. The gas industry has changed significantly since these feasibility studies were conducted. To use these studies as a binding ratemaking method would not only violate the CCN orders and agreements to which OPC cites, it would also unlawfully ignore the Commission's duty to consider all relevant factors and to set just and reasonable rates that allow SNG an opportunity to earn a reasonable rate of return.

OPC incorrectly states that SNG's burden in this case is to show that it has complied with the various CCN orders. Rather, SNG's burden is to prove that its rates are just and reasonable and provide for safe and adequate service. Staff's case, including its excess capacity adjustments in the Warsaw and Branson divisions and its rate of return recommendation, provides the Commission with a just and reasonable result because it insulates customers from SNG's expansion risks by setting rates based on ratepayers' actual cost of utility service—no more and no less. In this way, Staff's case complies with Missouri utility law and holds SNG to its promises.

B. The Rogersville Service Area

As OPC points out, the Commission's first CCN order for the SNG service area, in GA-94-127, includes a specific imputation of 1,797,000 Mcfs for certain communities in the Rogersville service area. Staff's calculation of the sales volumes in the Rogersville service area are based on the entire service area.[84]

OPC's argument is not reasonable for several reasons. First, it is not clear that the data exists to accurately separate the volumes from different areas to show the current volumes limited to the towns in the original CCN, and OPC has provided no reliable method to do so. Moreover, the CCN at issue was approved 20 years ago, and much has changed in terms of energy efficiency and conservation that affects gas usage.[85] Finally, Staff understands that portions of the proposed service territory that the 1,797,000 Mcf amount applies to were never actually built out by SNG.[86]

Staff does not object to SNG's request to eliminate this imputation requirement from future rate cases. The Commission is not legally bound by this 20-year-old

[84] Ex. No. 128, *Surrebuttal Testimony of Amanda C. McMellen*, p. 7, lns. 1-5.
[85] Ex. No. 6, *Surrebuttal Testimony of Timothy R. Johnston*, p. 14 ln. 12- p. 15 ln 10.
[86] Transcript Volume 12, p. 271 ln. 21- p. 272 ln. 2.

order,[87] and, in general, Staff believes the Commission should have the flexibility to address the actual conditions of a utility's current operations.

C. Branson and Warsaw Service Areas

While Staff believes that the Rogersville and Gallatin services areas are economically viable and the customers there should pay their full cost of service, Staff agrees that the shortfall from projected sales in the Branson and Warsaw areas are material.[88] Therefore, it would not be just and reasonable for customers in those areas to pay the full cost of service.

However, in contrast to OPC's method of setting rates based on imputed volumes, Staff reduced the revenue requirement for Warsaw and Branson by removing excess pipeline capacity from rate base. Instead, these amounts will be recorded by SNG in its Plant Held for Future Use account, which is a non-rate base item. In this way, customers in these areas only pay for the utility service and associated plant they actually use, and the responsibility for the shortfall in projected sales falls upon SNG's shareholders, who must continue to pay for the excess capacity. If customers and sales levels increase, the Company will also increase the amount of pipeline capacity booked to its plant in service account on a yearly basis. These increases will be analyzed for accuracy and appropriateness as part of future rate cases.

OPC agrees that Staff's plant held for future use adjustment is a "good approach,"[89] but argues that Staff's adjustment is incomplete because it does not include adjustments for operations and maintenance and corporate costs. However, as

[87] "[A]n administrative agency is not bound by stare decisis, nor are PSC decisions binding precedent on this Court." *State ex rel. AG Processing, Inc. v. Pub. Serv. Comm'n of State*, 120 S.W.3d 732, 736 (Mo. 2003).
[88] Ex. No. 128, Surrebuttal Testimony of Amanda C. McMellen, p. 7 lns 6-9.
[89] *Initial Brief of The Office of the Public Counsel,* p. 19.

explained in Staff's direct testimony, SNG capitalizes many of its costs, especially payroll.[90] Since these costs are capitalized, they are included in the original plant in service numbers. Therefore, a majority of the costs that OPC is concerned about in this context are not included in expenses in the income statement, and, further, some of these costs are not included in this case at all because they are in turn part of the excess capacity adjustments. Also, Staff's excess capacity adjustment materially reduced depreciation expense, which is a type of operations and maintenance expense.

D. SNG's $19 Million Purchase Price Discount

Staff's *Initial Brief* explains why Staff opposes OPC's recommendation that the Commission recognize a negative acquisition adjustment for the former MGU assets acquired by SMNG in GM-2011-0345.

OPC's argument is based on a faulty and dangerous premise. OPC seems to argue that a purchase price for assets in a merger constitutes "capital" invested by a company, and so OPC argues it would not be just and reasonable for SNG to collect a return on capital it didn't actually invest.

A merger purchase price should <u>not</u> be considered a capital investment to which a rate of return is to be applied. However, under OPC's reasoning, an amount paid by an acquiring utility for a company *above* net book value would seem to constitute a "capital investment." To treat a purchase price as capital would mean that utilities would be able to artificially inflate rate base by purchasing assets at a price above net book value, then recover a return on that excess purchase price. As explained in Staff's *Initial Brief*, this is exactly the kind of problem that adherence to the net book value/net original cost rule is designed to prevent.

[90] Ex. No. 102, *Direct Testimony of Amanda C. McMellen*, p. 18, lns 12-20.

OPC seems to argue that the Commission should adopt a policy of recognizing negative, but not positive, acquisition adjustments. This inconsistent treatment is not reasonable, and, moreover, OPC's reasoning would allow utilities to recover excess purchase price that has absolutely no effect on the actual value of the gas infrastructure serving customers—that is, OPC's reasoning would allow utilities to recover a return on money they never actually invested in gas infrastructure (exactly the result OPC claims it wants to avoid).

This ironic result arises from confusion between the *cost* a utility pays to acquire gas plant, and the *actual value* of those assets. The actual value of the assets do not change, regardless of the purchase price—which, again, is why purchase price should not be considered as a capital investment. The idea that a utility's return should be based on the *value* of its assets in service was already an axiom of public utility law when the Supreme Court issued its oft-cited 1923 decision in the *Bluefield Waterworks* case:

> Rates which are not sufficient to yield a reasonable return on the value of the property used at the time it is being used to render the service are unjust, unreasonable and confiscatory, and their enforcement deprives the public utility company of its property in violation of the Fourteenth Amendment. This is so well settled by numerous decisions of this court that citation of the cases is scarcely necessary.[91]

To further support its argument, OPC cites to the Commission's affiliate transaction (AT) rules. These rules are not intended to apply to mergers between two regulated utilities,[92] and trying to do so creates some conceptual problems because, in

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[91] *Bluefield Waterworks & Imp. Co. v. Pub. Serv. Comm'n of W. Va.*, 262 U.S. 679, 690, 43 S. Ct. 675, 678, 67 L. Ed. 1176 (1923).
[92] 4 CSR 240-40.015 Affiliate Transactions: "PURPOSE: This rule is intended to prevent regulated utilities from subsidizing their *nonregulated* operations." (Emphasis added).

this scenario, SMNG and MGU would be both "regulated entities" and "affiliated entities" pursuant to the rule. Application of the asymmetric pricing provisions within the AT rule only makes sense with one entity that is the regulated entity and a separate entity that is the affiliated unregulated entity.[93]

As Staff explained in its initial brief, the net book value/original cost rule is an established principle that resolves the issue. Staff does not recommend that the Commission depart from the rule in this case. Doing so, as OPC recommends, would establish a precedent that utilities would use to justify rate recovery of acquisition premiums, which would ultimately harm ratepayers. Staff does not recommend the Commission contort and stretch the affiliated transaction rule in ways not expressly authorized or contemplated in those rules.

In summary, Staff's testimony provides the Commission with a revenue requirement that, in accordance with long-standing utility law and practice, considers all relevant factors to arrive at a just and reasonable result. Ratepayers will pay for the utility service they actually use, and the utility will earn a return on the actual value of the plant used to serve customers—no more and no less. The Commission should adopt Staff's revenue requirement calculation and decline the invitation to depart from long-standing regulatory principles.

[93] 4 CSR 240-40.015(2)(A): "A regulated gas corporation shall not provide a financial incentive to an affiliated entity." In trying to apply this standard to the merger of two regulated entities, both entities would be considered regulated gas corporations, with each entity being the "affiliated entity" of the other.

IV. Rate Shock

The Missouri School Boards' Association's (MSBA) *Initial Post Hearing Brief* urges the Commission to adopt OPC's ratemaking methodology, which, as explained previously, the Commission must reject as unlawful and unreasonable. The MSBA cites percentages that, for reasons described in Staff's *Initial Brief*, are misleading and should be rejected.

First, the schools have not been paying their full cost of service, and given Mr. Erwin's experience in the gas industry, his clients should not be shocked to discover that, consistent with traditional regulatory practice, they are being asked to pay for their cost of service.[94] As explained by Staff witness Phil Lock in Staff's Cost of Service Report, in order for the schools to pay their cost of service, they should be assessed a customer charge per meter consistent with the companion sales rate.[95] At the hearing, Mr. Erwin agreed that schools should pay their cost of service.[96]

In addition, the estimated percentage increases quoted by MSBA do not represent actual increases to the gas bills that the schools will receive. A majority of a gas customers' bill is the cost of the natural gas. Staff provided an example of estimated percentage increases to the schools that includes the cost of gas.[97] Of course, the schools, like other transportation customers, negotiate their own price for natural gas and do not pay the PGA rate, but this exhibit simply shows that the increases to the schools' bills will not be as shocking as the MSBA would have the Commission believe.

[94] Ex. 402, *Surrebuttal Testimony of Louie R. Ervin, Sr.*, p. 8 ln. 6.
[95] Ex. 103, p. 55.
[96] Transcript Vol. 12, p. 352 ln 25-p. 353 ln 6.
[97] Ex. 139.

Also, the MSBA continues to argue that the Commission should consider the revised "cashout" provision when considering the schools' rate increase.[98] As explained by Staff witness Lesa Jenkins, the cashout provision is not a "rate." Rather, the cashout is simply a formula used to address imbalances that occur when a transportation customer causes more or less gas to be delivered onto the utility's system than the customer actually uses.[99] Therefore, whether or not the MSBA pays a cashout depends entirely on the accuracy of the MSBA's monthly capacity nominations. It is entirely within MSBA's control. It is not part of the schools' "rate," and therefore it is misleading for the MSBA to assert that the cashout provision should be considered as contributing to "rate shock."

Finally, MSBA floats the dubious proposition of a "phase-in" in this case—that is, a method of deferring the utility's recovery of some portion of an approved rate increase to some future time.[100] However, the statute authorizing the Commission to phase in rates applies expressly to electric corporations.[101] Thus the authority of the Commission in this matter is murky, because the Commission "is purely a creature of statute," and therefore its powers are limited to those conferred by statutes, either expressly, or by clear implication."[102]

Moreover, a phase-in is not the panacea MSBA might hope, because the statute requires that carrying costs be added to the rate increase as a "reasonable adjustment… to reflect the fact that recovery of part of such revenue is deferred to

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[98] Transcript Vol. 12, pg. 354 lns 18-21.
[99] Ex. 108, *Staff Class Cost of Service Report*, pgs 18-19; Ex. 114, *Rebuttal Testimony of Lesa Jenkins*, p. 3-15.
[100] Section 393.155 RSMo.
[101] Id.
[102] *State ex rel. Utility Consumers' Council of Missouri Inc. v. PSC*, 585 S.W.2d 41, 49 (Mo. banc 1979).

future years."[103] The Commission rejected a phase-in for a water company, finding that it would not be in the public interest because the carrying costs would mean ratepayers would suffer higher rates, and it would negatively impact the company's financial statements.[104]

Issues pertaining to the schools' rates were presented early in this case.[105] If any party intended for the Commission to seriously consider the complex legal and practical issues associated with a phase-in for a gas company in this case, the time to raise the issue is not on cross examination at hearing or in one paragraph of a post-hearing brief. The Commission should not consider a phase-in of rates in this case.

V. Conclusion

With its rate of return and revenue requirement testimony, Staff has presented the Commission with a just and reasonable resolution to this case. Staff has employed experienced professional judgment and mainstream methods and data to produce reasonable rate of return recommendations that protect ratepayers from the Company's risk of expansion, and that are entirely consistent with Commission law, precedent, and the public interest. While other parties have suggested the Commission depart from long-standing law and principle in setting SNG's revenue requirement, they have offered no viable, reasonable or lawful alternative revenue requirement numbers. Therefore, Staff urges the Commission to adopt its recommendations in this case.

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[103] Section 393.155.1. See also *In the Matter of the Determination of Carrying Costs for the Phase In Tariffs of KCP&L Greater Missouri Operations Company*, 408 S.W.3d 175, 187 (Mo.App.W.D. 2013).
[104] *In re Missouri American Water Company*, 2007 WL 4302535, WR-2000-281, *Report and Order on Second Remand.*
[105] Ex. 108, *Staff Class Cost of Service Report*, pgs 18-19; Ex. 114, *Rebuttal Testimony of Lesa Jenkins*, p. 3-15.

WHEREFORE, Staff respectfully submits its Reply Brief for the Commission's consideration.

Respectfully Submitted,

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CERTIFICATE OF SERVICE

I hereby certify that true and correct copies of the foregoing were served electronically to all counsel of record this 26th day of September, 2014.

/s/ John D. Borgmeyer