**BEFORE THE PUBLIC SERVICE COMMISSION**
**OF THE STATE OF MISSOURI**

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| In the Matter of Summit Natural Gas of | ) | |
| Missouri Inc.'s Filing of Revised Tariffs | ) | Case No. GR-2014-0086 |
| to Increase it's Annual Revenues for | ) | |
| Natural Gas Service. | ) | |

**REPLY BRIEF OF THE**
**OFFICE OF THE PUBLIC COUNSEL**

The Office of the Public Counsel ("Public Counsel") offers the following reply to the initial briefs filed by Summit Natural Gas of Missouri, Inc. ("SNG" or "Company") and the Staff of the Public Service Commission ("Staff").

**1. Cost of Capital**

SNG's witness Mr. James Anderson, and the Staff's witness, Mr. David Murray, are the primary cost of capital witnesses in this case. SNG's brief argues that Mr. Anderson has superior credentials due to his experience in the securities industry.[1] It is clear from Mr. Anderson's qualifications, however, that he lacks experience in public utility ratemaking, and that his recommendations are influenced by his past, current, and future affiliation with SNG.[2] Public utility ratemaking involves unique responsibilities as the Commission seeks to balance the interests of the Company in having an opportunity to earn a reasonable return, with the greater interest of protecting the public from unreasonable rate increases. *State ex rel. Crown Coach Co. v. Public Service Commission,* 179 S.W.2d 123 (Mo. App. K.C. 1944). Mr. Anderson has no experience in proposing rates that seek to balance these interests, and he is admittedly not experienced

[1] SNG Brief, p. 3.
[2] Ex. 1, Anderson Direct, p. 6.

as a cost of capital expert witness.[3]

SNG claims Mr. Anderson's testimony is impartial when SNG argues that he has "no current holdings of stock" and is therefore "financially indifferent."[4] This assertion of financial indifference is simply not believable. First, Mr. Anderson is an alternate member of SNG's and SNG's parent's Boards of Directors.[5] As such, he is a trustee for the stockholders and is duty bound to act in the best interests of those stockholders. *Johnson v. Duensing,* 351 S.W.2d 27 (Mo. 1961). He has no such duties towards SNG's customers. Second, Mr. Anderson's firm is in charge of SNG's equity and debt securities and would benefit financially if that relationship continued beyond this case.[6] Lastly, Mr. Anderson is being compensated for testimony supporting a rate increase for SNG.[7] These facts paint a different picture than one of an impartial and indifferent witness.

**a. Return on Equity**

SNG summarizes the support for Mr. Anderson's recommended 12% return on equity (ROE) by claiming that it "best balances the interests of ratepayers, the company's investors, and positions the company to address the market for competitive fuels."[8] Taking the last of these claims first, SNG does not explain or provide any support as to how a high 12% ROE would better position the company to address the market for competitive fuels. Nor does SNG explain what this assertion means. If what SNG is saying is that higher profits will help SNG eliminate competition from competitive fuel sources, such as propane, such a goal is certainly *not* in the interest of the public because

[3] Transcript (Tr.), p. 139.
[4] SNG Brief, p. 4.
[5] Ex. 1, Anderson Direct, p. 6.
[6] *Id.*
[7] Tr. 139.
[8] SNG Brief, p. 5.

the existence of such competition is beneficial for consumer prices and services.

Regarding the claim that a 12% ROE balances the interests of consumers, a 12% ROE is far higher than any ROE set by this Commission for a gas company in recent memory, and would significantly increase rates, which is not in the interest of consumers. This is especially true in light of the fact that SNG's predecessor specifically agreed that its ROE might result in a low single-digit return during the Company's current development phase.[9] It is certainly *not* in the interests of SNG's customers to be forced to bear a $253 to $384 annual rate increase. Such an increase would without a doubt cause significant hardships for many households, especially the sick, elderly, and families with children. SNG's and Mr. Anderson's recommended ROE does not adequately balance the needs of the public with the wants of SNG's shareholders.

SNG argues that the "primary driver" for SNG's ROE recommendation of 12% is Mr. Anderson's risk premium adjustment of 4.4%.[10] According to SNG, this risk premium adjustment is supported by the principles set forth in *Federal Power Com. v. Hope Natural Gas Co*. and the eleven (11) factors considered by Mr. Anderson.[11] In *Hope*, the United States Supreme Court stated, "Rates which enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed certainly cannot be condemned as invalid, even though they might produce only a meager return on the so-called "fair value" rate base." *Federal Power Com. v. Hope Natural Gas Co*., 320 U.S. 591, 605 (U.S. 1944). The Court in *Hope* recognized that even "meager" returns are capable of compensating investors for the risks assumed. *Id.*

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[9] Case No. GR-94-127, Report and Order, September 16, 1994, pp. 24-25.
[10] SNG Brief, p. 5.

SNG also argues that it has identified eleven (11) factors that are to be considered with SNG's recommended risk premium adjustment, which include risks that SNG asserts are unique to SNG.[12] According to the Staff's witness Mr. David Murray, the Staff *already considered* these factors in the Staff's recommendation.[13] Accordingly, the Staff's recommended ROE range takes all eleven factors into account.

SNG argues that because its net plant investment per customer is "much greater" than other Missouri gas companies, and because the proxy companies serve areas that are "much more densely populated than" SNG's "rural service areas," this supports a higher ROE for SNG.[14] However, just the opposite should be the case. These risk factors are the reason why the Staff concluded that the cost of building a system to so few customers in such a thinly populated area was not economically feasible. These risk factors are the reason why the Commission imposed an imputation on the original Tartan service area and recognized that "it may take more time than predicted to obtain the necessary conversions." And these risk factors are why the Company's *own sensitivity analysis* concluded that the Company's return might be reduced to a single-digit level.[15] SNG's argument is that because it entered into a risky business venture, its customers should now pay more. But this is precisely why the Commission repeatedly concluded in the certificate of convenience and necessity (CCN) cases that the Company would bear the risk of reaching its projections, and until those projections are reached, increases in the Company's return would be a shift of risk from company to consumers.[16]

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[11] *Id.*
[12] SNG Brief, p.5.
[13] Ex. 118, Murray Rebuttal, p. 14.
[14] SNG Brief, p.6.
[15] Case No. GR-94-127, Report and Order, September 16, 1994, pp. 24-25.
[16] *Id.*

The last point to be made on ROE is a response to SNG's argument that "had an equity investor invested in the proxy group of gas distribution utilities contained in Mr. Anderson's DCF analysis from the period of December of 2007 to October 2013, the return on that investment would have been 12.5%" and "the investor would have doubled his money."[17] This claim highlights the problem with SNG's entire argument for a 12% ROE and the disconnection between Mr. Anderson, a career investment banker from Colorado, and the Missouri rate-paying public. According to SNG, an investor *doubling* his investment after only five (5) years is something SNG's customers should be forced to support through this rate increase. However, it is simply not just and reasonable to require customers of a *regulated public utility* to fund such huge returns for SNG, a company that has voluntarily and by orders of the Commission assumed all risks that its expansion projects will achieve projections. An excessive ROE, as proposed by SNG, would force those risks onto consumers.

**b. Capital Structure**

SNG argues for a capital structure with significantly higher equity than debt, or put another way, one that strongly favors shareholders over the public simply because reality has not caught up with SNG's feasibility study projections.[18] SNG argues that "a capitalization of this nature is to be expected from a company like SNGMO which is in the early stages of infrastructure development when capital is being invested in new plant, but revenues in many of the service areas are lagging and have not yet caught up with projections."[19] Once again, SNG wants this Commission to ignore its commitments to assume the risk of meeting those projections by arguing that because it has not met its

[17] SNG Brief, p.6.
[18] *Id.*, p. 12.

feasibility study projections, rates should be *increased* through a capital structure that would have consumers pay higher profits for SNG's investors. And once again, Public Counsel reminds the Commission that such increases would violate the multiple CCN orders requiring SNG to bear this risk, and to bear it alone.

**2. Revenue Requirement**

**a. Imputation**

SNG argues that the feasibility studies that it used to successfully convince the Commission that its expansions were economically feasible "do not purport to represent a minimum level of customers or volumes necessary to make a project economic or viable."[20] Contrary to SNG's assertions, this is precisely *why* SNG submitted the feasibility studies – to prove that the expansions would be economically feasible based on the projections. This is also clear from the Commission's CCN orders. In the first case, the 1994 Tartan CCN case, the Commission concluded that a specific volume level for that particular service area would be necessary before the Commission would no longer be concerned that the risks of economic feasibility would not be passed onto consumers.[21] The Commission's Report and Order in that case concluded that the ordered imputation of volumes "adequately shift the risk to Tartan and its shareholders, and provide reasonable protection to customers against the possibility that Tartan has overestimated the conversion rates reasonably attainable."[22] The Commission based its finding of economic feasibility on the Company meeting its projections.

It is also evident from other CCN orders that the Commission continued to base

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[19] *Id.*
[20] SNG Brief, p.22.
[21] Case No. GR-94-127, Report and Order, September 16, 1994, p. 18.
[22] *Id.*

its determination of economic feasibility on the Company *attaining* its projections by ordering that the Company be responsible for the following: (1) "any failure to achieve forecasted conversion rates" (GO-2005-0120); (2) "detrimental effects of a loss resulting from inaccurate estimation of customer conversion or usage rates" (GA-2007-0212); and (3) "failure to achieve forecasted conversion rates/and or customer growth projections" (GA-2007-0168). The CCN orders after 2008 state that the Company is "totally responsible" or "fully responsible" for the success of the projects without explaining how that is to be achieved. However, the previous orders provide specific guidance by requiring that the projections be met, and this should be required of all expansion areas as a consistent, and as the only, ordered method of satisfying the imposed conditions.

Regarding the Rogersville Service Area specifically, SNG first argues that it has met the imputation threshold level of 1,797,000 Mcf, but as pointed out in Public Counsel's initial brief, this is an apples to oranges comparison because SNG has included volumes for areas that were added to the original area where the imputation was to be applied. SNG witness Mr. Johnston agreed during cross-examination that the current Rogersville Service Area includes communities that were not a part of that system when the threshold was set.[23] For an accurate comparison, the Commission would need to add the forecasted projections for the additional areas to the 1,797,000 Mcf to accurately reflect the level of imputation that must occur until the threshold volume level is met.

Staff witness Ms. Amanda McMellen identified why it is important to accurately match the projected volumes with the relative CCN application. When discussing the shortfalls experienced in the Branson and Warsaw areas, she testified that these areas had

not "attained the planned level of customers *on which the full amount of rate base investment made by SNG was premised*."[24] This is a key point. The full amount of rate base investment that was included in each feasibility study was supported by the projected customer levels and volumes. When customer numbers and volumes fall short, each customer will be required to pay more for their service than initially projected – something the conditional CCN orders protect against.

SNG also argues that the Commission should simply ignore the imputation because SNG's forecasts were wrong.[25] This is no basis for removing a consumer protection put in place to ensure that customers are not to suffer from unattainable projections, or to suffer from attainable projections that still need more time to be met. SNG wants the Commission to ignore the protections put in place to address this very situation. SNG argues that there are "numerous reasons" for not reaching its projections, and then speculates that the difference "is likely related to enhanced customer conservation."[26] During cross-examination, SNG witness Mr. Tim Johnston testified that SNG did not factor conservation into its feasibility studies because "we generally make the assumption that the organic growth rates and the conservation offset each other."[27] SNG's assumptions regarding conservation have proven to be wrong, and the risk that those assumptions would be wrong is SNG's burden to bear alone per the conditional CCN orders. In any event, regardless of the reason for SNG not yet reaching its projections, the Commission clearly and repeatedly put all risk that SNG had not

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[23] Tr. 254. Communities in the current Rogersville Service area that were not in the original service area include Lebanon (Tr.254) as well as Rogersville, Fordland, Diggins, Seymour and Norwood (Tr. 259).
[24] Ex. 108, McMellen Rebuttal, p. 3. Emphasis added.
[25] SNG Brief, p. 26.
[26] *Id.*

considered a particular factor onto SNG's shareholders, and not consumers. Risks that are to be assumed by SNG also include the risk that SNG would not yet provide service to certain communities within the certificated service area, such as Houston, Licking and Mountain View, that were used as a basis for the feasibility of the projects.

Surprisingly, the Staff states in its brief that imputing a level of volumes, customer levels, and or revenues "would violate the regulatory laws and principles that have governed this Commission for a century."[28] The Staff's argument is incorrect and somewhat puzzling. The Commission's authority to impose the conditions that Public Counsel now seeks to have enforced is clearly set forth in the statute authorizing the Commission to issue CCNs, which states in part, "The commission may by its order impose such condition or conditions as it may deem reasonable and necessary." § 393.170 RSMo Supp. 2013. The Commission certainly believed it had the authority to impose such conditions when it issued the first CCN to Tartan, as did the Staff when it recommended and supported this condition. In particular, the Staff recommended and supported the imputation of 1,797,000 Mcf in Case No. GA-94-127, the Tartan CCN case.[29] Furthermore, in *this case,* the Staff's own witness, Ms. Amanda McMellen, offered support for an imputation of volumes in her rebuttal testimony when she testified:

> Staff has taken the consistent position in past natural gas certificate and rate proceedings that the utility and its shareholders should bear the financial risk of such expansion, not the utility's customers. This risk can be placed on the gas utility in rate proceedings by such measures as implanting "excess capacity" adjustments to remove any unnecessary plant-in-service from rate base, <u>or, alternatively, by requiring that the utility impute a level of revenues in its cost of service calculations</u> equivalent to the projected level of customers originally assumed by the utility, if the utility has not in fact

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[27] Tr. 261.
[28] Staff Brief, p. 21 (Staff's brief is not page-numbered. This issue is addressed on the page that includes footnotes 129-134).
[29] Case No. GR-94-127, Report and Order, September 16, 1994.

attained that level of customers at the time its rates are set.[30]

Here the Staff made no assertion that an imputation is contrary to any law, and instead Staff offers this as an alternative available to the Commission.

**b. Excess Capacity Adjustment**

In regards to the excess capacity adjustments that both SNG and the Commission's Staff support, Public Counsel agrees that it is important to recognize and remove excess capacity plant; however, as explained in Public Counsel's initial brief, the inquiry into what plant is excessive should not stop at the main line. It should also include *all* costs associated with excess capacity.

To accomplish the excess capacity adjustment, SNG proposes to transfer to Account 105 of the Uniform System of Accounts (USOA) the plant and depreciation reserve balances associated with the excess capacity in Branson and Warsaw. SNG also proposes a "process" that includes, "Depreciation expense will not be calculated on FERC Account 105 gross plant balances."[31] SNG does not explain why it proposes that depreciation expense would not accrue on this gross plant balance. This proposal should be unacceptable to the Commission because the plant, despite not being at full usage, is being used and should therefore continue to depreciate. There is simply no justification for not depreciating the plant balance in Account 105. Accordingly, if the Commission orders the excess capacity adjustment agreed to by SNG and the Staff, the Commission should require SNG to continue depreciating the plant in Account 105.

**3. Purchase Price Discount (Negative Acquisition Adjustment)**

The undisputed facts on this issue are that SNG paid over $19 million less for the

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[30] Ex. 108, McMellen Rebuttal, p. 4. Emphasis added.
[31] SNG Brief, p. 21.

Southern Missouri Natural Gas (SMNG) assets than the net original book value of the assets. SNG argues in its initial brief, "The merger purchase price should have no impact or import to the Commission's decision in this case."[32] SNG reasons that this would be consistent with past practice, and cites to a single case, Case No. EM-2000-292, the merger of UtiliCorp with St. Joseph Power & Light.[33] SNG's reliance on this case is misplaced for several reasons, the first being that the *UtiliCorp* case involved an acquisition premium, which occurs when the acquiring utility pays greater than book value, whereas the present case involves a negative acquisition adjustment, where the acquiring utility pays less than book value. In the case of an acquisition premium, the Commission concluded that customers should be protected by use of the "net original cost rule" as follows:

> The net original cost rule was developed in order to protect ratepayers from having to pay higher rates simply because ownership of utility plant has changed, without any actual change in the usefulness of the plant. If a utility were allowed to revalue its assets each time they changed hands, it could artificially inflate its rate base by selling and repurchasing assets at a higher cost, while recovering those costs from its ratepayers. Thus, ratepayers would be required to pay for the same utility plant over and over again.[34]

In the present case, the consumer-protection purpose of net original cost rule is inapplicable because customers would not be protected in this instance by adhering to this rule when the company pays considerably less than the net original cost. In the *UtiliCorp* case, the Commission's discussion of a negative acquisition adjustment is merely *dicta* in that the statement was not part of the legal basis for the Commission's

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[32] SNG Brief, p. 29.
[33] *In the Joint Matter of UtiliCorp United Inc. and St. Joseph Light & Power Company,* Case No. EM-2000-292, 12 Mo.P.S.C.3d 388, (February 26, 2004).
[34] *Id.* p.4.

judgment.[35] Dicta are merely expressions of opinion, not in anywise necessary for the actual decision of any question before the Commission, and "*are not controlling authorities in any sense*." *State ex rel. Anderson v. Hostetter*, 346 Mo. 249 (Mo. 1940) [emphasis added]. Moreover, the Commission in the *UtiliCorp* case provides no independent reason for allowing a utility to recover more from ratepayers for assets than what it paid for those assets, other than to compare it to an acquisition premium. There should be an independent rationale for allowing SNG to force consumers to pay $19 million more for assets than what the Company paid for those assets. It was SNG's burden to establish a convincing rationale, and SNG has failed to meet that burden.

The Staff spends a considerable portion of its brief arguing against Public Counsel's position on this issue, with few citations to the record of the case. And once again, the Staff has reversed its position without an explanation. When SNG's predecessor applied for a CCN to serve the Branson area, the Staff proposed a condition that would require the Company to do exactly what Public Counsel is proposing in this case.[36] The negative acquisition adjustment condition proposed by the Staff stated:

> SMNG agrees that if, at any time, it sells or otherwise disposes of its assets before SMNG has cost based rates in a sale, merger, consolidation or liquidation transaction at a fair value less than its net original cost for those assets, the purchaser/new owner shall be expected to reflect those assets on its books at its purchase price or the fair value of the assets, rather than at the net original cost of the assets. This provision is intended to define SMNG's responsibility relative to the exercise of this certificate relative to SMNG's risk, not SMNG's customers, to absorb the costs in the event serving of this area is found to be uneconomic under original cost of service regulation. SMNG also acknowledges that it is the intention of the Parties that the

[35] *Id.*

[36] *In the Matter of the Application of Southern Missouri Gas Company, L.P., d/b/a Southern Missouri Natural Gas, for a Certificate of Public Convenience and Necessity Authorizing it to Construct, Install, Own, Operate, Control, Manage and Maintain a Natural Gas Distribution System to Provide Gas Service in Branson, Branson West, Reed`s Spring and Hollister, Missouri,* Case No. GA-2007-0168, Report and Order, February 15, 2008, pp. 14-15.

> provisions of this paragraph shall apply to any successors or assigns of SMNG. Nothing in this paragraph is intended to increase or diminish the existing rights or obligations of the parties with respect to ratemaking treatment of SMNG's existing assets outside the properties related to this certificate.[37]

Just six (6) years ago the Staff predicted exactly what has happened – that SNG overbuilt and overvalued its assets and had to sell at a discount. In that case, Staff proposed to require SMNG to reflect on its books the purchase price, which the Staff also characterized as being synonymous with the "fair value of the assets."[38]

In response to the Staff's proposed condition, SMNG argued "it would be more appropriate for the Commission to review such accounting issues on the "back end" – that is, if and when the identity of the hypothetical future purchaser, the purchase price, existing rate base, and other relevant circumstances were actually known."[39] SMNG also argued that this provision was unnecessary because of existing conditions, "including the one which required SMNG's shareholders to assume the financial risk associated with the expansion of SMNG's service area."[40] According to the Company, it was unnecessary to require the Company to book the assets at the purchase price because consumers would be protected by the condition requiring SMNG to assume all financial risk. Following the Company's argument, if the assumption of financial risk is to address the Staff's concern regarding the Company selling its assets at below book value, the only way that will occur is if the Commission uses that condition to require SNG to record the assets at the purchase price rather than the book price.

This is consistent with the Commission's order in the Branson CCN case, where it

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[37] *Id.,* p.15.
[38] *Id.*
[39] *Id.*
[40] *Id.*

concluded, in part, that the Staff's proposed condition was "unnecessary since SMNG has already indicated that its shareholders will take the economic risk associated with the expansion of its service area to Branson, Hollister, and Branson West, just as they did in the Lebanon case."[41] In other words, both the Company and the Commission concluded that the condition requiring the Company to assume the economic risk would protect customers on the "back end" from a situation where the customers are paying more for the assets than what the Company paid for those assets. The only way for that conclusion by the Commission to hold true is if the Commission, now on the "back end" of this issue, recognizes that it would violate those conditions to require customers to pay more than what the Company itself values the SMNG assets to be worth. Requiring customers to pay more than the value the Company now places on its assets would constitute a shift of risk from the Company to its customers.

To the extent the Commission finds that a waiver of provision of the Uniform System of Accounts (USOA) would be necessary, the Commission would only need to order a one-time waiver of its rule requiring the Company to follow the USOA for its accounting in this instance. 4 CSR 240-40.040(5).

Regarding the Commission's affiliate transaction rule, 4 CSR 240-40.015, SNG argues that the rule is not applicable in this case because the rule is meant to apply to a situation where a regulated affiliate is attempting to subsidize its non-regulated enterprises.[42] However, the purpose of the affiliate transaction rule also states that the "*financial standards, evidentiary standards and record keeping requirements*" are "*applicable to <u>any</u> Missouri Public Service Commission (commission) regulated gas*

[41] *Id.*, p. 17.
[42] SNG Brief, p. 32.

*corporation whenever such corporation participates in transactions with any affiliated entity.*"[43] Here there is no distinction between regulated and unregulated, and it specifically applies to all transactions with an affiliate.

SNG also claims that the affiliate transaction rules apply only to goods and services. This is an incorrect and concerning interpretation of the affiliate transaction rule because it implies that SNG is not aware of the rule's application to asset transfers. The rule states specifically at 4 CSR 240-40.015(2)(A)2, that an affiliate may not transfer assets of any kind to an affiliated entity below the greater of fair market price or fully distributed cost. The difficulty in applying this rule is in determining what constitutes the fair market value and fully distributed cost. Public Counsel's Chief Economist Ms. Barbara Meisenheimer explained in her rebuttal testimony:

> While at this point there appears to be no clear way to determine the fair market price as might have occurred in an "arms length" transaction, it is at least reasonable to have expected SMNG to have received the booked cost as a representation of fully distributed cost of the assets. To conform to the Affiliate Transaction Rules while also accepting the discounted sale price, SMNG should have written off a portion of the booked value. Likewise, since the transaction was not an arms length transaction, MGU should not be allowed any advantage by valuing the assets at a value higher than it paid for the assets.

An important question to ask is whether there is an independent basis for concluding that a negative acquisition adjustment should benefit the Company at the expense of its customers. SNG has not satisfied its burden of establishing that independent basis. The unique circumstance of this case, where the Company repeatedly agreed to and was ordered to bear all risk that its projections were accurate, creates a reason to order the company to reduce rate base by the $19 million negative acquisition adjustment. This will ensure that SNG does not avoid the risk of overvaluing its assets

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[43] 4 CSR 240-40.015, *Purpose*. Emphasis added.

by passing that risk on to its customers.

### 4. Conclusion

Public Counsel urges the Commission to protect customers from this unprecedented rate increase through imputations and excess capacity adjustments. If the Commission is inclined to give SNG a rate increase, Public Counsel asks that it be no more than $50 annually, which is consistent with all other regulated gas companies in Missouri.[44] If necessary, any additional increase above $50 should be phased in over a number of years to prevent rate shock.

Respectfully submitted,

OFFICE OF THE PUBLIC COUNSEL

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## CERTIFICATE OF SERVICE

I hereby certify that copies of the foregoing have been mailed, emailed or hand-delivered to all counsel of record this September 26, 2014:

**/s/ Marc Poston**

[44] See table on Page 29 of Public Counsel's initial brief.