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

PUBLIC COUNSEL'S REPLY BRIEF

COMES NOW the Office of the Public Counsel ("Public Counsel") and offers this reply to the initial brief filed by Liberty Utilities (Midstates Natural Gas) Corp d/b/a Liberty Utilities ("Liberty").

1. Cost of Capital: Capital Structure

In its argument on capital structure, Liberty first argues that it would be more difficult for Liberty to earn its authorized return on equity if the Commission-ordered equity ratio is lower than the actual equity ratio allocated to Liberty by its parent.[1] The Staff's testimony, however, provides evidence that the levels of capital for each of the operations of Liberty's parent (Liberty Utilities Company, or "LUCo") "are not stable since they are simply a function of the amount of capital needed at a point in time and the timing of capital needed."[2] Moreover, Liberty's capital structure is simply *allocated* by LUCo and is subject to LUCo's subjective decisions to increase the cost of capital by assigning more equity to its regulated Liberty operations – decisions that cannot be audited or verified.[3] With the current low interest rate environment, there is no

[1] Liberty Brief, p. 4.
[2] Ex. 137, Marevangepo Rebuttal Testimony, p. 4.
[3] *Id.,* p. 5.

"justification for LUCo's decision to allocate higher percentage levels of equity versus debt to certain subsidiaries/operations."[4] For these reasons, it makes more sense to order a capital structure that "represents a long-term capital structure position for LUCo."[5] The Staff's evidence shows that "the only logical targeted capital structure would be one that is consistent with LUCo on a consolidated basis since Liberty Midstates' business risk is similar to that of LUCo and LUCo is the only "investible" capital structure."[6]

Liberty's initial brief identifies the reasons that the Staff disagrees with using Liberty's allocated capital structure as follows: (1) Liberty is not rated by credit rating agencies; (2) Liberty does not issue its own debt; and (3) Liberty does not issue its own equity.[7] Missing from Liberty's list are the Staff's additional reasons for not recommending Liberty's assigned capital structure, including the reasons that Liberty's capital structure "has no bearing on the cost of capital required by investors."[8] In response to these criticisms, Liberty's initial brief argues that the Staff's "misgivings" are "misplaced" because Liberty's assigned capital structure is consistent with the proxy group companies.[9] Liberty's response does not contest the facts premised by the Staff's position; that is, the facts showing that: (1) Liberty has no credit rating; (2) Liberty does not issue debt; (3) Liberty does not issue equity; and (4) Liberty's assigned capital structure has no bearing on the cost of capital required by investors. This acceptance of the Staff's facts is reason alone to reject Liberty's proposed capital structure because it

[4] *Id.*
[5] *Id.*
[6] *Id.,* pp. 4-5.
[7] Liberty Brief, p.7.
[8] Ex. 138, Marevangepo Surrebuttal, p. 6.
[9] Liberty Brief, p.7.

shows that Liberty's assigned capital structure is irrelevant to investors, just as it should be irrelevant to setting a capital structure for Liberty.

In response to Liberty's argument that its capital structure is consistent with the proxy groups, Mr. Hevert's statement is simply not supported by the record. Mr. Marevangepo explained:

> Robert Hevert is making an inappropriate comparison and not providing enough information about the context of these capital structures. Ratemaking capital structures are usually adjusted from the per-books capital structures due to various treatments, mechanisms and adjustments afforded or performed in different jurisdictions.
>
> If Robert Hevert had wanted to inform the Commission of the context of the allowed ROE data, then he would have also provided the corresponding approved capital structure to which it was applied. So if one were to appropriately apply the consistency measure against approved ratemaking capital structures, Staff believes its recommendation to use LUCo's capital structure, as it relates specifically to the common equity ratio, is consistent with a simple average of capital structures reported by Regulatory Research Associates (RRA) from 2000 to 2014.[10]

The Staff's evidence shows that the "capital structure for ratemaking should be a separate, identifiable capital structure and one that drives a company's cost of capital."[11] The capital structure proposed by Liberty does not satisfy any of one these criteria, and for this reason, Liberty's proposed capital structure should be rejected.[12] The only separate, identifiable capital structure that drive's Liberty's cost of capital is the capital structure of its parent, LUCo. For these reasons, a decision that orders LUCo's capital structure for ratemaking purposes would be just and reasonable.

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[10] Ex. 138, Marevangepo Surrebuttal, p. 9.

[11] *Id.*, p. 7.

[12] *Id.*

2. Cost of Capital: Return on Equity

Liberty's argues that it's Return on Equity (ROE) witness, Mr. Robert Hevert, has testified on this issue in rate proceedings "on approximately 100 occasions."[13] On those "100 occasions", however, Mr. Hevert testified only on behalf of utility companies.[14] As a company-witness-for-hire, Mr. Hevert has a strong incentive to inflate his recommended returns and ensure future employment from other utility companies. The Staff's witness, on the other hand, Mr. Zephania Marevangepo, has approached ROE from a neutral viewpoint that attempts to balance the interests of both investors and customers, and his recommended ROE of 8.20% to 9.20% does just that.[15]

One significant reason for the difference in ROE recommendations between Mr. Hevert and Mr. Marevangepo is each expert's growth rate. According to the Staff's calculations, the mean projected 5-year growth rate for the proxy group of companies is 3.96%, slightly below the Staff's recommended ranges of 4.0% to 5.0%.[16] Mr. Hevert, on the other hand, in his Multi-Stage DCF analysis, used a perpetual growth rate that "is approximately 91 basis points higher than the published projections for the long-term growth rate for the United States' overall economy."[17] The Staff's evidence shows "that Robert Hevert's growth rates diametrically contradict the reality of practical investment assumptions made by investors and investment advisors in regulated utilities."[18] "Staff has over time reviewed confidential asset and equity valuation reports" and "Staff has

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[13] Liberty Brief, p. 18.
[14] Ex. 5, Hevert Direct, Attachment A.
[15] Ex. 137, Marevangepo Rebuttal, p. 14.
[16] Ex. 15, Staff Report, Cost of Service, Revenue Requirement, Appendix 2, Schedule 8-4
[17] Ex. 137, Marevangepo Rebuttal, p. 12.
[18] *Id.*

never seen growth rates greater than 4 percent being imputed in *any* of those analyses."[19] Mr. Marevangepo's rebuttal testimony challenges Mr. Hevert when he states, "Staff would be highly enlightened if Robert Hevert can provide equity valuation reports or analyses for APUC that show perpetual growth rates of anywhere close to 5.71 percent."[20] Mr. Hevert's surrebuttal testimony did not provide the requested reports or analyses, and his conclusions regarding growth rates are, therefore, unsupported. For these reasons, and those argued in Public Counsel's initial brief, an order approving an ROE of between 8.20% and 9.20% is just and reasonable.

3. Depreciation:

Liberty is simply incorrect when it states that the Commission has never ordered depreciation rates for the accounts in which Liberty accounted for its new computer hardware and software.[21] The *only* Commission-ordered rate for USOA Account 399 is the 4.75% or 5.00% rates ordered for Account 399 for each district, which the Commission affirmed once again as the appropriate rates when it authorized Liberty's acquisition of the Atmos Energy Corporation properties in Missouri.[22] If Liberty wishes to create sub-accounts for a certain subset of computer hardware and software, Liberty will need to prepare a depreciation study and submit it to the Commission that supports the proposed rates. Otherwise, Liberty is bound by the prior Commission orders and its agreement in Case No. GM-2012-0037. And as explained in Public Counsel's initial

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[19] *Id.* (emphasis added).
[20] *Id.*, pp. 12-13.
[21] Liberty Brief, p. 47.
[22] Case No. GM-2012-0037, *In the Matter of the Joint Application of Atmos Energy Corporation and Liberty Energy (Midstates) Corp. for Authority to Sell Certain Missouri Assets to Liberty Energy (Midstates) Corp. d/b/a Liberty Utilities, and, in Connection Therewith, Certain Other Related Transactions*, Order Approving Unanimous Stipulation and Agreement, March 24, 2012, Exhibit A, Unanimous Stipulation and Agreement, p. 8.

brief, replacement of a large corporate computer hardware and software, a large system with multiple functions, should occur far less frequently than what Liberty proposes.

4. Conclusion

For the reasons set forth above, the Commission should order a capital structure in line with the capital structure recognized by the investment community – that being the capitals structure of LUCo. In addition, an ROE of 8.20% to 9.20% will adequately compensate investors and attract sufficient equity capital. Lastly, the Commission should use the already-ordered depreciation rates of 4.75% go 5.00% for the corporate computer hardware and software because those are the only rates supported by a depreciation study, and, moreover, it is simply unjust and unreasonable for a public utility to replace its large corporate accounting and billing systems more frequently than every 15 years.

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CERTIFICATE OF SERVICE

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