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 INITIAL BRIEF

The Missouri Office of the Public Counsel ("Public Counsel") offers this initial brief on behalf of the 55,000 customers of Liberty Utilities (Midstates Natural Gas) Corp. d/b/a Liberty Utilities ("Liberty," "Liberty Midstates," or "Company"). Most of the issues raised in this case were settled between the parties in the August 12, 2014 Partial Stipulation and Agreement as to Certain Issues, or the September 10, 2014 Revised Second Partial Stipulation and Agreement as to Certain Issues. This leaves three general issues to be resolved by the Commission: (1) cost of capital, (2) contract customers, and (3) depreciation.

1. Cost of Capital: Capital Structure

The Commission's decision on capital structure will resolve the percentage of Liberty's capital assigned to equity capital, a more expensive form of capital provided by shareholders, and debt capital, a less expensive borrowed capital. There are two competing capital structures recommended by the witnesses. The Staff's witness, Mr. Zephania Marevangepo, proposes that the Commission order Liberty to use its parent company's capital structure of ** ** equity and ** ** debt.[1] Liberty's

[1] Ex. 13, Staff Report: Revenue Requirement Cost of Service, p. 20.

witness, Mr. Robert Hevert, proposes using the capital structure of **58.34%** common equity and **41.66%** long term debt, which is the structure that was allocated to Liberty Midstates by Liberty's parent, Liberty Utilities Company (LUCo).[2]

The Staff's Revenue Requirement Cost of Service Report provides the Commission with substantial evidence and sound reasoning for ordering Liberty to use the capital structure of LUCo. The evidence in this case shows:

(1) **Equity and debt is issued through LUCo, not Liberty Midstates**. Liberty does not issue its own debt but relies on LUCo for capital assignments.[3] Therefore, LUCo has an investible capital structure, whereas Liberty Midstates does not.

(2) **LUCo is the basis for rating agency reviews of risk, not Liberty Midstates.** The ratings assigned to the debt of the regulated operations are based on LUCo's operations, not Liberty's, because the debt is guaranteed by LUCo.[4]

(3) **LUCo has a credit rating, not Liberty Midstates**. Liberty "is not rated by any credit rating agency," but "(LUCo and APUC) are rated by S&P and DBRS – a Canadian-based rating agency."[5]

(4) **LUCo's capital structure is market tested, Liberty Midstates' is not**. The capital structure of LUCo is "market tested" in that investors in LUCo rely on LUCo's common equity ratio to determine the required return on their debt investment.[6]

This evidence shows that the capital structure allocated to Liberty Midstates by its parent is of no consequence to investors, whereas the capital structure of LUCo is central to a shareholder's decision-making process when investing.

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[2] Ex. 5, Hevert Direct, p. 3.
[3] Ex. 13, Staff Report: Revenue Requirement Cost of Service, p. 18.
[4] *Id.*
[5] *Id.*, p. 16.
[6] *Id.*, p. 20.

Liberty's proposal should also be rejected because its capital structure is *allocated*, and, therefore, the 58.34% common equity and 41.66% long term debt proposed by Liberty <u>cannot be audited or verified</u>.[7] The Staff's rebuttal evidence shows "there is no quantifiable financial and investment justification for assigning higher equity capital percentages to Liberty Midstates."[8] Accordingly, it is unjust and unreasonable to require Liberty's customers to pay more for capital when such a rate increase has not and cannot been proven to be just and reasonable.

The customer impact difference between the two proposals is that Liberty's proposal to assign a significantly greater portion of the capital structure to equity would greatly increase the revenue requirement, and therefore, increase customer rates since equity is more expensive than debt. In a past Missouri Gas Energy (MGE) rate case, the Commission found, "The advantage of debt in the capital structure is that debt costs less than equity. Thus, the more debt in the capital structure the lower the cost of capital will be."[9] Public Counsel urges the Commission to once again recognize this "advantage" of having more debt in Liberty's capital structure. In the MGE case, like the present case, the Commission also considered two competing capital structure proposals – the use of the actual capital structure of MGE's parent company, or the hypothetical capital structure allocated by the parent to MGE.[10] The Commission noted that an investor in MGE invests in the parent company, and ultimately concluded that it is just and

[7] *Id.*, p. 5.
[8] *Id.*
[9] Case No. GR-2009-0355, *In the Matter of Missouri Gas Energy and its Tariff Filing to Implement a General Rate Increase for Natural Gas Service*, Report and Order, February 10, 2010, p.14.
[10] *Id.*

reasonable to use the capital structure of the parent.[11] The Commission reasoned that to do otherwise, "would allow MGE to recover revenues in excess of costs."[12] Likewise, an investor in Liberty invests in LUCo not Liberty, and for similar reasons, it is just and reasonable for the Commission to order Liberty to use LUCo's capital structure for setting rates in this case.

Further supporting the Staff's proposed capital structure is the capital structure Atmos Energy Corporation (Atmos) proposed in the last rate case before Atmos was acquired by Liberty in 2012. In Case No. GR-2010-0192, Atmos proposed a capital structure of 49.38% equity and 50.72% long-term debt, which is more in line with LUCo's capital structure than Liberty's proposal.[13] Atmos's testimony evidence to support its capital structure was evidence showing that Atmos was not a separate legal entity from its parent, that Atmos did not issue its own debt, and that Atmos relied upon its parent for all debt and equity funding needed for their operations.[14]

Liberty's transfer in ownership should not result in a rate increase for Missouri ratepayers, especially when those increases are due to unverifiable allocations of capital structure. In the Unanimous Stipulation and Agreement approved by the Commission when Liberty acquired the Missouri properties from Atmos, the parties agreed, and the Commission ordered, Condition No. 20, titled "No Detriment," which states, "The Signatories agree that the intent of the Stipulation is to avoid detrimental impacts to customers, and that this Stipulation should be interpreted accordingly."[15] Public Counsel

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[11] *Id.*
[12] *Id.*
[13] Ex. 13, Staff Report: Revenue Requirement Cost of Service, p. 17.
[14] *Id.*, p. 18.
[15] Order Approving Unanimous Stipulation and Agreement, Case No. GM-2012-0037, Appendix 1, p. 18.

urges the Commission to avoid detrimental effects caused by the sale of Atmos by rejecting Liberty's allocated capital structure and ordering the verifiable and credit-rated capital structure of LUCo.

2. Cost of Capital: Return on Equity

The Return on Equity (ROE) ordered by the Commission will determine Liberty's level of profit. A high ROE will cause higher rates for Missouri's ratepayers and will increase profits for Liberty's parent company shareholders, whereas a low ROE will help ratepayers by reducing rates. The key is to set the rate at a level that is *no more* that what is *necessary* to allow the Company to earn a reasonable return. *Bluefield Water Works & Improvement Co. v. Public Serv. Comm'n*, 262 U.S. 679, 693 (U.S. 1923).

The Staff's Revenue Requirement Cost of Service Report supports an ROE for Liberty of 8.20% to 9.20%.[16] Liberty's witness, Mr. Hevert, testified in favor of an ROE range of 10% to 10.5%.[17]

The Staff's Report determined a reasonable cost of common equity through an analysis of a proxy group of eight companies using the constant-growth DCF methodology, followed by "a CAPM analysis and a survey of other indicators as a check of the reasonableness of its recommendations."[18] The DCF is "widely used by investors to evaluate stable-growth investment opportunities."[19] The DCF methodology determines the cost of equity by adding the dividend yield to a perpetual growth rate that is meant to replicate the annual appreciation of the stock.[20] The projected dividend yield

[16] Ex. 13, Staff Report: Revenue Requirement Cost of Service, p. 35.
[17] Ex. 5, Hevert direct, p. 46.
[18] Ex. 13, Staff Report: Revenue Requirement Cost of Service, p. 22.
[19] *Id.*, p. 23.
[20] *Id.*, p. 24.

for the eight comparable companies is approximately 3.78%.[21] The growth rate, on the other hand, should recognize "that utility companies should grow at a rate *less* than that of the overall economy due to the mere fact that investors invest in utility companies for yield and not growth."[22] The evidence supports a long-term constant growth rate of less than 4.55%.[23] When adding the dividend yield to the growth rate, the Staff calculated "a natural gas distribution industry cost of equity estimate of 7.80 percent to 8.80 percent before the credit rating differential adjustment."[24] After the adjustment, the Staff recommended an ROE range of 8.20% to 9.20%.[25] An ROE that is within the Staff's range is well-supported by the record and would create a reasonable balance between the public interest and shareholder interests.

3. Contract Customers:

Prior to authorizing discounted rates under a special contract, the Commission should require Liberty to conduct a class cost of service study to determine the costs of serving the special contract customer and the impact on other ratepayers of approving the special contract. Any tariff authorizing special contracts should state that prior to allowing Liberty to charge other customers for any discount it gives to a special contract customer, Liberty is required to justify that the discount is necessary to retain the customer and that other customers receive a net benefit from providing the discount.[26] This is an essential protection to ensure a reasonable outcome for *all* Liberty customers.[27]

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[21] *Id.*
[22] *Id.* Emphasis added.
[23] *Id.*, p. 29.
[24] *Id.*, p. 31.
[25] *Id.*, p. 35.
[26] Ex. 41, Meisenheimer Rebuttal, pp. 11-13; Ex.42, Meisenheimer Surrebuttal, pp. 1-2.
[27] *Id.*

4. Depreciation:

This issue asks the Commission to determine what depreciation rates should be ordered for corporate plant accounts 399.1, 399.3, 399.4 and 399.5. The evidence in this case shows that the Commission should order the depreciation rates that it already ordered Liberty to use for Uniform System of Accounts (USOA) Account 399 until such time that Liberty performs and presents a depreciation study to the Commission.[28] These are the same rates that Liberty agreed to use when it acquired its Missouri assets from Atmos. According to the Unanimous Stipulation and Agreement agreed to by Liberty and ordered by the Commission, Liberty is required to adhere to the following condition regarding depreciation:

> 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).[29]

There is no ambiguity here – Liberty agreed to and was *ordered* by the Commission to use the depreciation rates from Case No. GR-2006-0387. The Commission has exclusive authority to determine Liberty's depreciation rates under §393.240.2 RSMo Supp. 2013. Appendix 1 attached to the stipulation in Case No. GM-2012-0037 includes the depreciation rates ordered in Case No. GR-2006-0387, which assign either a 4.75% or a 5.00% depreciation rate to USOA Account 399, depending on the depreciation rate assigned to each of the seven (7) original service districts; Butler (4.75%), Kirksville (4.75%), SEMO (4.75%), UCG (5.00%), Palmyra (5.00%),

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[28] Ex. 44, Addo Surrebuttal, pp. 2-6.

[29] Order Approving Unanimous Stipulation and Agreement, Case No. GM-2012-0037, Appendix 1, p. 8.

Neelyville (5.00%), or Rich Hill (4.75%).[30] Liberty consolidated these seven districts down to three (3) districts, without a Commission order authorizing such depreciation changes.[31] Converting back to seven districts, according to the Staff, is not possible "since records do not exist to segregate the consolidated divisions back in the districts for which ordered depreciation rates exist," and, therefore, "Staff recommends accepting the consolidation for depreciation purposes."[32]

Liberty's witness, Mr. James Fallert, supported the Staff's depreciation rates with the exception of what he characterizes as corporate hardware and software.[33] Mr. Fallert states that this corporate hardware and software is used in Liberty's corporate offices in Jackson, Missouri, and includes computers, servers and software used to run the Company's accounting, customer information, and billing systems.[34] Specifically, most of the new systems include a Cogsdale system for Liberty's customer information and billing system, and Great Plains software for Liberty's accounting system.[35]

Mr. Fallert testified that despite the Commission orders requiring Liberty to use the Case No. GR-2006-0387 depreciation rates, Liberty is currently using a depreciation rate of 14.29% for corporate hardware and software, which is approximately three times higher than what was ordered.[36] The only authority relied on by Liberty for its depreciation rate is a Staff work-paper from Atmos's last rate case, Case No. GR-2010-0192.[37] There is no Commission order authorizing Atmos or Liberty to use higher

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[30] *Id.*, Schedule JAR-1, Appendix 1 to Appendix 1.
[31] Ex. 13, Staff Report: Revenue Requirement Cost of Service, p. 73.
[32] *Id.*
[33] Ex. 10, Fallert Rebuttal, p. 9.
[34] *Id.* Tr. p. 557.
[35] Tr. p. 558.
[36] *Id.*
[37] Ex. 36, Robinett Surrebuttal, p. 2.

depreciation rates than what was ordered in Case No. GR-2006-0387 for Atmos, and continued for Liberty in Case No. GM-2012-0037. Surprisingly, Mr. Fallert testified that Liberty's main argument is not that the rate properly reflects the useful life of the assets; rather, their main argument is that 14.29% the rate they have been mistakenly using, so they should be allowed to continue.[38]

The total expense for the computer and software upgrades is approximately $16,000,000, with approximately 65% of that, or $10,400,000, allocated to Missouri.[39] This is a large and expensive system for a company the size of Liberty, and such systems do not need to be, and are not, replaced as frequently as Liberty claims. In a 2011 case, Missouri American Water Company was ordered to use a 5% depreciation rate, or a 20-year service life, for their new Business Transformation hardware and software.[40] In a 2012 case, Laclede Gas Company sought a depreciation rate for corporate software used for a new computer management system to provide customer billing, information, and accounting programs.[41] The Commission concluded that it would be unreasonable for Laclede to purchase a new management system, and five years later, turn around and purchase another, especially when the prior systems had been in place for 10 to 25 years.[42] In that case, the Commission concluded that the computer hardware and software acquired by Laclede would last approximately 15 years, which equates to a 7% depreciation rate.[43] The same reasoning applies here – it is unreasonable to assume that Liberty would acquire an expensive new computer management system, and in seven

[38] Tr. 572-573.
[39] Tr. 557-558.
[40] Order Approving Unanimous Stipulation and Agreement, Case No. WR-2011-0337, March 7, 2012.
[41] Tr. 560; Report and Order, Case No. GO-2012-0363, October 3, 2012, p. 6.
[42] Report and Order, Case No. GO-2012-0363, October 3, 2012, p. 7.
[43] *Id.*, p. 8.

years purchase another. Liberty's system should last 15-20 years, consistent with the systems of Laclede Gas Company and Missouri American Water Company. Liberty has provided no evidence to prove otherwise.

One difference between Laclede's accounting and Liberty's accounting for similar software is that Liberty accounted for the new software and hardware in USOA Account 399, whereas Laclede used Account 391.[44] Even if Liberty had added the new corporate hardware and software into Account 391, the depreciation rate would also be 4.75%.[45] Under either Liberty's method of using Account 399, or Laclede's method of using Account 391, the results for Liberty should be the same – a 4.75% depreciation rate until such time that a depreciation study in a general rate case supports a different rate.

Liberty's proposal to change ordered depreciation rates, without a depreciation study supporting such rates, should be denied. Liberty's witness, Mr. Fallert, admitted during cross-examination that the best evidence for changing a depreciation rate is a depreciation study, which he acknowledged Liberty did not provide in this case.[46] Until such a study is submitted in a general rate case, the Commission should reaffirm the rates it previously ordered for Account 399.

5. Conclusion

When deliberating on the issues addressed above, Public Counsel asks the Commission to consider the impacts that each issue will have on the public, and in particular, Liberty's most at-risk customers because those customers will be impacted the most by any rate increase. An order from the Commission that rejects the proposed rate increase in its entirety, which is a resolution strongly supported by the record evidence

[44] *Id.*, p. 6.
[45] Tr. pp. 562-563.
[46] Tr. p. 556.

and positions of the Staff and Public Counsel, will help protect Liberty's customers from this unreasonable request to raise rates without cost justification.

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CERTIFICATE OF SERVICE

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