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**

INITIAL POST-HEARING BRIEF OF STAFF

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INTRODUCTION

On February 6, 2014, Liberty Utilities (Midstates Natural Gas) Corp. d/b/a Liberty Utilities ("Liberty," "Liberty Utilities," or "Company") filed revised tariffs and written testimony seeking a rate increase of approximately $7.6 million in its base rates. Of this amount, approximately $1.3 million was related to Liberty's Infrastructure System Replacement Surcharge, or ISRS, which will be reset to zero as a result of this case. The law is clear "that at any hearing involving a requested rate increase the burden of proof to show the proposed increase is just and reasonable rests on the corporation seeking the rate increase."[1] Section 393.150.2 RSMo states in pertinent part that "[a]t any hearing involving a rate sought to be increased, the burden of proof to show that the increased rate or proposed increased rate is just and reasonable shall be upon the gas corporation, electrical corporation, water corporation or sewer corporation." Therefore, as the party seeking a rate increase, Liberty "bears the burden of proving that its proposed rate increase is just and reasonable."[2]

In reaching its decision, "the Commission is not bound to apply any particular formula or combination of formulas. Instead, the Supreme Court has said:

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[1] *In the Matter of Lake Region Water & Sewer Company's Application to Implement a General Rate Increase in Water and Sewer Service*, File No. WR-2013-0461 *et al.,* Report and Order issued April 30, 2014.
[2] *Id.*

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> Agencies to whom this legislative power has been delegated are free, within the ambit of their statutory authority, to make pragmatic adjustments which may be called for by particular circumstances. [citing *Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U.S. 575, 586 (1942)]

Furthermore, in quoting the United States Supreme Court in *Hope Natural Gas* [320 U.S. 591 (1944)], the Missouri Court of Appeals said:

> [T]he Commission [is] not bound to the use of any single formula or combination of formulae in determining rates. Its rate-making function, moreover, involves the making of 'pragmatic adjustments.' . . . Under the statutory standard of 'just and reasonable' it is the result reached, not the method employed which is controlling. It is not theory but the impact of the rate order which counts. [citing *State ex rel. Associated Natural Gas Co. v. Pub. Serv. Comm'n*, 706 S.W.2d 870, 873 (Mo. App. W.D. 1985)]"[3]

The parties in this case have filed partial stipulations and agreements resolving a number of issues. Therefore, this brief will address only the issues presented for the Commission's consideration during the evidentiary hearing.

ARGUMENT

1. Cost of Capital Issues:

a. What capital structure should the Commission use in this case to determine a revenue requirement for Liberty?

- *Staff recommends* ***** ***** *percent equity and* ***** ***** *percent debt, based on the capital structure of Liberty Utilities Company ("LUCo"), the corporate parent of Liberty Midstates.*

b. What is the appropriate embedded cost of debt that the Commission should apply in this case to determine a revenue requirement for Liberty?

- *Staff recommends* ***** ***** *percent based on LUCo's embedded cost of debt.*

[3] *Id.*

c. What is the appropriate cost of equity that the Commission should apply in this case to determine a revenue requirement for Liberty?

- *Staff recommends a range of **8.20% to 9.20%, midpoint 8.70%.***

Introduction:

Staff has determined, based upon its expert analysis of market-driven data using traditional analytical tools, that Liberty's cost of common equity[4] is within the range of 8.20% to 9.20%, mid-point 8.70%,[5] which should be combined with Staff's recommended capital structure as of September 30, 2013, of * ***** equity and * ***** debt,[6] and with Staff's recommended cost of debt of * *****, [7] to arrive at the recommended allowed rate of return ("ROR") in this case: 6.39% to 6.85%, midpoint 6.62%.[8]

What is the significance of these issues?

The ROR is the Weighted Average Cost of Capital or "WACC";[9] it is calculated from the capital structure, cost of debt and cost of equity. Capital structure describes how an enterprise is financed. The components are debt and equity. These components may be expressed as a percentage of each component's weight of total capital (e.g., debt-to-total capital). The debt-to-total capital ratio indicates the proportion of debt used to finance an enterprise. Because equity holders have only a residual claim on the enterprise's assets, the relative proportion of debt and equity, among other

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[4] Also referred to as "return on equity" or ROE.
[5] Ex. 13, *Staff's Cost of Service Report,* p. 7.
[6] *Id.*
[7] Ex. 31, *Marevangepo Rebuttal,* pp. 2-3, 6.
[8] *Id.,* pp. 3, 7.
[9] Ex. 13, p. 6.

core cash flow/ leverage analysis ratios,[10] define the financial risk inherent in the equity investment. In the present case, the capital structure itself is a matter of controversy. In light of capital structure positions that have been approved by the Commission in other major gas and electric cases, Staff recommends use of LUCo's capital structure and embedded cost of debt for ratemaking purposes because it is the entity that drives Liberty's cost of capital. Besides, Liberty does not have a credit rating; does not issue equity; does not issue long-term debt; and does not raise its own short-term debt. All of these things occur at the LUCo level. Therefore, Liberty's capital structure is irrelevant to the cost of capital required by investors.

The cost of common equity is always controversial and is a matter of expert testimony. Staff has presented the authoritative testimony of Zephaniah Marevangepo, who has estimated Liberty's cost of equity using traditional analytical tools and professional judgment.

In addition to the Company's prudent operating and maintenance expenses, revenue requirement includes both a return "of" and a return "on" the net current value of the shareholders' investment. The former is provided by depreciation expense; the latter by the rate of return. The rate of return is a multiplier which, applied to the net current rate base, results in the return or "profit" allowed to the investors in return for the use of their private property in serving the public. The Due Process Clause requires that the shareholders be allowed an opportunity to earn a reasonable return on their

[10] Funds From Operations to Debt (FFO/Debt) and Debt to Earnings Before Interest, Taxes, Depreciation and Amortization (Debt/EBITDA).

investment.[11] Pursuant to financial theory, a fair rate of return is an amount sufficient to meet the utility's capital costs.[12]

SUMMARY OF RECOMMENDATIONS:		
	Staff	*Company*
CAPITAL STRUCTURE		
Equity	*** *** [13]	**58.34**[14]
Debt	*** *** [15]	**41.66**[16]
COST OF DEBT		
Cost of Debt	*** *** [17]	**4.50**[18]
COST OF EQUITY		
Roe Range & Recommendation	**8.20 – 9.20** **8.70**[19]	**10.0 – 10.50** **10.50**[20]
Table 1.		

<u>CAPITAL STRUCTURE AND COST OF DEBT</u>

Liberty Utilities Company ("LUCo") owns Liberty, which directly owns and operates the Missouri LDC operation formerly owned by Atmos Energy Corporation.[21] Liberty is one of thirty regulated water, sewer, electric, and natural gas utilities, located in ten states, owned ultimately by LUCo.[22] LUCo, in turn, is a subsidiary of Liberty Utilities (Canada) Corp., itself a subsidiary of Algonquin Power & Utilities Company ("APUC").[23] Liberty is in the business of distributing natural gas to 85,000 customers in

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[11] ***State ex rel. Utility Consumers Council of Missouri, Inc. v. Public Service Commission,*** 585 S.W.2d 41, 49 (Mo. banc 1979) ("***UCCM***").
[12] Ex. 13, p. 10.
[13] *Id.,* p. 7.
[14] Ex. 5, p. 47.
[15] Ex. 13, p. 7.
[16] Ex. 5, p. 47.
[17] Ex. 31, pp. 2-3.
[18] Ex. 6, *Hevert Surrebuttal,* p. 46.
[19] Ex. 13, p. 7.
[20] Ex. 5, p. 46.
[21] Ex. 13, p.15.
[22] *Id.,* p. 3.
[23] *Id.,* pp. 3-4.

Missouri, Illinois and Iowa.[24] In Missouri, Liberty serves 55,000 customers in three districts: NEMO, SEMO and WEMO.[25]

Liberty has no credit rating.[26] *****

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. * [30] Liberty does not issue debt or equity.[31] Liberty relies on LUCo for debt, and LUCo and APUC for equity contributions. Since cash is fungible, Staff has no way to determine whether equity contributions from APUC to Liberty, through LUCo, are truly equity or are actually debt capital.[32] For these reasons, Staff does not consider Liberty's actual capital structure to be a legitimate ratemaking capital structure because it is of no consequence to investors.[33] Why? Because there are no direct investments of either equity or debt in Liberty.[34]

Mr. Marevangepo testified:

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[24] *Id.,* pp. 15-16.
[25] *Id.,* pp. 4, 16.
[26] *Id.,* p. 16.
[27] *Id.*
[28] *Id.*
[29] *Id.*
[30] *Id.*
[31] *Id.,* p. 18.
[32] *Id.*
[33] *Id.,* p. 19.
[34] *Id.,* p. 20.

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> Although Staff understands that APUC and LUCo may attempt to assign capital to subsidiaries for its own internal reporting and management needs, it is not proper to use this subjective process for purposes of setting a fair and reasonable allowed ROR.[35]

LUCo is the parent company of all of APUC's regulated operations in the United States.[36] LUCo has a credit rating.[37] LUCo uses a centralized approach to raising debt capital for its regulated utility operations.[38] As noted, Liberty does not issue any of its own debt.[39] LUCo issues debt through a financing subsidiary, Liberty Utilities Finance ("Finance"), however, the ratings assigned to the debt issued by Finance are based on the rating agencies' opinion of the risk associated with LUCo's operations because this debt is guaranteed by LUCo.[40]

Staff also recommended that APUC's capital structure should not be considered for purposes of determining Liberty's rates because APUC is not the sole driver of the credit rating assigned to LUCo by DBRS. While LUCo's S&P credit rating is based on the consolidated risk profile of APUC's regulated operations in the United States and its unregulated operations in Canada, Staff noted that DBRS assesses the risk profiles of APUC and LUCo separately. Consequently, Staff made a cost of equity upward adjustment based on LUCo's explicit credit rating differential as reported by DBRS. Mr. Marevangepo testified:

> DBRS (a Canadian credit rating agency) rates LUCo and APUC separately and differently. … DBRS differentiates LUCo's credit rating from APUC's credit rating by assigning LUCo a higher credit rating.

[35] *Id.,* p. 19.
[36] *Id.*
[37] *Id.*
[38] *Id.*
[39] *Id.*
[40] *Id.*

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To summarize: LUCo has a credit rating; Liberty does not. LUCo issues debt, Liberty does not. Neither LUCo nor Liberty issues equity directly to the public. However, LUCo indirectly issues equity to the public through APUC. For all of these reasons, Staff recommends that the Commission use LUCo's capital structure rather than Liberty's or APUC's for ratemaking purposes.

The amount of debt and debt cost reported on Liberty's books are products of the debt allocation process performed by LUCo for all its United States operations.[41] For that reason, this debt cost does not capture the dynamic nature of LUCo's centralized management of its capital structure and its corresponding debt costs.[42] For logical consistency, in view of Staff's capital structure recommendation above, Staff recommends that LUCo's consolidated embedded cost of debt of * * be matched with LUCo's consolidated capital structure for purposes of setting an allowed rate of return for Liberty Midstates' Missouri gas distribution operation.[43]

DETERMINATION OF THE COST OF COMMON EQUITY

The cost of common equity capital must be estimated. This is a difficult task, as academic commentators have recognized.[44] It is said that this "is an area of ratemaking in which agencies welcome expert testimony and yet must often make difficult choices

[41] *Id.,* p. 21.
[42] *Id.*
[43] *Id.*
[44] C.F. Phillips, Jr., ***The Regulation of Public Utilities: Theory & Practice*** 394 (PUR: Arlington, VA, 1993); L.S. Goodman, 1 ***The Process of Ratemaking***, 606 (PUR: Vienna, VA, 1998).

between conflicting testimony."[45] The evaluation of expert testimony is left to the Commission, which "may adopt or reject any or all of any witness's [sic] testimony."[46]

Constitutional Parameters:

The United States Supreme Court, in two frequently-cited decisions, has established the constitutional parameters that must be met in setting the cost of common equity.[47] Each of the experts has affirmed that he conducted his studies and made his recommendations with these parameters in mind. In the earlier of these two cases, ***Bluefield Water Works***, the Court stated that:

> 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 services are unjust, unreasonable and confiscatory, and their enforcement deprives the public utility company of its property in violation of the Fourteenth Amendment.[48]

In the same case, the Court provided the following guidance as to the return due to equity owners:

> 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. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and

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[45] Goodman, *supra,* 606.
[46] ***State ex rel. GS Technologies Operating Company, Inc. v. Public Service Commission of Missouri,*** 116 S.W.3d 680, 690 (Mo. App., W.D. 2003); ***State ex rel. Associated Natural Gas Company v. Public Service Commission,*** 37 S.W.3d 287, 294 (Mo. App., W.D. 2000) (quoting ***State ex rel. Associated Natural Gas Company v. Public Service Commission,*** 706 S.W.2d 870, 880 (Mo. App., W.D. 1985)).
[47] ***Federal Power Commission v. Hope Natural Gas Company***, 320 U.S. 591, 64 S.Ct. 281, 88 L.Ed. 333 (1943); ***Bluefield Water Works & Improvement Company v. Public Service Commission of West Virginia***, 262 U.S. 679, *43 S.Ct. 675, 67 L.Ed. 1176* (1923).
[48] ***Bluefield***, *supra,* 262 U.S. at 690, 43 S.Ct. at 678, 67 L.Ed. at 1181.

> enable it to raise the money necessary for the proper discharge of its public duties.[49]

The Court restated these principles in ***Hope Natural Gas Company***, the later of the two cases:

> '[R]egulation does not insure that the business shall produce net revenues.' But such considerations aside, the investor interest has a legitimate concern with the financial integrity of the company whose rates are being regulated. From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.[50]

From these two decisions, three guiding principles can be discerned:

(1) An adequate return is commensurate to the returns realized from other businesses with similar risks. This is the principle of the commensurate return.

(2) An adequate return is sufficient to assure confidence in the financial integrity of the utility and to maintain the utility's credit rating. This is the principle of financial integrity.

(3) An adequate return is sufficient to enable the utility to obtain necessary capital. This is the principle of capital attraction.

The first of these principles is based on risk and requires a comparative process. The return on common equity set by the Commission must be about as much as investors would realize from other investments with similar risks. What entities are those? Other public utilities. Financial analysts and investors recognize that every line of business is, by its very nature, subject to a set of unique risks. Consequently, the business entities that face corresponding risks and uncertainties to the utility under

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[49] *Id.,* 262 U.S. at 692-93, 43 S.Ct. at 679, 67 L.Ed. at 1182-1183.

[50] ***Hope***, *supra,* 320 U.S. at 603, 64 S.Ct. 288, 88 L.Ed. 345 (citations omitted).

consideration are necessarily other utilities engaged in delivering the same service under similar conditions. Therefore, the Commission must look to the returns realized by a proxy group of comparable companies in setting the utility's return on common equity.

The second principle, simply stated, refers to the effect of the Commission's decision on the utility's credit rating. If the Commission's decision will not cause it to drop (except in extraordinary circumstances when certain costs are disallowed due to imprudent decision-making, in which the deterioration in credit rating is an indirect consequence of imprudent management), then the utility's credit is maintained and confidence is unimpaired that the utility will continue in business in the future, meeting its obligations as they come due, providing safe and adequate service to its customers, and yielding a fair return to its shareholders.

The third principle refers to the utility's ability to compete in the market place for necessary capital. LUCo competes for capital with other utilities and utilities likewise compete with unregulated businesses.

Methodology for Determining the Cost of Equity:

Two principal methods have emerged for determining the cost of common equity: these are the "market-determined" approach and the "comparable earnings" approach.[51] The market-determined approach relies upon stock market transactions and estimates of investor expectations.[52] Examples of market-determined methods are the Discounted Cash Flow method ("DCF") and the Capital Asset Pricing Model

[51] Phillips, *supra,* 394.
[52] *Id.*

("CAPM").[53] The comparative earnings approach is a comparative method and relies upon the concept of "opportunity cost," that is, the return the investment would have earned in the next best alternative use.[54] The comparative earnings approach requires a comparative study of earnings on common equity in both regulated and unregulated enterprises of similar risk.[55] Another frequently-encountered method that does not fall within the boundaries of either of the principal approaches referred to above is the Risk Premium method ("RP"). This method is "relatively straightforward" and requires that the analyst "(1) determine the historic spread between the return on debt and the return on common equity, and (2) add this risk premium to the current debt yield to derive an approximation of current equity return requirements."[56]

In the final analysis, the method employed to estimate the cost of common equity is unimportant, as long as the result that is reached satisfies the constitutional requirements.[57] "If the total effect of the rate order cannot be said to be unjust or unreasonable, judicial inquiry is at an end."[58] "It is the impact of the rate order which counts; the methodology is not significant."[59] Within a wide range of discretion, the Commission may select the methodology.[60] It may employ a combination of methodologies and vary its approach from case-to-case and from company-to-

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[53] *Id.*
[54] *Id.,* at 397.
[55] *Id.,* at 397-98.
[56] *Id.,* at 399.
[57] ***State ex rel. Arkansas Power & Light Company v. Missouri Public Service Commission,*** 736 S.W.2d 457, 462 (Mo. App., W.D. 1987); ***State ex rel. Associated Natural Gas Company v. Public Service Commission of Missouri,*** 706 S.W.2d 870, 879 (Mo. App., W.D. 1985).
[58] ***Hope***, *supra,* 320 U.S. at 602, 64 S.Ct. at 287, 88 L.Ed. 345 at ___ .
[59] ***State ex rel. GTE North, Inc. v. Public Serv. Commission,*** 835 S.W.2d 356, 361, 371 (Mo. App., W.D. 1992).
[60] ***Missouri Gas Energy v. Public Service Commission***, 978 S.W.2d 434 (Mo. App., W.D. 1998), *rehearing and/or transfer denied*; ***State ex rel. Associated Natural Gas Company v. Public Service Commission***, 706 S.W.2d 870, 880, 882 (Mo. App., W.D. 1985); ***State ex rel. Missouri Public Service Company v. Fraas***, 627 S.W.2d 882, 888 (Mo. App., W.D. 1981).

company.[61] "No methodology being statutorily prescribed, and ratemaking being an inexact science, requiring use of different formulas, the Commission may use different approaches in different cases."[62] The Constitution "does not bind ratemaking bodies to the service of any single formula or combination of formulas."[63] "Agencies to whom this legislative power has been delegated are free, within the ambit of their statutory authority, to make the pragmatic adjustments which may be called for by particular circumstances."[64]

The Proxy Groups:

Guided by the principle of the commensurate return, and because Liberty's stock is not publicly traded, each analyst employed a proxy group of publicly-traded companies:

COMPARATIVE PROXY GROUPS	
Marevangepo[65]	**Hevert[66]**
AGL Resources	AGL Resources
Atmos Energy Corp.	Atmos Energy Corp.
Laclede Group, Inc.	Laclede Group, Inc.
New Jersey Resources	New Jersey Resources
Northwest Natural Gas	Northwest Natural Gas
Piedmont Natural Gas	Piedmont Natural Gas
Southwest Gas Corp.	Southwest Gas Corp.
WGL Holdings, Inc.	WGL Holdings, Inc.
--	South Jersey Ind.
Table 2.	

Mr. Marevangepo selected a proxy group of eight companies from an initial group of 20 market-traded natural gas utilities, applying six criteria to ensure that his proxy

[61] ***State ex rel. City of Lake Lotawana v. Public Service Commission***, 732 S.W.2d 191, 194 (Mo. App., W.D. 1987).
[62] ***Arkansas Power & Light,*** *supra,* 736 S.W.2d at 462.
[63] ***Federal Power Commission v. Natural Gas Pipeline Company***, 315 U.S. 575, 586, *62 S.Ct. 736, 743, 86 L.Ed. 1037, 1049-50* (1942).
[64] *Id.*
[65] Ex. 105, *Staff's Cost of Service Report – Appendix 2,* Sch. 8-2.
[66] Ex. 5, p. 8, Table 1.

group was appropriately constructed and was reflective of Liberty's risk characteristics:[67]

- Stock publicly traded;
- At least 65% operating income from distribution;
- At least 65% of assets are distribution assets;
- Two analysts for long-term projected EPS growth available within the last 90 days;
- Positive historical 5-year compound annual growth rate in dividends per share; and
- At least investment grade credit rating.

The average credit rating of Mr. Marevangepo's proxy companies is "A."[68] Mr. Hevert used a similar method to construct a proxy group.[69] He used similar criteria.[70] His proxy group included all eight of Mr. Marevangepo's proxy companies, as well as one other: South Jersey Industries.[71] Staff rejected South Jersey Industries because it lacked at least two analyst reports for long-term projected EPS growth within the last 90 days.[72]

The Experts' Analytical Methods:

Mr. Marevangepo and Mr. Hevert used variants of the same analytical methods. Mr. Marevangepo relied upon the Constant Growth Discounted Cash Flow ("DCF") method[73] and checked his results using the Capital Asset Pricing Model ("CAPM")[74] and a variant of the Risk Premium ("RP") termed the "Rule of Thumb."[75] He also tested his results against average authorized returns as reported by Regulatory

[67] Ex. 13, pp. 22-23.
[68] Ex. 13, p. 16.
[69] Ex. 5, pp. 6-9.
[70] *Id.,* pp. 7-8.
[71] *Id.,* p. 8, Table 1.
[72] Ex. 15, Sch. 7-1.
[73] Ex. 13, pp. 23-31.
[74] *Id.,* at pp. 32-33.
[75] *Id.,* at p. 34.

Research Associates ("RRA"). Mr. Hevert used the Quarterly Growth DCF,[76] the Constant Growth DCF,[77] the Multi-Stage DCF,[78] the CAPM,[79] and a version of the Risk Premium method.[80]

The Discounted Cash Flow (DCF)

The DCF approach is based on the theory that a stock's current price represents the present value of all expected future cash flows.[81] In its simplest form – the Constant Growth version -- the DCF model expresses the cost of equity as the sum of the expected dividend yield[82] and a long-term growth rate.[83]

Marevangepo's DCF Results	
Dividend Yield	3.78[84]
Growth Rate	4.0-5.0[85]
Result	7.8-8.8[86]
Table 3.	

The dividend yield figure used by each analyst is the average of the dividend yield calculated for each member of the proxy group.[87] Staff devoted a significant effort to determining the range of growth rates it finally used, 4.0% to 5.0%.[88] In estimating a growth rate, Staff analyzed both actual and projected dividends per share ("DPS"), earnings per share ("EPS") and book value per share ("BVPS") for each of the comparable companies and also equity analysts' consensus estimates for long-term

[76] Ex. 5, pp. 10-17.
[77] *Id.,* at pp. 17-19.
[78] *Id.,* at pp. 19-24.
[79] *Id.,* at pp. 25-31.
[80] *Id.,* at pp. 31-34.
[81] Ex. 5, p. 10.
[82] The dividend yield is the annual dividend divided by the market value of the shares. Ex. 13, p. 23.
[83] *Id.;* Ex. 13, p. 23; Ex. 5, pp. 10-11.
[84] Ex. 13, p. 24.
[85] *Id.,* p. 31.
[86] *Id.*
[87] *Id.,* pp. 22-23.
[88] *Id.,* pp. 24-31.

compound annual growth rates.[89] The average consensus long-term growth rate for the proxy group is currently 3.96 percent.[90] Staff also reviewed long-range gross domestic product ("GDP") growth rate forecasts from a number of authoritative sources, historical growth trends for such of the proxy companies for which such information was available, and conducted correlation studies of gas industry growth to GDP growth.[91] Staff concluded:

> Because the gas distribution industry only achieved growth in the low 4 percent range during a period of high capital investment and higher economic growth (see Schedule 8-8), Staff believes investors are likely using constant-growth rates closer to 4 percent. However, because some of the more recent historical growth rates are closer to 5 percent, Staff will use an overall range of 4 percent to 5 percent.[92]

Mr. Hevert used three variants of the DCF model, including a Constant Growth DCF similar to the one used by Staff. He also used a Quarterly Growth version that "incorporates investors' expectation of the quarterly payment of dividends, and the associated quarterly compounding of those dividends as they are reinvested at investors' required ROE."[93] The Quarterly Growth version differs from the Constant Growth DCF in that it "incorporates the time value of money associated with quarterly compounding" into the dividend yield factor[94]

Both the Constant Growth and Quarterly Growth versions of the DCF use a perpetual growth rate.[95] For his Quarterly Growth DCF, Mr. Hevert determined that "growth in EPS represents the appropriate measure of long-term growth."[96] For the

[89] *Id.*
[90] Ex. 15, Sch. 8-4.
[91] Ex. 13, pp. 25-31, and Ex. 15, Sch's 8-5 through 8-8.
[92] Ex. 13, p. 31.
[93] Ex. 5, p. 11.
[94] *Id.,* pp. 11-12.
[95] *Id.,* p. 13.
[96] *Id.*

Constant Growth DCF, Mr. Hevert used both analysts' projections of earnings growth[97] and, as an alternative, the Retention Growth model.[98]

Hevert's DCF Results[99]			
	Mean Low	*Mean*	*Mean High*
Quarterly Growth DCF Results			
30-day Av.	8.05	9.29	10.76
90-day Av.	8.05	9.28	10.76
180-day Av.	8.03	9.26	10.74
Constant Growth DCF Results			
30-day Av.	7.93	9.12	10.55
90-day Av.	7.92	9.12	10.55
180-day Av.	7.90	9.10	10.53
Multi-Stage DCF Results			
30-day Av.	9.58	9.92	10.36
90-day Av.	9.58	9.91	10.36
180-day Av.	9.56	9.89	10.34
Table 4.			

Mr. Hevert also employed a Multi-Stage DCF analysis which "enables the analyst to specify growth rates over three distinct stages."[100] A benefit of the Multi-Stage DCF is that "it avoids the sometimes limiting assumption that the subject company will grow at the same, constant rate in perpetuity."[101] Instead, the analyst employs three different growth rates to reflect near-term, intermediate, and long-term growth forecasts.[102] The growth rates Mr. Hevert employed were, first, earnings-per-share ("EPS") growth as an average of (1) Value Line; (2) Zacks; (3) First Call; and (4) Retention Growth rates;[103] second, a transition value;[104] and third, projected long-term GDP growth.[105]

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[97] *Id.,* pp. 13-15.
[98] *Id.,* pp. 15-16.
[99] *Id.,* p. 25 (Table 7).
[100] *Id.,* p. 19.
[101] *Id.,* p. 20.
[102] *Id.*
[103] *Id.,* p. 22 (Table 5).
[104] *Id.*
[105] *Id.*

The Capital Asset Pricing Model (CAPM)

Staff used the CAPM as a test of reasonableness, while Mr. Hevert gave it equal weight with his other analyses. In the CAPM, the cost of equity is determined by comparing the risk of a given investment compared to the risk of the market as a whole.[106] To the risk-free rate (Rf) is added the product of β and the market-risk premium (Rm – Rf), where β is a measure of the divergence of the risk of the subject security from that of the market as a whole. For the risk-free rate, Mr. Marevangepo used the average yield on long-term (30 years) U.S. Treasury bonds.[107] Mr. Hevert, in turn, used the current 30-day average yield on 30-year Treasury bonds and the projected 30-year Treasury yield.[108] For the market-risk premium, Mr. Hevert developed forward-looking ("*ex-ante*") estimates of the market-risk premium by subtracting the current 30-year Treasury yield from the market-required return, which he calculated by performing a Constant Growth DCF analysis for each of the S&P 500 companies for which Bloomberg and Value Line provided consensus growth rates.[109] Staff, in turn, relied on the long-term (from 1926 to 2013) arithmetic and geometric average historical differences between earned returns on stocks and earned returns on bonds, but did not average the two figures but, instead, calculated a result using each.[110] For β, Mr. Hevert used both the average β reported by Bloomberg and Value Line for each proxy company and a β coefficient that he calculated "as the ratio of the standard deviation of returns for the subject company and the market, respectively,

[106] Ex. 13, pp. 32-33; Ex. 5, pp. 25-31.
[107] Ex. 13, p. 32.
[108] Ex. 5, p. 27.
[109] *Id.,* pp. 27-28; Sch. RBH-5.
[110] Ex. 13, p. 33.

multiplied by the correlation of returns between the two."[111] Staff, in turn, "relied on estimates directly calculated through an Excel spreadsheet designed specifically to be used with the SNL database of market and financial information."[112] Staff then adjusted the raw result using the Blume adjustment formula as used by *Value Line*.[113]

COMPARATIVE CAPM INPUTS AND RESULTS		
	Marevangepo	**Hevert**
Risk Free Rate	3.63[114]	3.87, 4.15[115]
Market Risk Premium	4.64, 6.20[116]	7.53, 8.63[117]
Beta	0.80[118]	0.851[119]
Result	7.31, 8.55[120]	10.21-12.78[121]
Table 5.		

Bond Yield Plus Risk Premium Approach

Liberty's expert witness also used a Bond Yield Plus Risk Premium analysis to which he gave equal weight.[122] Like all Risk Premium approaches, this analysis is based on the fact that equity holders, who have a residual interest and will not get paid until after all creditors are satisfied, consequently require a premium over what they would have earned as bond holders to compensate them for the additional risk of their investment.[123] "Risk premium approaches, therefore, estimate the Cost of Equity as the

[111] Ex. 5, pp. 28-29.
[112] Ex. 13, p. 32.
[113] *Id.,* pp. 32-33.
[114] *Id.,* p. 32.
[115] Ex. 5, p. 27.
[116] Ex. 13, p. 33.
[117] Ex. 31, p. 13.
[118] Ex. 13, p. 33.
[119] Ex. 5, p. 30.
[120] Ex. 13, p. 33.
[121] Ex. 5, p. 31 (Table 8); Sch. RBH-7.
[122] *Id.,* pp. 31-34.
[123] Ex. 5, p. 31.

sum of the equity risk premium and the yield on a particular class of bonds."[124] Mr. Hevert explained further:

> [S]ince the equity risk premium is not directly observable, it typically is estimated using a variety of approaches, some of which incorporate *ex-ante,* or forward-looking estimates of the Cost of Equity, and others that consider historical, or *ex-post,* estimates. An alternative approach is to use actual authorized returns for natural gas utilities to estimate the Equity Risk Premium.[125]

Mr. Hevert calculated the Risk Premium as "the difference between the authorized ROE and the then-prevailing level of long-term (i.e., 30-year) Treasury yield."[126] To his calculated risk premia, Mr. Hevert added the current 30-year Treasury bond yield of 3.87%, the near-term projected 30-year Treasury bond yield of 4.15%, and the long-term projected Treasury bond yield of 5.25%.[127] His results were 10.19%, 10.27%, and 10.69%.[128]

<u>The Rule of Thumb</u>

Mr. Marevangepo also used a "rule of thumb" analysis as an additional test of reasonableness.[129] This method allows estimation of the cost of equity by adding a risk premium to the yield-to-maturity ("YTM") of the subject company's long-term debt.[130] The typical risk premium, based on experience in the U.S. markets, is 3 to 4 percent.[131]

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[124] *Id.*
[125] *Id.,* pp. 31-32.
[126] *Id.,* p. 32.
[127] *Id.,* p. 34 (Table 9).
[128] *Id.*
[129] Ex. 13, p. 34.
[130] *Id.*
[131] *Id.*

MAREVANGEPO'S "RULE OF THUMB" RESULTS[132]		
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
Table 6.		

Comparison to Reported Regulatory Decisions

Mr. Marevangepo also compared his DCF results to reported regulatory ROE decisions.[133]

REPORTED ROE DECISIONS[134]		
	Gas	**Electric**
2014, 1st Quarter	9.54	10.23
2013, all	9.68	10.02
Table 7.		

Analytical Flaws and Errors:

It is Staff's position that "Hevert's cost of equity model inputs … are diametrically contrary to existing practical investment expectations [and therefore] inflated the results of his cost of equity models.[135] Mr. Marevangepo testified, "Upon reviewing Robert Hevert's cost of equity study, Staff established that the perpetual growth rate assumptions and inputs used in Robert Hevert's DCF models were inflated."[136] Mr. Marevangepo further testified, "Hevert's perpetual growth rate assumptions and inputs far exceed those that are reported and used in practice by equity analysts and

[132] *Id.*
[133] *Id.,* pp. 34-35.
[134] *Id.*
[135] Ex. 31, p. 7.
[136] *Id.,* pp. 7-8.

financial advisors performing valuation analyses for purpose of mergers and acquisitions."[137] Mr. Hevert created his growth rate by averaging growth estimates from (1) Zacks, (2) First Call, (3) Value Line, and (4) "his individual computation of a retention growth rate estimate."[138] These are three-to-five-year EPS growth forecasts and are not the sort of perpetual growth rates typically used by investors.[139] The effect of using these forecasts as a growth rate is to inflate the ultimate results of the DCF model in which they are input.[140] Mr. Marevangepo pointed out that Mr. Hevert's perpetual growth rates "are much higher than the publicly available long-term growth rate estimates of the United States' overall economy" and that their use assumes that "regulated natural gas utilities are expected to infinitely outgrow the economy of the country/region in which they operate."[141]

COMPARATIVE GROWTH RATES		
	Marevangepo	**Hevert**
Quarterly DCF	--	5.34[142]
Constant DCF	4.0-5.0[143]	5.34[144]
3rd Stage	--	5.71[145]
Table 7.		

Mr. Marevangepo also noted that Mr. Hevert used inflated risk premia in his CAPM.[146] They are based on DCF analyses that are themselves defective due to the use of grossly exaggerated growth rates.[147] Mr. Marevangepo commented, "for as long

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137 *Id.,* p. 8.
138 *Id.,* pp. 8, 10.
139 *Id.,* p. 8.
140 *Id.,* p. 10.
141 *Id.*
142 Ex. 31, p. 11.
143 Ex. 13, p. 31.
144 Ex. 31, p. 11.
145 *Id.,* p. 12.
146 *Id.,* p. 13.
147 *Id.*

as Robert Hevert is using 3-year to 5-year earnings growth rate estimates to represent perpetual growth rates in his DCF analysis, his DCF results are going to be inflated."[148] Staff also criticized Mr. Hevert's Bond Yield Plus Risk Premium analysis for its use of reported awarded ROEs because it equates awarded ROEs with the cost of equity.[149] The ROEs authorized by utility regulatory commissions are generally *higher* than the cost of equity, which is set by the market.[150]

CONCLUSION

Staff recommends that the Commission, for the reasons discussed herein, set Liberty's authorized cost of common equity within the range of 8.20% to 9.20%, mid-point 8.70%, combined with Staff's recommended capital structure of ***** ***** equity and ***** ***** debt and with Staff's recommended cost of debt of ***** *****, to arrive at the recommended allowed rate of return ("ROR") in this case: 6.39% to 6.85%, midpoint 6.62%.[151]

Kevin A. Thompson

2. Contract Customers:

a. Is Liberty currently authorized to enter into special contracts at non-tariffed rates with its customers in Missouri, such as Noranda and General Mills?

As authority for its special contracts with Noranda and General Mills, at the evidentiary hearing Liberty referred repeatedly to paragraph 7 of the stipulation and agreement in Case No. GR-2010-0192 which provided that:

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[148] *Id.*
[149] *Id.,* p. 15.
[150] *Id.*
[151] Table 1, *supra,* and Ex. 31, pp. 3, 7.

> The Signatories agree that revenues associated with special contracts shall not be imputed in this case. The Signatories agree that Atmos[152] shall offer to extend the special contracts of Noranda and General Mills to expire on the effective date of rates approved in Atmos's [*sic*] next general rate case. The rates for such extended period shall be those in effect at the end of the respective contract's original term. This paragraph shall not be construed to limit the ability of Atmos and Special Contract customers: i) to accept alternative mutually agreeable contract provisions, or ii) to enter into alternative mutually agreeable contracts for service.[153]

Despite Liberty's implication to the contrary, Staff did not fail to recognize this stipulation language; in fact, Staff quoted the foregoing language in its Revenue Requirement Cost of Service Report and even attached a copy of the stipulation to its written testimony.[154] What Liberty fails to recognize is that this stipulation only applies to its contracts with Noranda and General Mills – not to any other special contracts Liberty may wish to enter in the future. More importantly, Liberty fails to acknowledge that the authorization contained in this stipulation language will, by its express terms, *expire on the effective date of rates approved in this case*.

As the Commission is aware, the purpose of this rate case, like any other general rate case, is to set rates, terms and conditions of service on a going-forward basis. Since the authorization in the Atmos stipulation for special contracts like those between Liberty and Noranda or Liberty and General Mills expires upon the effective date of rates approved in this case and was limited to those specific contracts, Liberty needs a tariff authorizing such contracts if it wishes to have such contracts going forward. Section 393.140(11) RSMo provides that the Commission shall:

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[152] Atmos was Liberty's predecessor.
[153] Ex. 13 HC, Staff Revenue Requirement Cost of Service Report, p. 54, lines 3-12; Ex. 23 HC, Cox Surrebuttal, Schedule KC-1.
[154] *Id.*

> (11) *Have power to require every gas corporation*, electrical corporation, water corporation, and sewer corporation to file with the commission and *to print and keep open to public inspection schedules showing all rates and charges made, established or enforced or to be charged or enforced, all forms of contract or agreement* and all rules and regulations relating to rates, charges or service used or to be used, and all general privileges and facilities granted or allowed by such gas corporation, electrical corporation, water corporation, or sewer corporation; but this subdivision shall not apply to state, municipal or federal contracts. Unless the commission otherwise orders, no change shall be made in any rate or charge, or in any form of contract or agreement, or any rule or regulation relating to any rate, charge or service, or in any general privilege or facility, which shall have been filed and published by a gas corporation, electrical corporation, water corporation, or sewer corporation in compliance with an order or decision of the commission, except after thirty days' notice to the commission and publication for thirty days as required by order of the commission, which shall plainly state the changes proposed to be made in the schedule then in force and the time when the change will go into effect. The commission for good cause shown may allow changes without requiring the thirty days' notice under such conditions as it may prescribe. *No corporation shall charge, demand, collect or receive a greater or less or different compensation for any service rendered or to be rendered than the rates and charges applicable to such services as specified in its schedule filed and in effect at the time*; nor shall any corporation refund or remit in any manner or by any device any portion of the rates or charges so specified, nor to extend to any person or corporation any form of contract or agreement, or any rule or regulation, or any privilege or facility, except such as are regularly and uniformly extended to all persons and corporations under like circumstances. The commission shall have power to prescribe the form of every such schedule, and from time to time prescribe by order such changes in the form thereof as may be deemed wise. The commission shall also have power to establish such rules and regulations, to carry into effect the provisions of this subdivision, as it may deem necessary, and to modify and amend such rules or regulations from time to time. (Emphasis added)

At the hearing Liberty seemed to take the position that its “Negotiated Gas Sales Service” tariff (Tariff sheets number 34 and 35)[155] authorizes its Noranda and General Mills contracts. However, a cursory comparison of the contracts and the Negotiated Gas Sales Service tariff shows this is not the case. For example, perhaps one of the

[155] Ex. 56.

most obvious distinctions between the contracts permitted under tariff sheets 34 and 35 and the Noranda and General Mills contracts ** [156] – [157] . ** [158]

Furthermore, Liberty's response to data request number 161 shows clearly that Liberty did not – until apparently recently – consider the Noranda and General Mills contracts to fall under its Negotiated Gas Sales Service tariff. When requested to provide certain information on any customers who took service under this tariff during the test year, Liberty responded that "[t]he Company did not have any customers who took service under this tariff during the test year."[159]

In summary, Liberty's existing tariffs do not have a reference to the type of service Liberty provides under its special contracts with Noranda and General Mills.[160] Any authority Liberty had under the old Atmos stipulation was specific to these two contracts and expires on the effective date of rates approved in this case. Therefore, on a going-forward basis – when the rates, terms and conditions of service resulting from

[156] Ex. 56, sheet no. 35.
[157] Ex. 2 HC, Krygier Direct, Schedule CDK-4 HC; Ex. 3 HC, Krygier Rebuttal, Schedule CDK-R6 HC.
[158] Ex. 2 HC, Krygier Direct, Schedule CDK-5 HC.
[159] Ex. 53.
[160] Ex. 13 HC, Staff Revenue Requirement Cost of Service Report, p. 53, line 5.

this rate case will be in effect – Liberty will have no authority for special contracts like the ones it has with Noranda and General Mills.[161]

b. If Liberty is not currently authorized to enter into special contracts at non-tariffed rates with its customers in Missouri such as Noranda and General Mills, should the Commission authorize Liberty to adopt a tariff to allow it to enter into such special contracts? If yes, what should such tariff state?

Whether Liberty should be authorized, on a going-forward basis, to enter special contracts like its Noranda and General Mills contracts in addition to (or in place of) contracts under its Negotiated Gas Sales Service tariff is a policy decision for the Commission, specific to Liberty's situation.[162] However, if Liberty is to be so authorized, a new tariff is needed.

As stated above, Section 393.140(11) RSMo provides in part that the Commission shall have the power to require every gas corporation "to file with the commission and to print and keep open to public inspection schedules showing all rates and charges made, established or enforced or to be charged or enforced, [and] all forms of contract or agreement" and also that "[n]o corporation shall charge, demand, collect or receive a greater or less or different compensation for any service rendered or to be rendered than the rates and charges applicable to such services as specified in its schedule filed and in effect at the time." Section 393.130.3 RSMo further states that:

> No gas corporation, electrical corporation, water corporation or sewer corporation shall make or grant any undue or unreasonable preference or advantage to any person, corporation or locality, or to any particular description of service in any respect whatsoever, or subject any particular person, corporation or locality or any particular description of service to

[161] Not to be confused with negotiated contracts which comply with the provisions of Liberty's Negotiated Gas Sales Service tariff, Ex. 56.

[162] This does not mean that this is the type of policy decision which would require a rulemaking of general applicability.

> any undue or unreasonable prejudice or disadvantage in any respect whatsoever.

As stated in Staff's Revenue Requirement Cost of Service Report, without a tariff provision which allows special contracts such as those between Liberty and Noranda and General Mills, and which sets forth criteria for entering into such contracts, special contracts are by definition discriminatory since "special" contracts provide special treatment for some customers and would be, without an authorizing tariff, completely at Liberty's discretion.[163] Such a tariff is necessary to ensure that it is clear what provisions of the Company's tariffs are being applied to which customers; that special contract provisions are not in conflict with the Company's tariff provisions; and to provide appropriate parameters under which special contracts are allowed.[164] Such a tariff is also required by the statutory provisions cited above.

If the Commission decides to allow Liberty to have special contracts like its Noranda and General Mills contracts, the Commission should order the adoption of the tariff set forth as Schedule DMS-5 to the surrebuttal testimony of Staff witness David M. Sommerer, Exhibit 39 HC. Staff addressed this issue in its direct filing and provided example tariff language in its Revenue Requirement Cost of Service Report[165] which was not in tariff format, and provided actual tariff language in Schedule DMS-5. Unlike Staff, Liberty did not even address the issue of special contract tariff language in its direct filing, but provided a proposed tariff in its rebuttal filing in response to Staff.[166]

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[163] Ex. 13 HC, Staff Revenue Requirement Cost of Service Report, p. 53, lines 9-11.
[164] Ex. 39 HC, Sommerer Surrebuttal, p. 9, lines 6-9.
[165] Ex. 13 HC, p. 53.
[166] See Ex. 3 HC, Schedule CDK-R7.

Liberty's proposed special contract tariff is ambiguous about the relationship between a special contract and Liberty's existing tariffs.[167] Liberty's proposed tariff also is designed to replace existing tariff sheets number 34 and 35, the Negotiated Gas Sales Service tariff which includes availability for sales service customers (as opposed to transportation customers) and applies to alternative fuel customers; although the Company's proposed tariff replaces the current tariff concept and appears to deal with special contract situations, it has left the title of the service as "Negotiated Gas Sales Service," which is confusing at best since it is proposed to deal with transportation service (not sales service) bypass issues.[168] In addition, Liberty's proposed tariff does not require a customer to provide Liberty with any actual evidence of the investment required on the part of the customer in order to take service directly from the interstate or intrastate pipeline (*i.e.,* bypass) like Staff's proposed tariff would require.[169] Accordingly, if the Commission determines Liberty should be authorized to adopt a tariff authorizing special contracts like the Noranda and General Mills contracts, the Commission should order the adoption of the tariff set forth on Exhibit 39 HC, Schedule DMS-5.

c. What rate should the Commission use to calculate Liberty's revenues from Noranda and General Mills for purposes of this rate case?

The Commission should use the Company's tariff rate which would be applicable to these customers – rather than the discounted rates contained in the special contracts – to calculate Liberty's revenues from Noranda and General Mills for purposes

[167] Ex. 39 HC, Sommerer Surrebuttal, p. 9, lines 13-14.
[168] *Id.* at pp. 9-10.
[169] See Ex. 3 HC, Schedule CDK-R7 and Ex. 39 HC, Schedule DMS-5.

of this rate case.[170] ** ____

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________________________________ ** [171]

In addressing a recommended adjustment representing the difference between the full tariffed rate and the decreased (or “flexed”) rate charged to certain transportation customers pursuant to an approved tariff provision in a Missouri Gas Energy case the Commission found that:

> [The tariff] language makes it clear that MGE has the authority to flex down charges for certain customers but the tariff does not affect ratemaking treatment.
>
> The Commission recognized the regulatory problem inherent with “flex” provisions in its decision in Case No. GR-95-160. In that case, the Commission stated:
>
>> The Commission is fully aware of the obstacles faced by the natural gas utility industry in a post-636 competitive environment. In order to provide a reasonable opportunity to respond to competitive pressure, within the bounds of the regulatory structure, the Commission will reject the tariff proposal of the Staff and allow United Cities to file a substitute tariff in accordance with the following standards.
>>
>> The Commission will allow United Cities to negotiate and perform transportation contracts with rate flex sufficient to retain economically worthwhile customers on the system, without causing subsidization by the remainder of the ratepayers.
>>
>> United Cities may flex its tariffed transportation rate to meet competition, but must recover all variable costs plus a reasonable contribution to its fixed costs during the course of the contract. *United Cities executes and performs under such contracts at its own risk. All transportation contracts will be thoroughly examined and reviewed in any subsequent rate case* or PGA/ACA proceeding to determine whether the contract meets the above standard.

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[170] Ex. 13 HC, Staff Revenue Requirement Cost of Service Report, p. 54.
[171] *Id.*; *see also* Tr. Vol. 14 HC, p. 303, lines 16-20.

> *United Cities will be expected to show substantial and [competent] evidence of imminent by-pass by the transportation customer and will, in addition, be required to show that the contracted rate satisfies the requirement to collect no less than the variable costs attributable to the particular transportation customer plus reasonable contribution.*
>
> . . .
>
> *The Commission would not[e] that, upon prima facie showing by another party that a transportation contract was flexed down below the full tariffed rate, United Cities will be required to show by full, complete, substantial and competent evidence that the arrangement 1) was necessary to avoid imminent bypass, 2) recovers variable costs plus a reasonable contribution to fixed costs,* and 3) in instances involving affiliates, was at arms [sic] length and flexes rates no lower than necessary to meet relevant competition. (Emphasis added)[172]

In the United Cities Gas case quoted by the Commission in the Missouri Gas Energy case above, the Commission was confronted with both a tariff language issue and a proposed adjustment "to reflect the fact that United Cities is transporting gas to Pet, Inc. at below the full transportation rate and, therefore, at less than the full profit margin for transportation customers."[173] The Commission's Report and Order stated that Staff's proposed adjustment reflected "the amount of revenue from full margin rate lost as a result of the contract," and reflected "the fact that the shareholders, not the remainder of the ratepayers, should bear this loss."[174] In that case, United Cities alleged, although the Commission found no substantial evidence to support the allegation, that Pet, Inc. was "fully prepared to strike a bargain with Panhandle Eastern

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[172] *In the Matter of Missouri Gas Energy's Tariff Sheets Designed to Increase Rates for Gas Service in the Company's Service Area*, 5 Mo. P.S.C. 3d 437, 448-449 (1997) [quoting *In the Matter of United Cities Gas Company's tariff revisions designed to increase rates for gas service provided to the customers in the Missouri service area of the Company*, 4 Mo. P.S.C. 3d 121, 130-131 (1995)].
[173] *In the Matter of United Cities Gas Company's tariff revisions designed to increase rates for gas service provided to the customers in the Missouri service area of the Company*, 4 Mo. P.S.C. 3d 121, 127 (1995).
[174] *Id.*

Pipeline and by-pass the [United Cities] system altogether. United Cities alleges that negotiating the agreement at the below-full-margin level was more beneficial to the interests of both the Company and the remainder of the ratepayers than if Pet, Inc. left the system entirely."[175] In ruling in favor of Staff's proposed adjustment, the Commission went on to state that:

> After examination of the Staff's testimony and other evidence, the Commission finds that the *Staff has shown that United Cities has made a contract for rates which are below the full tariffed rate. The Staff has alleged that this, in and of itself, indicates that United Cities is not being reimbursed the appropriate cost of the service from Pet, Inc. United Cities has denied that this is the case, but has done so with generalities, not specifics*, as to the cost to serve Pet, Inc. and how those costs are apportioned and accounted for within the agreed-upon transportation rate.
>
> The Commission finds that the Staff has made a prima facie showing of imprudence and caused the burden of persuasion to shift to United Cities. The Commission would note, in making this finding, that it is aware of the post-636 realities of the marketplace. In this regard, the Commission states that special contracts containing rates which are flexed below the full tariffed rate, such as the Pet, Inc. contract, are not presumed by the Commission to be improper. The failure of United Cities in this case was a failure, not necessarily in making the Pet, Inc. contract, but in maintaining its burden of persuading the Commission of the prudence of the Pet, Inc. contract.
>
> *United Cities has not provided the Commission with substantial and competent evidence*, when obligated to do so by the Staff's presentation, *that its contractual arrangement with Pet, Inc. was necessitated by* the *imminent by-pass* of Pet, Inc., was an appropriate arms-length transaction with its affiliated gas marketer, *and recovered the appropriate amount of fixed and variable costs*.[176] (Emphasis added)

In this case, Liberty's contracts with Noranda and General Mills are at rates which are below the full tariffed rates, yet Liberty has not presented the Commission with "full, complete, substantial and competent evidence" that the contracts were "necessary to avoid" or "necessitated by" *imminent* bypass or that the contract rates

[175] *Id.*
[176] *Id.* at 127-128.

"recover variable costs plus a reasonable contribution to fixed costs" or recover "the appropriate amount of fixed and variable costs" as required by the Missouri Gas Energy and United Cities Gas cases quoted above.[177] In fact, Liberty has failed to offer any real evidence or support for the rates contained in the special contracts.[178] When Staff requested Liberty to ** [redacted] **[179]

Basically, Liberty's entire justification for the discounted rates given to Noranda and General Mills is simply the Company's "belief" – unsupported by any real evidence or studies or analysis – that the customers "might" leave the Liberty system if they were charged the full tariffed rate.[180] As in the United Cities Gas case quoted earlier, Liberty's purported evidence consists of "generalities" at best, not "specifics." This does not constitute substantial and competent evidence that such rates are necessary to

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[177] Although it does not serve as authority for the Noranda and General Mills contracts (as discussed in an earlier portion of this brief), even Liberty's Negotiated Gas Sales Service tariff provides that "For ratemaking purposes the Company shall have the burden to prove that the negotiated flexed rate was prudent." Ex. 56.
[178] Ex. 22 HC, Cox Rebuttal, p. 4, lines 12-13; Ex. 23 HC, Cox Surrebuttal, p. 3, lines 11-12.
[179] Ex. 23 HC, Cox Surrebuttal, HC Schedule KC-2.
[180] Ex. 3 HC, Krygier Rebuttal, p. 3, lines 15-17; Ex. 23 HC, Cox Surrebuttal, p. 4 line 17 through p. 5 line 7.

avoid imminent bypass or that such rates recover the appropriate amount of both fixed and variable costs.

As for Liberty's argument that it was merely "stepping into the shoes of Atmos," the Commission should remember that Liberty signed a new contract with Noranda during the course of this case.[181] In fact, ** [182] . **[183] As for the General Mills contract, ** . [184]

[181] Ex. 3 HC, Krygier Rebuttal, p. 4.
[182] Ex. 3 HC, Krygier Rebuttal, Schedule CDK-R6 HC.
[183] Ex. 3 HC, Krygier Rebuttal, Schedule CDK-R6 HC Exhibit "A" and Ex. 2 HC, Krygier Direct, Schedule CDK-4 HC Exhibit "A".
[184] Ex. 2 HC, Krygier Direct, Schedule CDK-5 HC.

.[185]

. ** The Commission should also remember that the authorization for both the Noranda and General Mills special contracts under the old Atmos stipulation expires upon the effective date of rates approved in this rate case.

Furthermore, even Atmos would have been subject to an adjustment for the special contracts in this rate case. Paragraph 7 of the stipulation and agreement in Case No. GR-2010-0192 – the prior Atmos case to which Liberty has repeatedly referred – stated that "[t]he Signatories agree that revenues associated with special contracts shall not be imputed *in this case*" (emphasis added),[186] which was by its express terms limited to *that case*, and did not apply to any future rate cases. In addition, paragraph 14 of that same stipulation and agreement provided:

> This Stipulation is being entered into solely for the purpose of settling the issues in File No. GR-2010-0192 and consolidated File No. GR-2006-0387. Unless otherwise explicitly provided herein, none of the Signatories to this Stipulation shall be deemed to have approved or acquiesced in any ratemaking or procedural principle, including, without limitation, any method of cost determination or cost allocation or revenue-related methodology. *Except as explicitly provided herein, none of the Signatories shall be prejudiced or bound in any manner by the terms of this Stipulation in this or any other proceeding,* regardless of whether this Stipulation is approved.[187] (Emphasis added)

[185] Ex. 3 HC, Krygier Rebuttal, Schedule CDK-R6 HC Article 11.2 and Ex. 2 HC, Krygier Direct, Schedule CDK-4 HC Paragraph 3(e).
[186] Ex. 23 HC, Cox Surrebuttal, Schedule KC-1.
[187] *Id.*

"Stepping into the shoes" of Atmos does not shield Liberty from an adjustment in this rate case.

During opening statements at the hearing, Commissioner Hall asked whether Noranda and General Mills could legally bypass Liberty and take transportation service directly from a pipeline company without first coming to the Commission and getting the authority to do so.[188] Without knowing the specific details of the bypass, such as but not necessarily limited to what facilities are to be constructed and by what entity or entities will they be owned; will any other customers be served by the bypass; what type of service or services (interstate or intrastate, where the actual gas is bought and produced, etc.) will be provided; it is difficult if not impossible to answer this question definitively. As a general proposition, however, it has been held, in an appeal of an order of the Federal Energy Regulatory Commission ("FERC") allowing an interstate pipeline to construct a tap and meter facility to deliver natural gas directly to two industrial consumers, that the application came within the jurisdiction of the FERC and the state utility commission did not have concurrent jurisdiction.[189] Similarly, it has been held that:

> The Natural Gas Act grants the Federal Energy Regulatory Commission jurisdiction to regulate the interstate transportation of natural gas, 15 U.S.C. § 717(b), and the Supreme Court has held that the [FERC's] jurisdiction is exclusive; state regulation is preempted. *Northwest Central Pipeline Corp. v. State Corporation Comm'n,* 489 U.S. 493, 506-07, 109 S.Ct. 1262, 103 L.Ed.2d 509 (1989); *Schneidewind v. ANR Pipeline Co.,* 485 U.S. 293, 300-01, 108 S.Ct. 1145, 99 L.Ed.2d 316 (1988); see also *Cascade Natural Gas Corp. v. FERC,* 955 F.2d 1412, 1421 (10th Cir. 1992). It seems to us, as it has seemed to the other courts to have

188 Tr. Vol. 11, pp. 115, 139.

189 *Cascade Natural Gas Corporation v. Federal Energy Regulatory Commission,* 955 F.2d 1412 (10th Cir. Ct. of App. 1992). It should also be noted that in Footnote 1 of the opinion it was stated that the construction of the industrial consumers' pipeline and its preceding approval were not the subject matter of this proceeding.

> addressed the issue, see *id.* at 1418-19; *Public Utilities Comm'n v. FERC,* 900 F.2d 269, 276-77 (D.C. Cir. 1990); *Michigan Consolidated Gas Co. v. Panhandle Eastern Pipe Line Co.,* 887 F.2d 1295, 1300 (6th Cir. 1989), that the transportation of natural gas bought and produced out of state to Indiana residents via Midwestern's pipeline is interstate transportation rather than being intrastate transportation from, as it were, the purchasers to themselves. It is via the pipeline that gas is brought from out-of-state producers to Indiana residents. Midwestern was therefore required to obtain, and so sought and did obtain, FERC's authorization to build the lines necessary to connect its pipeline to the premises of the buyers. See 15 U.S.C. § 717f(c); 18 C.F.R. § 157; *Northwest Central Pipeline Corp. v. State Corporation Comm'n, supra,* 489 U.S. at 520, 109 S.Ct. 1262.[190]

It appears that, at least if the bypass arrangement is correctly structured, it would require FERC authorization but not authorization from this Commission.

On the last day of the hearing, Commissioner Hall also asked whether, if the Commission determines that the rate charged by Liberty to Noranda and General Mills was appropriate during the test year (presumably due to the stipulation in the prior Atmos rate case), the Commission is bound by the actual revenues and expenses during the test year (bound to use the contract rates for purposes of determining revenues in this case) and thereby cannot make any adjustments related to those special contracts in this rate case going forward.[191] The answer, which will be discussed further below and which is probably apparent from earlier portions of this brief, is that the Commission is not so bound and is free to order the adjustments related to the special contracts which have been recommended by Staff.

The Commission has previously found that "[a] test year is a historical year *used as the starting point* for determining the basis for adjustments;" "[a]ll of the aspects of the test year operations may be adjusted upward or downward;" and "[t]he Commission identifies a utility's ongoing costs to provide utility service in the future and what rates

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[190] *Midwestern Gas Transmission Company v. McCarty,* 270 F.3d 536, 538 (7th Cir. Ct. of App. 2001).
[191] Tr. Vol. 15, p. 620.

will need to be set to collect those ongoing costs *in the future*."[192] In almost every general rate case the Commission orders or approves certain annualization and normalization adjustments to revenues, such as weather normalization and customer numbers, to set rates on a going-forward basis. If the Commission was bound to use actual test year revenues in every situation despite the evidence, such common annualization and normalization adjustments would not be permitted. In addition, it is not uncommon to include certain known and measurable expenses in rates even though they were not present during the test year. For example, in this case Staff's annualized payroll figure included an adjustment to reflect a 2.5% wage increase based upon the most current union contract terms which was to occur on June 1, 2014[193] – well past the test year.

As set forth earlier in this brief, the Missouri Court of Appeals has said that "[T]he Commission [is] not bound to the use of any single formula or combination of formulae in determining rates. Its rate-making function, moreover, involves the making of 'pragmatic adjustments.' . . . Under the statutory standard of 'just and reasonable' it is the result reached, not the method employed which is controlling. It is not theory but the impact of the rate order which counts."[194] Furthermore, in the Order Approving Stipulation and Agreement in the 2010 Atmos case repeatedly relied upon by Liberty, the Commission recognized that:

> The rate-making process . . . i.e., the fixing of 'just and reasonable' rates, involves a balancing of the investor and the consumer interests. [citing *Federal Power Com'n v. Hope Natural Gas Co.,* 320 U.S. 591, 603 (1944)]

[192] *In the Matter of Lake Region Water & Sewer Company's Application to Implement a General Rate Increase in Water and Sewer Service,* 2010 WL 3378384 (Mo.P.S.C. Slip Copy 2010) pages 12-13.
[193] Ex. 13 HC, Staff Revenue Requirement Cost of Service Report, p. 56 line 29 through p. 57 line 5.
[194] *State ex rel. Associated Natural Gas Co. v. Pub. Serv. Comm'n*, 706 S.W.2d 870, 873 (Mo. App. W.D. 1985).

Further, that balancing has no single formula:

> The Constitution does not bind rate-making bodies to the service of any single formula or combination of formulas. Agencies to whom this legislative power has been delegated are *free*, within the ambit of their statutory authority, *to make the pragmatic adjustments which may be called for by particular circumstances*. [citing *Federal Power Com'n v. Natural Gas Pipeline Co.,* 315 U.S. 575, 586 (1942)] (Emphasis added)

Moreover, making such pragmatic adjustments is part of the Commission's duty:

> What annual rate will constitute just compensation depends upon many circumstances and must be determined by the exercise of a fair and enlightened judgment, having regard to all relevant facts. [citing *Bluefield Water Works & Improvement Co. v. Public Service Com'n of the State of West Virginia,* 262 U.S. 679, 692 (1923)]

And:

> [T]he Commission [is] not bound to the use of any single formula or combination of formulae in determining rates. Its rate-making function, moreover, involves the making of 'pragmatic adjustments.' [citing *State ex rel. Associated Natural Gas Co. v. Public Serv. Com'n,* 706 S.W.2d 870, 873 (Mo. App. 1985)(citing *Hope Natural Gas Co.,* 320 U.S. at 602-03)]

Thus, the law requires a just and reasonable end, but does not specify a means:

> Under the statutory standard of 'just and reasonable' it is the result reached not the method employed which is controlling. It is not theory but the impact of the rate order which counts. [citing *State ex rel. Associated Natural Gas Co. v. Public Serv. Com'n,* 706 S.W.2d 870, 873 (Mo. App. 1985)(citing *Hope Natural Gas Co.,* 320 U.S. at 602-03)][195]

The Commission should also remember that the stipulation and agreement from the previous Atmos case itself contemplated that revenue adjustments might be made in future rate cases[196] and that:

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[195] *In the Matter of Atmos Energy Corporation's Tariff Revision Designed to Implement a General Rate Increase for Natural Gas Service in the Missouri Service Area of the Company,* File No. GR-2010-0192 et al., Order Approving Stipulation and Agreement, p. 5 (2010) – See Ex. 23 HC, Cox Surrebuttal, Schedule KC-1-36.

[196] See Ex. 23 HC, Cox Surrebuttal, Schedule KC-1-3 (provisions of first sentence of paragraph 7 limited to that case).

> This Stipulation is being entered into solely for the purpose of settling the issues in File No. GR-2010-0192 and consolidated File No. GR-2006-0387. Unless otherwise explicitly provided herein, none of the Signatories to this Stipulation shall be deemed to have approved or acquiesced in any ratemaking or procedural principle, including, without limitation, any method of cost determination or cost allocation or revenue-related methodology. *Except as explicitly provided herein, none of the Signatories shall be prejudiced or bound in any manner by the terms of this Stipulation in this or any other proceeding,* regardless of whether this Stipulation is approved.[197] (Emphasis added)

For purposes of calculating Liberty's revenues from Noranda and General Mills, the Commission should use the tariff rate which has been authorized and approved by the Commission rather than the deeply discounted rates contained in the special contracts, because Liberty has not proven those discounts to be justified. The Commission should remember that ** ______________________________

____ . ** Liberty's other customers should not be forced to bear the burden and subsidize the rates Liberty charges under the special contracts, at least not without Liberty providing adequate evidentiary justification for the discounts. Therefore, the Commission should order ** ________

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______________________________ . **[198]

d. What rate should the Commission use to calculate Liberty's revenues from SourceGas for purposes of this rate case?

The Commission should use ** ______________________________

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[197] Ex. 23 HC, Cox Surrebuttal, Schedule KC-1-8 and KC-1-9.
[198] Ex. 13 HC, Staff Revenue Requirement Cost of Service Report, p. 54 and Tr. Vol. 14 HC, p. 303, lines 16-20.

[199]

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Although the issue regarding the SourceGas contract is somewhat similar to the issue regarding the Noranda and General Mills contracts discussed above, the Commission should recognize that the SourceGas issue is not identical, since SourceGas is not a Missouri customer of Liberty. Rather, SourceGas is a natural gas local distribution company located in the state of Arkansas.[202]

Since SourceGas is located in Arkansas, in order to serve SourceGas Liberty was required to go to FERC for the requisite authorization.[203] From a ratemaking perspective, there are two general approaches for addressing the costs and expenses associated with this type of service.[204] One alternative would be to analyze the plant and related expenses associated with providing the service and then allocate those costs out of Liberty's SEMO jurisdiction, *i.e.*, out of Liberty's Missouri cost of service.[205] The other approach is to credit the available revenues to the SEMO cost of service

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199 Ex. 13 HC, Staff Revenue Requirement Cost of Service Report, pp. 55-56; Ex. 39 HC, Sommerer Surrebuttal, p. 1 line 20 through p. 2 line 3.
200 Tr. Vol. 14 HC, pp. 529-530; Ex. 39 HC, Sommerer Surrebuttal, p. 1 line 20 through p. 2 line 3.
201 See Highly Confidential Reconciliation, page 1 line 13.
202 Ex. 13 HC, Staff Revenue Requirement Cost of Service Report, pp. 55 lines 5-11.
203 See *Id.*
204 *Id.* at lines 11-12.
205 *Id.* at lines 12-14.

(the Missouri cost of service) in recognition of the fact that some of the SEMO plant and related expenses are being used to provide service to SourceGas.[206] Since Liberty has chosen to not calculate a cost of providing service to SourceGas[207] the revenue-crediting method is being used in this rate case.

When Atmos, Liberty's predecessor, owned the system and provided service to SourceGas across the state line, Atmos developed a cost of service study to establish its maximum FERC rate for its service to SourceGas.[208] However, unlike Atmos, when Liberty went to FERC to receive its authorization to serve SourceGas and set its maximum rate, Liberty chose not ** ____________________ , **[209] but instead chose "to use [the] rates on file with MoPSC [the Missouri Public Service Commission] for its interstate service," which was one of the options available under the FERC's regulations.[210] In its Order Issuing Blanket Certificate of Limited Jurisdiction, the FERC specifically noted that "Liberty is adopting the cost based rates approved by MoPSC."[211] It is also worthy of note that in its case before the FERC, Liberty stated that "SourceGas ha[d] no reasonable expectation" of continuing to receive the discount it had been receiving from Atmos;[212] the FERC agreed "that SourceGas cannot assume an ability to continue its firm service at a discounted rate after the expiration of its contract at the end of April 2012."[213]

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[206] *Id.* at 14-16.
[207] *Id.* at 17-18.
[208] Tr. Vol. 13, p. 497, lines 6-8. After setting its maximum FERC rate based on cost of service, Atmos granted SourceGas a discounted volumetric rate of $0.1771/MMBtu. See Ex. 39 HC, Sommerer Surrebuttal, Schedule DMS-3 page 7 (paragraph 22 of FERC Order Issuing Blanket Certificate of Limited Jurisdiction).
[209] Ex. 39 HC, Sommerer Surrebuttal, p. 7 lines 31-32.
[210] Ex. 39 HC, Sommerer Surrebuttal, Schedule DMS-3 page 2 (paragraph 6 of FERC Order Issuing Blanket Certificate of Limited Jurisdiction).
[211] *Id.* at page 11 (paragraph 39 of FERC Order Issuing Blanket Certificate of Limited Jurisdiction).
[212] *Id.* at page 8 (paragraph 26 of FERC Order Issuing Blanket Certificate of Limited Jurisdiction).
[213] *Id.* at page 10 (paragraph 35 of FERC Order Issuing Blanket Certificate of Limited Jurisdiction).

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Despite adopting the cost based rates approved by the Missouri Commission as its maximum FERC-approved rates, Liberty ** . [214] . [215] [216] [217] ** [218]

Despite Liberty's characterization that its existing contract with SourceGas is simply a "similar arrangement" to the predecessor agreement between Atmos and SourceGas, **

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[214] Ex. 13 HC, Staff Revenue Requirement Cost of Service Report, pp. 55-56; Tr. Vol. 14 HC, pp. 529-530; Ex. 39 HC, Sommerer Surrebuttal, p. 1 line 20 through p. 2 line 3.

[215] Ex. 13 HC, Staff Revenue Requirement Cost of Service Report, p. 56, lines 2-3.

[216] Ex. 62 HC, Liberty response to data request 224(e).

[217] Ex. 62 HC, Liberty response to data request 224(n).

[218] Tr. Vol. 14 HC, p. 489, lines 4-7.

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[219] Ex. 39 HC, Sommerer Surrebuttal, p. 2 lines 5-9.
[220] *Id.* at p. 2 lines 12-23.
[221] *Id.* at p. 4 lines 9-11.
[222] Tr. Vol. 14 HC, p. 490 lines 17-22.

[redacted]. **[223]

At the hearing, Liberty's witness agreed that FERC's policy regarding discounts allows the difference between the maximum cost-based rate and the discounted rate to be spread to *other shippers which receive FERC-jurisdictional service* and that SourceGas is Liberty's only shipper receiving such service.[224] At the hearing, Staff's witness Mr. Sommerer ** [redacted]

[223] Ex. 39 HC, Sommerer Surrebuttal, p. 4 lines 12-22.
[224] Tr. Vol. 13, p. 479 line 22 through p. 480 line 10.

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** [225]
(Emphasis added)

Liberty should not be allowed to do this, especially not based on the evidence presented by Liberty in this case.

At the hearing on this issue, Liberty at least implied that ** . ** [226] However, this is simply incorrect. In a case involving a company (Arkansas Oklahoma Gas Corporation, or "AOG") operating under a Hinshaw exemption (like Liberty)[227], West Central Arkansas Gas Consumers, Inc. ("WCAGC") opposed AOG's proposed rate decrease, as well as AOG's discounting practices.[228] FERC stated:

> WCAGC's concern is that AOG's setting of its interstate rates at a level below the level that could be supported based o[n] a full allocation of the costs AOG incurs in performing the service could cause AOG's intrastate customers to subsidize the interstate service. However, *AOG's rates for intrastate service are within the jurisdiction of the Arkansas Public Service Commission. WCAGC and other parties may raise the subsidization issue in the retail rate proceeding, and none of our findings in the instant proceeding prevents the Arkansas Public Service Commission from ensuring that Arkansas retail customers do not subsidize the interstate service*.[229] (Emphasis added)

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[225] Tr. Vol. 14 HC, p. 542 line 18 through p. 543 line 22.
[226] Tr. Vol. 12 HC, p. 98 lines 5-10.
[227] Tr. Vol. 13, p. 494 line 11 through p. 496 line 9.
[228] *Arkansas Oklahoma Gas Corporation*, 109 FERC ¶ 61,196 (2004) Docket No. PR04-8-001, Order on Rehearing paragraph 3.
[229] *Id.* at paragraph 7.

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For purposes of calculating Liberty's revenues from SourceGas, the Commission should use ** ____

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____ ** Therefore, the Commission should order ** ____

__________ . **

Jeffrey A. Keevil

3. Depreciation:

What depreciation rates should be ordered by the Commission for corporate plant accounts 399.1, 399.3, 399.4 and 399.5[230]?

Depreciation Introduction

These four accounts reflect computer hardware and software that Liberty Utilities uses across its Missouri, Illinois and Iowa jurisdictions, for which the Company's Missouri customers pay an allocated amount. The Commission has never ordered depreciation rates for these corporate allocated plant accounts, and Staff and Company disagree on what rate the Commission should order for those accounts in this case.

[230] Accounts currently in dispute between Staff and Liberty Utilities.

The Commission should order a depreciation rate of 4.75 % for each of the disputed accounts. All of the accounts in dispute concern corporate allocated plant depreciation rates, for which there are no currently-ordered depreciation rates; therefore, since Liberty Utilities' has not performed a depreciation study to justify a rate for these accounts, Staff's recommended rates for these corporate allocated plant accounts reflect currently-ordered depreciation rates for the general plant accounts of the former Butler and Kirksville districts. Staff's recommendation in this case is reasonable in that the rate of 4.75% is comparable to other Missouri regulated utilities for similar plant.

Facts

Depreciation is the "loss in service value not restored by current maintenance, incurred in connection with the consumption or prospective retirement of electric plant in the course of service from causes which are known to be in current operation and against which the utility is not protected by insurance. Among the causes to be given consideration are wear and tear, decay, action of the elements, inadequacy, obsolescence, changes in the art, changes in demand and requirements of public authorities."[231] The depreciation rate for each plant account is designed to recover, over the average service life of the assets in that account, the original cost of the assets, plus an estimate for any cost of removal less scrap value.[232]

The hardware and software in the accounts at issue are used at the Company's corporate office in Jackson, Missouri and allocated to its divisions in Iowa, Illinois and

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[231] Uniform System of Accounts Prescribed for Public Utilities and Licenses Subject to the Provisions of the Federal Power Act, 18 C.F.R. Part 101.
[232] Case No. ER-2010-0036, Staff Revenue Requirement Cost of Service Report p. 96, lines. 5-7.

Missouri.[233] In 2006, in rate case no. GR-2006-0387, the Commission ordered that Atmos assign to account 399 a value of 4.75% for its Butler district, 4.75% for Kirksville district, 4.75% for SEMO district, 5.0% for UCG district, 5.0% for the Palmyra district, 5.0% for Neelyville and 4.75% for the Rich Hill district.[234] In 2012, Atmos was granted approval to sell its natural gas and natural gas transportation systems to Liberty Utilities in GM-2012-0037. Liberty Utilities was ordered to adopt the depreciation rates of its predecessor Atmos for account 399 for each service district.[235] However, the Commission has never ordered specific rates for subaccounts 399.1, 399.3, 399.4 or 399.5 for any of the Company's districts, which according to the supplemented schedule of rates created of Staff for this case is designated as corporate allocated plant.[236]

Under the USOA, account 399 is labeled as "Other tangible property," which is used to record "the cost of tangible utility plant not provided for elsewhere."[237] Account 399.3 is designated for "network hardware" which includes assets such as routers and switches. Account 399.4 designated as "PC hardware" is the physical component of computers such as the monitor, keyboard and hard drive. Finally, account 399.5, "PC software" includes computer programs, libraries and associated documentation.

Staff's Position

The Commission should reject the Company's recommendation, because the Company has not performed a depreciation study to justify the 14.29% and 18.98%

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[233] Ex. 11, Fallert Surrebuttal, p. 9, lines 21-23.

[234] Rates are found in Attachment B to the Partial Non-Unanimous Stipulation and Agreement in GR-2006-0387.

[235] "For purposes of accruing depreciation expense, Liberty-Mid-States shall adopt the currently ordered depreciation rates for Atmos approved by the Commission in File No. GR-2006-0387 and attached as Schedule JAR-1 (Appendix 1)."

[236] Plant held in common for the Missouri, Iowa and Illinois jurisdictions. Amount of plant is portioned out by state, then district.

[237] Uniform System of Accounts Prescribed for Natural Gas Companies Subject to the Provisions of the Natural Gas Act, 18 C.F.R. Part 101.399.

rates. In order to change depreciation rates from those previously ordered by the Commission, a depreciation study is required to be performed. Commission Rule 4 CSR 240-3.275 states that "each gas utility subject to the commission's jurisdiction shall submit a depreciation study…to the manager of the commission's energy department and to the Office of the Public Counsel, as required by the terms of subsection (1)(B)." As part of the resolution of the merger case between Atmos and Liberty Utilities in Case No. GM-2012-0037, Staff agreed to waive the requirement of filing a depreciation study for the present case.[238] The unanimous stipulation and agreement approved by the Commission in the merger case stated in part that "Staff recognizes the Depreciation Study submitted by Atmos is sufficient for meeting the requirement of 4 CSR 240-3.275. The Signatories acknowledge that this study shall be deemed to meet Liberty-Midstates' requirement to perform a depreciation study within 5 years or 3 years prior to the next rate case."[239] Accordingly, Liberty Utilities did not perform a depreciation study in this case.[240]

Absent a depreciation study being performed, Staff believes the next best evidence of what depreciation rates should be is those rates that are currently-ordered by the Commission. However, when examining the most current Commission order in GM-2012-0037, a problem arises because the order did not assign specific depreciation amounts for each corporate plant account in dispute. And as such, neither Staff nor Liberty Utilities have been able to find an ordered rate for corporate hardware and software.[241] The crux of the disagreement between Staff and the Company is what

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[238] Ex. 36, Robinett Surrebuttal, p. 3, lines 7-8.
[239] EFIS item no. 16, *Unanimous Stipulation and Agreement*, p. 8.
[240] Tr. Vol. 13, p. 556, lines 20-22.
[241] Tr. Vol. 13, p. 565, lines 13-15.

depreciation rates should be assigned to corporate allocated plant accounts when there is no previous Commission order, or depreciation study for guidance.

In situations where the Commission has not ordered a depreciation rate for a specific corporate allocated plant account, Staff is of the position that the Company should use the depreciation rates ordered for the general plant account. Liberty Utilities agrees with this principle, as was explained by Liberty Utilities witness Mr. Fallert on the stand. When asked by Staff if general plant account depreciation rates are appropriate to use when there are no specific corporate allocated plant rates ordered, Mr. Fallert stated "that if you don't have any specific subaccounts, that would imply that all the plant going into that account's going in at the -- at the general plant rate." [242] When Mr. Fallert was questioned on what the currently-ordered depreciation rates for account 399 were, Mr. Fallert stated: "Butler is 4.75%, Kirksville is 4.75%, SEMO is 4.75%, UCG is 5.00%, Palmyra is 5.0%, Neeleyville is 5.00%, and Rich Hill is 4.75%."[243] Considering records transferred from Atmos to Liberty Utilities, as a part of the sale, were consolidated into three divisions from the seven that had depreciation rates ordered, the rate of 4.75% reflects the currently-ordered rates for the NEMO, WEMO and SEMO district for general plant account 399.[244] Until such time as a depreciation study can be performed to justify a change from that rate, it is Staff's position that Liberty Utilities' three districts maintain a rate of 4.75% for corporate hardware and software.

Liberty Utilities' Position and Analysis

Liberty Utilities is in agreement with Staff's proposed depreciation rates for all plant accounts, with the exception of rates for the corporate hardware and software at

[242] Tr. Vol. 13, pp. 567-568, lines 19-4.
[243] Tr. Vol. 13, p. 566, lines19-23.
[244] Ex. 13 HC, Staff Revenue Requirement Cost of Service Report, p. 73, lines 19-21.

issue in this case.[245] The Company believes that the 14.29% and 18.98% rates were established in GR-2006-0387, the most recent rate case for its predecessor Atmos.[246] Thus, Liberty Utilities argues that a rate of 14.29% (7 years) for system hardware and software and a 18.98% rate (5.3 years) for PC hardware and software similarly should be ordered for the accounts in dispute in this case.[247] According to the Company, Liberty Utilities and Staff used the14.29% and 18.98% for the disputed accounts for the last two rate cases brought by Liberty Utilities' predecessor Atmos.[248] Mr. Fallert further argued that Staff's accounting schedule 8 in the Atmos 2010 rate case utilized 14.29% and 18.98% to derive its recommendation. [249] According to Mr. Fallert, this use provided the Company with assurance that those rates were in fact the authorized rates.[250]

Despite assurance on the part of Liberty Utilities that they were using authorized depreciation rates based on Staff's accounting schedules in Atmos' 2010 rate case, ultimately the rates used in the workpapers of Staff in that case were never ordered by the Commission.[251] As was acknowledged by Mr. Fallert during the hearing, "Commission authorization in the form of an Order is required first before depreciation rates [are] to be used. All the depreciation rates should go into an order authorizing the use of those rates by the Commission."[252] Without rate 14.29% and 18.98% actually being authorized by the Commission in a Report and Order, any prior use of the rates by Staff or the Company in 2006 or 2010 in preparing its case, is of no import.

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[245] Ex. 10, Fallert Rebuttal, p. 9, lines 20-21.
[246] Ex. 11, Fallert Surrebuttal, p. 2, lines 10-11.
[247] Ex. 11, Fallert Surrebuttal, pp. 4-5, lines 20-2; Ex. 10, Fallert Rebuttal, p. 10, lines 17-19.
[248] Tr. Vol. 13, pp. 571-572, lines 21-1.
[249] Ex. 11, Fallert Surrebuttal, p. 3, lines 11-16.
[250] Tr. Vol. 13, p. 573, lines 7-14.
[251] Tr. Vol. 13, p. 572, lines 22-24.
[252] Tr. Vol. 13, p. 564, lines 16-18.

In his Surrebuttal testimony, Mr. Fallert made it a point to state that Staff recommended for Summit Natural Gas Company a range of 12.90% to 14.29% for the same accounts in dispute in this case. However when questioned about his knowledge of the Summit Natural Gas case on the stand, Mr. Fallert stated that he didn't even examine Summit's filing for a depreciation study.[253] The implication made by Mr. Fallert in his Surrebuttal testimony, that Staff is somehow being unreasonable regarding its recommendation in this case, because Staff recommended in different utilities case a rate of 12.90% to 14.29% for similar asset items, is unwarranted.[254] Not only are rate cases extremely complex, but they also differ from one utility to another, therefore the "one size fits all" approach explained by Mr. Fallert in his testimony is not appropriate for deciding complex cases. For example, in case number GO-2012-0363, Laclede was ordered to use a rate of 7% for its "New Blue" system.[255] Similarly, Empire in their 2012 rate cases stipulated to 10% depreciation rates for their new accounting software.[256] Finally, Missouri American Water Company stipulated to a 5% rate for its Business Transformation hardware and software.[257] Staff's recommendation in this case is reasonable in that the rate of 4.75% is comparable to other Missouri regulated utilities for similar plant and most importantly, the rates were authorized for use by the Commission.

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[253] Tr. Vol. 13, p. 568, lines 14-15.
[254] Ex. 11, Fallert Surrebuttal, p. 4-5, lines 21-2.
[255] Ex. 36, Robinett Surrebuttal, p. 2-3, lines 20-4.
[256] *Id.*
[257] *Id.*

Depreciation Conclusion

Liberty Utilities argues that without the benefit of a depreciation study, depreciation rates should not be changed.[258] Staff would agree with the Company in that regard. Staff's position does not argue for changing rates, rather that they stay the same. Staff's position has always been that the depreciation rates for the disputed accounts should be 4.75%, the rates of the *currently-ordered* depreciation rates for general plant account 399. Alternatively, Liberty Utilities is asking the Commission to order *new* rates when "there is no evidence to show where and how the 14.29% and 18.98% rates were derived, [and] there is no way to know if those rates are reasonable..." [259] Staff believes it inappropriate and bad public policy to implement depreciation rates in a seemingly fortuitous way without the depreciation rate being fully vetted by the all the parties and ordered by the Commission. Until a depreciation study is performed by Liberty Utilities during its next rate case that warrants a change in those currently-ordered, the Commission should authorize the continuance of the depreciation rate of 4.75% for accounts 399.1, 399.3, 399.4 and 399.5.

Akayla J. Jones

CONCLUSION

For the reasons set forth in this brief and in Staff's Exhibits in this case, the Commission should issue an order adopting Staff's recommendations on each of the contested issues.

[258] Tr. Vol. 13, p. 572, lines 2-6.
[259] Tr. Vol. 13, p. 575, lines 3-9.

WHEREFORE, Staff respectfully submits this Initial Post-Hearing Brief for the Commission's consideration.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that copies of the foregoing have been mailed, hand-delivered, or transmitted by facsimile or electronic mail to counsel for all parties of record this 10th day of October, 2014.

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