BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Spire Missouri, Inc.'s Request to Increase its Revenues for Gas Service

Case No. GR-2017-0215 *et al.*

INITIAL BRIEF OF MISSOURI INDUSTRIAL ENERGY CONSUMERS

Lewis Mills, #35275
Edward F. Downey, #28866
221 Bolivar Street, Suite 101
Jefferson City, MO 65109
Telephone: (573) 556-6627
Facsimile: (573) 556-7442
Email: lewis.mills@bryancave.com
Email: efdowney@bryancave.com

Diana M. Vuylsteke, # 42419
211 N. Broadway, Suite 3600
St. Louis, Missouri 63102
Telephone: (314) 259-2543
Facsimile: (314) 259-2020
Email: dmvuylsteke@bryancave.com

Attorneys for Missouri Industrial Energy Consumers

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Comes now, the Missouri Industrial Energy Consumers (MIEC) and, for its initial brief, states as follows:

A. INTRODUCTION

This Brief will address the following issues (listed in the order addressed herein and as identified in the Motion to Delay the Start of Proceedings, and Amended List of Issues, Order of Witnesses, Order of Cross-Examination and Order of Opening Statements):

B. Cost of Capital (Issue III.a.)

1. Return on Equity (Issue III.a.i.)

2. Capital Structure (Issue III.a.ii.)

C. Revenue Stabilization Mechanism (Issue IV.a.i.)

D. Surveillance (Issue III.i.i.)

E. Trackers (Issue III.h.i.)

While the resources of the MIEC are focused on these issues for the purposes of this initial brief, the MIEC reserves the right to address additional issues in its Reply Brief.

B. COST OF CAPITAL

1. Return on Equity

a. Introduction

A fair cost of common equity for a regulated utility is defined in Hope[1] and Bluefield.[2] These decisions identify the general standards that must be considered in a regulator's determination of the cost of common equity and authorized return: (1) be sufficient to maintain financial integrity; (2) attract capital under reasonable terms; and (3) be commensurate with returns investors could earn by investing in other enterprises of comparable risk. The Commission is very cognizant of the dictates of Hope and Bluefield, often citing them at length in its Reports and Orders,[3] so an in-depth analysis is not necessary here.

As is typical in modern rate cases, the issue of the proper return on equity to award is the issue with the largest revenue requirement difference among the parties. In this case, the reason for that difference is obvious: the Commission Staff, and the MIEC and the Office of the Public Counsel (OPC) proposed a return on equity consistent with recent Missouri Commission decisions, whereas Spire Missouri, Inc. proposed an inflated return on equity that is not at all consistent with those decisions. Staff witness David Murray proposed a return on equity of 9.25 percent (the midpoint of his range of 9.0-9.5 percent). MIEC and OPC jointly sponsored witness Michael Gorman, who proposed a return on equity of 9.2 percent, which is the approximate midpoint of his recommended range of 8.9-9.4 percent. Spire witness Ahern proposed a return on equity of 10.35 percent.

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[1] Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591 (1944).

[2] Bluefield Water Works and Improvement Co. v. Public Service Commission of West Virginia, 262 U.S. 679. 43 S.Ct. 675, 67 L.Ed. 1176 (1923).

[3] See, *e.g.*, Case No. ER-2012-0166, Report and Order, issued December 12, 2012, pages 10-12.

On May 3, 2017, the Commission issued its Report and Order in Case No. ER-2016-0285, *In the Matter of Kansas City Power & Light Company's Request for Authority to Implement A General Rate Increase for Electric Service*. In that Report and Order the Commission found that Kansas City Power & Light Company's (KCPL's) cost of equity was 9.5 percent. Shortly before that, on March 8, 2017, the Commission approved a Unanimous Stipulation and Agreement in Case No. ER-2016-0179, *In the Matter of Union Electric Company d/b/a Ameren Missouri's Tariffs to Increase Its Revenues for Electric Service*. Although that agreement did not explicitly state a return on equity, the Commission in its order approving the agreement found:

> The parties explained to the Commission's satisfaction that the return on equity they contemplated when they entered into the stipulation and agreement would be within a range of 9.2 percent to 9.7 percent. MECG indicated it was contemplating an ROE of 9.2 percent, Ameren Missouri indicated it was contemplating an ROE of between 9.3 percent and 9.7 percent[4], and Staff indicated the return on equity it contemplated was 9.3 percent to 9.4 percent. Considering the positions of the parties, the Commission determines that an implicit return on equity in the range of 9.2 percent to 9.7 percent is reasonable in light of the overall settlement.

The midpoint of the range that the Commission found appropriate in Case No. ER-2016-0179 is 9.45 percent.

In KCPL's previous rate case, ER-2014-0370, *In the Matter of Kansas City Power & Light Company's Request for Authority to Implement a General Rate Increase for Electric Service*, the Commission awarded KCPL a 9.5 percent return on equity in its Report and Order issued on September 2, 2015. In Ameren Missouri's previous rate case, ER-2014-0258, *In the Matter of Union Electric Company d/b/a Ameren Missouri's Tariff to Increase Its Revenues for Electric Service*, the Commission awarded Ameren Missouri a 9.53 percent return on equity in its Report and Order issued on April 29, 2015.

[4] At the on-the-record presentation of the agreement, Ameren Missouri stated that the return on equity implicit in the ER-2016-0179 agreement was "within shouting distance" of the 9.53 percent awarded in the previous case.

There are four reasons that these decisions and these return on equity awards are relevant: 1) they are the most recent decisions involving major Missouri utilities; 2) they demonstrate a consistent approach to determining cost of equity by this Commission; 3) the underlying market conditions have not changed significantly since the decisions were issued; and 4) natural gas distribution utilities are similar to -- but less risky than -- vertically integrated electric utilities.[5] By keeping these recent decisions in mind in assessing the appropriate return on equity for Spire, Staff witness Murray and MIEC/OPC witness Gorman presented consistent and credible positions to the Commission. Spire witness Ahern's recommended 10.35 percent return on equity is not consistent with the testimony of the other two witnesses in this case, nor is it consistent with recent Commission decisions. As noted above, in the 2015 KCPL rate case, ER-2014-0370, the Commission awarded KCPL a 9.5 percent return on equity. The Company witness in that case (Robert Hevert, who also provides testimony in this case on capital structure) had proposed a 10.3 percent return on equity. Bear in mind that his 10.3 percent recommendation was for an electric utility, generally considered to have greater business risk than a natural gas distribution utility like Spire. Even so, the Commission in its Report and Order at page 19 rejected his testimony, finding that his proposed return on equity was "excessive." That "excessive" 10.3 percent return on equity is **actually lower** than Spire's 10.35 percent proposal in this case.

While the observations in this introductory section are certainly not determinative, they are instructive in establishing a context in which to view the evidence submitted by the various witnesses offering testimony on return on equity in this case.

b. MIEC/OPC Witness Gorman's Evidence

i. Introduction

[5] See, *e.g.,* Transcript, page 1142.

Michael Gorman is familiar to this Commission, which has consistently found him to be a credible and persuasive witness. In the Report and Order in ER-2014-0370, the Commission found:

> 36. The return on equity recommendations of witnesses Gorman, Marevangepo, and Reno are all reasonable and an accurate estimate of the current market cost of capital for KCPL, as those recommendations rely on verifiable and independent market data and accepted market-based rate of return models. Gorman testified credibly that these return on equity recommendations demonstrate that KCPL's current cost of equity is 9.5 percent or less.

In another recent case[6], the Commission found witness Gorman "to be the most credible and most understandable of the three ROE experts who testified in this case." And in yet another recent case, the Commission found that "Michael Gorman, the witness for SIEUA, AG-P and FEA, did the best job of presenting the balanced analysis the Commission seeks."[7]

ii. Regulated Utility Industry Authorized Returns on Equity, Access to Capital, Credit Strength and Market Outlook

In this case, Mr. Gorman again presents a balanced analysis. In his Direct Testimony (Exhibit 402), Mr. Gorman began his analysis of Spire's cost of capital by examining trends in authorized returns on equity for regulated utilities, utilities' credit standing, and utilities' access to capital used to fund infrastructure investment. He noted that authorized returns for both gas and electric utilities have been declining since about 2009, while at the same time, credit outlooks have been strengthening.[8] Gas utilities continue to have ready access to capital markets at attractive rates, and indeed capital expenditures on infrastructure are expected to continue at historically high levels.[9] Mr. Gorman notes that gas utility stocks today are very strong and robust relative to the last 11 years, and explains that: "Robust valuations are an indication that utilities can sell

[6] Case No. ER-2012-0166, Report and Order, issued December 12, 2012, at page 70.
[7] Case No. ER-2007-0004, Report and Order, issued May 17, 2007, at page 62.
[8] Exhibit 402, pages 4-6.
[9] *Ibid*., pages 7-9.

securities at high prices, which is a strong indication that they can access equity capital under reasonable terms and conditions, and at relatively low cost."[10]

Mr. Gorman next analyzed the outlook for several factors that are important for determining a utility's cost of equity. He explains that Fitch, Moody's and S&P all view utilities as having stable outlooks, and that utility stock price performance over the last several years has also been stable, which supports his conclusion that utility stock investments are regarded by market participants as a moderate- to low-risk investment.[11] Mr. Gorman concludes his discussion of the regulated utility industry market outlook by observing that:

> Federal Reserve [Quantitative Easing] monetary policy changes related to a strengthening economy have not and are not expected to increase long-term interest rates. Further, this outlook is reflected in consensus economists' forecasts of long-term interest rates, which indicate a relatively low capital market cost period for at least the intermediate period.[12]

Having examined general macroeconomic factors that serve as background information to help the Commission understand the environment in which Spire has been and will be operating, Mr. Gorman addressed the specific cost of common equity for Spire. Mr. Gorman used four models to calculate Spire's cost of equity: 1) a constant growth Discounted Cash Flow ("DCF") model using consensus analysts' growth rate projections; 2) a constant growth DCF using sustainable growth rate estimates; 3) a multi-stage growth DCF model; and 4) a Capital Asset Pricing Model ("CAPM").

iii. DCF Analyses

The DCF model requires inputs of current stock price, expected dividend, and expected growth rate in dividends in order to calculate investors' required return on equity. In Mr. Gorman's consensus estimate constant growth DCF, he used a 13-week average of the weekly

[10] *Ibid*., pages 9-10.
[11] *Ibid*., pages 10-12.
[12] *Ibid*., pages 12-17.

high and low stock prices of the utilities in his proxy group for the period ending on August 11, 2017. For the dividend input, he used the most recently paid quarterly dividend as reported in Value Line on June 2, 2017. For his expected growth rate in dividends, he relied on a consensus of professional security analysts' earnings growth estimates, which are a reasonable proxy for investors' expectations. The average growth rate determined using this method was 6.05%, and the constant growth DCF model resulted in average and median constant growth DCF returns of 8.93 percent and 8.14 percent, respectively.[13]

Mr. Gorman did a second constant growth DCF analysis, using a sustainable growth rate rather than the consensus estimate growth rate used in his first DCF analysis. The average sustainable growth rate for the proxy group using this internal growth rate model is 6.18 percent, and the sustainable growth rate constant growth DCF analysis resulted in average and median DCF results of 9.05 percent and 8.76 percent, respectively.[14]

The third DCF analysis that Mr. Gorman conducted used multi-stage growth rates rather than the constant growth rates used in the first two DCF analyses. He explained the rationale behind the multi-stage growth DCF model, and his implementation of it, as follows:

> The multi-stage growth DCF model reflects the possibility of non-constant growth for a company over time. The multi-stage growth DCF model reflects three growth periods: (1) a short-term growth period consisting of the first five years; (2) a transition period, consisting of the next five years (6 through 10); and (3) a long-term growth period starting in year 11 through perpetuity. For the short-term growth period, I relied on the consensus analysts' growth projections described above in the discussion of my constant growth DCF model. For the transition period, the growth rates were reduced or increased by an equal factor reflecting the difference between the analysts' growth rates and the long-term sustainable growth rate. For the long-term growth period, I assumed each company's growth would converge on the maximum sustainable long-term growth rate.
>
> ...
>
> For stage one growth, I used the consensus analysts' growth rate projections discussed above in my constant growth DCF model. The first stage growth covers the first five years, consistent with the term of the analyst growth rate projections.

[13] *Ibid*., page 26.
[14] *Ibid*., page 29.

> The second stage, or transition stage, begins in year 6 and extends through year 10. The second stage growth transitions the growth rate from the first stage to the third stage using a linear trend. For the third stage, or long-term sustainable growth stage, starting in year 11, I used a 4.20% long-term sustainable growth rate based on the consensus economists' long-term projected nominal GDP growth rate.[15]

The multi-stage growth DCF analysis resulted in average and median DCF results of 7.39 percent and 7.15 percent, respectively.

The results of all three DCF models are summarized as follows:

Summary of DCF Results

Description	Proxy Group Average	Proxy Group Median
Constant Growth DCF Model (Analysts' Growth)	8.93%	8.14%
Constant Growth DCF Model (Sustainable Growth)	9.05%	8.76%
Multi-Stage Growth DCF Model	7.39%	7.15%

Mr. Gorman's conclusion from his DCF analyses was that they support a conservative, high-end DCF estimate of return on equity of 8.9 percent.

iv. Risk Premium Analysis

Mr. Gorman's risk premium analysis was based on two estimates of an equity risk premium. The first estimated risk premium is the difference between the required return on utility common equity investments and U.S. Treasury bonds. The second equity risk premium estimate is the difference between regulatory commission-authorized returns on common equity and contemporary "A" rated utility bond yields by Moody's. Mr. Gorman summarizes the results of his Risk Premium Analysis as follows:

> To be conservative, I am recommending more weight to the high-end risk premium estimates than the low-end. I state this because of the relatively low level

[15] *Ibid*., pages 30, 36.

> of interest rates now but relative upward movements of utility yields more recently. Hence, I propose to provide 65% weight to my high-end risk premium estimates and 35% to the low end. Applying these weights, the risk premium for Treasury bond yields would be approximately 5.8%, which is considerably higher than the 31 year average risk premium of 5.40% and reasonably reflective of the 3.7% projected Treasury bond yield. A Treasury bond risk premium of 5.8% and projected Treasury bond yield of 3.7% produce a risk premium estimate of 9.5%.
>
> Similarly, applying these weights to the utility risk premium indicates a risk premium of 4.6%. This risk premium is above the 31-year historical average risk premium of 4.03%. This risk premium in connection with the current observable Baa utility bond yield of 4.34% produces an estimated return on equity of approximately 8.94%.
>
> Based on this methodology, my Treasury bond risk premium and my utility bond risk premium indicate a return in the range of 8.9% to 9.5%, with a midpoint of 9.20%.[16]

v. CAPM Analysis

The CAPM method of analysis is based upon the theory that the market-required rate of return for a security is equal to the risk-free rate, plus a risk premium associated with the specific security. The CAPM requires an estimate of the market risk-free rate, the Companies' *beta*, and the market risk premium. Mr. Gorman used Blue Chip Financial Forecasts' projected 30-year Treasury bond yield of 3.70 percent in his CAPM analysis, and the average Value Line estimate of *beta* for the proxy group, which is 0.73. Witness Gorman used two different market risk premium estimates: a forward-looking estimate and one based on a long-term historical average. The forward-looking market risk premium was 7.8 percent, and the historical market risk premium was 6.0 percent. Used in the CAPM model, these risk premiums produced return on equity estimates of 9.42 percent and 8.10 percent, respectively.[17]

vi. Return on Equity Summary

The results of Mr. Gorman's return on equity analyses are summarized in the following table:

[16] *Ibid*., page 43.
[17] *Ibid*., page 49.

Return on Common Equity Summary	
Description	**Results**
DCF	8.90%
Risk Premium	9.20%
CAPM	9.40%

Based on all of his analyses, Mr. Gorman recommends a return on equity of 9.2 percent, which is the approximate midpoint of the analyses in the above table. He explains that this recommendation:

> reflect[s] observable market evidence, the impact of Federal Reserve policies on current and expected long-term capital market costs, an assessment of the current risk premium built into current market securities, a general assessment of the current investment risk characteristics of the utility industry, and the market's demand for utility securities.[18]

But he adds a final important caveat. He notes that if the Commission determines to weight the DCF analyses more heavily than the risk premium and the CAPM analyses (which it has historically done), then a fair return on equity for Spire would be 8.9 percent.[19]

c. Staff Witness Murray's Evidence

Like MIEC/OPC witness Gorman, Staff witness Murray used a DCF analysis and a CAPM analysis (although not a risk premium analysis) to assist in developing a recommended return on equity for Spire. And like Mr. Gorman, Mr. Murray also analyzed recently awarded returns on equity and current and projected market conditions.

[18] *Ibid*., page 50.
[19] *Ibid*.

Mr. Murray conducted a single, constant growth rate DCF analysis, much like the first two DCF analyses that Mr. Gorman conducted. Mr. Murray used a growth rate range of 4.2 percent to 5.0 percent, resulting in a cost of equity estimate of 6.90 percent to 7.70 percent.[20]

Mr. Murray's CAPM analysis was similar to Mr. Gorman's, although the inputs were a bit different. Mr. Murray calculated a *beta* of 0.71 (as opposed to Mr. Gorman's 0.73), and used risk premiums of 6.0 percent and 4.5 percent (as compared to Mr. Gorman's 6.0 percent and 7.8 percent). Mr. Murray's CAPM estimates were 7.14 percent and 6.08 percent; because his risk premium inputs were lower than Mr. Gorman's, his CAPM-estimated cost of equity was also lower.[21]

Mr. Murray concluded that that an authorized return on equity for Spire in the range of 9.0 percent to 9.5 percent would be reasonable, "but given that investors view gas utilities in Missouri as having less business risk, an allowed ROE no higher than 9.25% would be most appropriate."[22]

d. Spire Witness Ahern's Evidence

Spire witness Ahern, like witness Gorman, performed DCF, risk premium, and CAPM analyses.[23] However, because of overstated risk premium estimates in both her risk premium and her CAPM analyses, and because of two inappropriate adders, her estimate of the cost of equity is not reasonable. Indeed, like it did with the estimate of witness Hevert in Case No. ER-2014-0370 discussed above, the Commission should simply find her estimate to be "excessive."

Of the three analyses that Ms. Ahern performed, the DCF analysis produces the lowest estimated return on equity, and Ms. Ahern recommends that the Commission give it little weight.[24]

[20] Exhibit 205, Staff's Direct Cost of Service Report (Public), page 39.
[21] *Ibid.*, page 43.
[22] *Ibid.*, page 45.
[23] Exhibit No. 38, Direct Testimony of Pauline M. Ahern.
[24] *Ibid.*, page 26.

But her reasons for urging the Commission to ignore her DCF analysis do not bear scrutiny. MIEC/OPC witness Gorman explains why:

> The DCF results generally produce economically logical results by comparison of the two major components of the DCF return: (1) the dividend yield, and (2) the growth rate. The utility stock investments are both income investments and growth investments. Hence, the stock yield component of the DCF model can be compared to alternative income investments of comparable risk to assess how it compares to alternative market investments.
>
> On my Schedule MPG-R-6, I show a comparison of natural gas utility stock dividend yields compared to A-rated utility bond yields. This is an approximate risk comparable investment for the income component of a utility stock DCF return. As shown on this schedule, utility stock yields are currently around 2.6%, which compares to A-rated utility bond yields of around 4.1%. This spread of around 150 basis points is in line with the 12-year average shown on this schedule. A high utility stock yield relative to an A-rated utility bond yield is an indication that the DCF model yield component is higher than normal and thus is a robust income return relative to alternative similar risk income investments.
>
> From a DCF growth perspective, utility stocks are also producing strong growth outlooks relative to the past. The industry historical growth in dividends has been around 4.4%. (Schedule MPG-R-7). This compares to outlooks for future growth in utility dividends and earnings of around 5.8% (Schedule PMA-D3) to 6.1% (Gorman Direct Testimony, Schedule MPG-5). As such, a DCF return on utility stocks reflects a yield component and a growth component that both reflect robust return outlooks for utility stock investors, and are economically logical in comparison to alternative investments of comparable risk.
>
> For these reasons, Laclede witness Ahern's contention that the DCF model is not producing reasonable results simply is without merit and should be disregarded.[25]

Ms. Ahern also performed two risk premium analyses: a predictive risk premium model ("PRPM™"), and a utility risk premium model. Both are significantly flawed. The PRPM™ measures the volatility of risk premiums based on return volatility of a stock index "total" return, less bond "income" return, but it artificially inflates the risk premium, and distorts its volatility. Mr. Gorman explains the problems with the PRPM™:

> Specifically, a significant component of return volatility on stock is created by capital gains and losses. Without recognizing capital gains and losses, stock return volatility and bond return volatility would be muted significantly. This is a significant distinction because Ms. Ahern reflects the increased return volatility for stocks based on capital gains and losses, but ignores this significant investment return component for bond yields. Therefore, Ms. Ahern has not accurately measured the level of the

[25] Exhibit 414, Rebuttal Testimony of Michael Gorman, page 26.

> risk premium, nor accurately characterized the volatility across time caused by market factors. Importantly, both stock and bond returns will be impacted by the capital gains and losses created by market factors that influence stock prices and bond prices. Ms. Ahern has significantly understated the return volatility of investing in bonds, and inflated the equity risk premium.[26]

Ms. Ahern's utility risk premium model is also flawed, but the problem with that model is much more straightforward. She premises her model on a projected prospective bond yield of 4.89 percent, which is completely unrealistic. At the time of his Rebuttal Testimony, Mr. Gorman noted that then-current data showed that the 13-week average A-rated utility yield was approximately 3.90 percent. Using that number would lower Ms. Ahern's estimated cost of equity using the utility risk premium model about 100 basis points to approximately 8.5 percent.[27]

Ms. Ahern performed a variant of the CAPM analysis called the Empirical CAPM, or ECAPM. Significant flaws in the way that Ms. Ahern performed the ECAPM analysis preclude the Commission from relying on it. "First, the practical result of Ms. Ahern's ECAPM is that the return is based on a *beta* estimate of 0.77, instead of her actual *Value Line* utility beta of 0.69."[28] Second, Ms. Ahern's use of an adjusted *beta* in her ECAPM analysis double-counts the increase in the CAPM return estimates for Spire, because it has a *beta* less than 1.0.[29]

The foregoing discussion demonstrates why the Commission should not rely on Ms. Ahern's return on equity analysis. But it actually gets worse, because she adds insult to injury by proposing two entirely unnecessary and inappropriate "adders" to further inflate her estimated cost of equity. Without these "adders," her estimate is 10.0 percent, and with them it is 10.35 percent. Ms. Ahern's first "adder" is 20 basis points based on an alleged increase in risk because of Spire's size compared to the size of the companies in her proxy group. There are two major problems with this "adder." First, it is based on a fictional and hypothetical market capitalization of a stand-alone Spire Missouri.

[26] *Ibid.,* page 28.
[27] *Ibid.,* page 29.
[28] *Ibid.,* page 30.
[29] *Ibid.*

There is no competent evidence to support this made-up capitalization. Second, it ignores the fact that Spire Missouri has entered into a shared services agreement with Spire, Inc., through which Spire Missouri receives services from its parent company. As Mr. Gorman explains:

> These service company transactions mitigate [Spire Missouri's] stand-alone small company risk from a standpoint of management expertise, access to capital, and technical expertise such as legal, engineering, financial and IT. Further, the public shareholders of Spire, Inc. benefit from the diversity of Spire subsidiaries that operate across regions. Therefore, this diversity in operations can mitigate small company risk of the operating performance of the subsidiaries impacts on Spire's financial results.[30]

The second "adder" that Ms. Ahern proposed is for flotation costs, or the costs of issuing or floating common equity. The main problem with this "adder" is that not all common equity for Spire comes from public stock issuances, because much of it comes from retained earnings and certain other types of transactions that increase common equity without incurring stock flotation costs. The actual percentage of market capitalization of Spire common stock of $3.0 billion in relationship to flotation costs of $58.68 million would produce a *de minimis* flotation cost adjustment of around 0.06%. There is simply no basis to make such an adjustment.

e. Conclusion

The estimate of the cost of equity performed by Spire simply contains too many flaws to be reliable. The estimates of Staff witness Murray and MIEC/OPC witness Gorman, while arrived at using different approaches, are consistent and reasonable. The Commission should award Spire an authorized return on equity of 9.2 percent based on the evidence adduced by MIEC/OPC witness Gorman.

[30] *Ibid.*, page 20.

2. Capital Structure

a. Introduction

Spire initially proposed to set rates based on a capital structure that consists of 57.2 percent Common Equity and 42.8 percent Long-Term Debt, and at the true-up changed that proposal to 54.2 percent equity and 45.8 percent debt. Both MIEC/OPC witness Gorman and Staff witness Murray testified that using such an equity-rich capital structure would result in rates that are unjust and unreasonable, much higher than necessary to protect Spire's financial wellbeing and allow it to provide safe and adequate service. The two witnesses took different approaches, but each recommends a capital structure that is more reasonable and fairer to customers than the equity-rich capital structure recommended by Spire. Staff witness Murray proposes that the Commission use Spire, Inc.'s actual capital as of the true-up date, including short-term debt. MIEC/OPC witness Gorman proposes to use Spire's proposed capital structure as of the true-up date, but with an adjustment to remove the capital supporting the goodwill asset that Spire created when Laclede acquired MGE. Mr. Gorman's adjustments result in a capital structure of 47.2 percent equity and 52.8 percent long term debt. Either of these recommendations would result in a capital structure that is reasonable for ratemaking purposes. Mr. Gorman's approach has the added advantage of being explicitly compliant with the agreement reached in the acquisition case that no portion of the acquisition premium would be "directly or indirectly" passed through to ratepayers.

Moreover, it is undisputed that the Companies' proposed capital structure including the goodwill asset costs more than the capital structure proposed by Mr. Gorman. Spire witness Hevert agreed that "as a condition precedent to being permitted to acquire MGE, Laclede Gas Company agreed to forego any direct or indirect recovery of the acquisition premium." He also agreed "that there should be no direct or indirect consequence of goodwill in the transaction...." And finally he agreed that "if the Commission were to adopt the capital structure recommended by

the Company rather than the capital structure recommended by Mr. Gorman, ratepayers would pay a higher rate."[31] Mr. Gorman's recommended capital structure explicitly corrects Spire's attempt to indirectly recover some of the acquisition premium by including it as goodwill in its proposed capital structure. Mr. Murray's approach effectively avoids the issue by adopting the parent company capital structure, which does not include the goodwill asset.

The biggest problem with Spire's theory that Laclede's acquisition of MGE -- including the goodwill asset -- was financed with roughly equal parts equity and debt is that goodwill cannot be supported by debt. Mr. Gorman explained that problem at the hearing:

> the acquisition funded both the net book value of around $800 million plus the goodwill assets of about 210 million. That total acquisition was roughly 50 percent debt and 50 percent equity. But because utility debt has to be serviced from investments that produce cash flows, the amount of -- the portion of the equity acquisition made by Laclede was the $800 million of net book value. So in relationship to the utility debt to the net book value, it was roughly 56 percent debt and about 44 percent equity or $450 million of debt relative to $800 million of net book value and about 44 million of equity relative to net book value. The additional $210 million of the acquisition price was premium to the net book value, and that represented a transaction between shareholders, not a transaction that allowed the utility to secure capital from investors and make investment in utility plant and investment [sic]. Rather, it represented capital where one utility shareholder bought the stock of another utility shareholder.

b. MIEC/OPC Witness Gorman's Evidence

MIEC/OPC witness Gorman took a two-step approach to determining the appropriate capital structure to recommend to the Commission for the purpose of setting rates. Both steps begin with an examination of Spire's proposed capital structure. Mr. Gorman first examined that capital structure to determine whether it appropriately represents the actual mix of debt and equity that Spire is using to invest in utility plant. It was readily apparent that it did not, because Spire's balance sheet reflects a goodwill asset, which cannot be supported by debt capital because it does

[31] Transcript, pages 1228-1229.

not produce cash flows.[32] After making an adjustment to Spire's proposed capital structure to remove the equity supporting the goodwill asset, Mr. Gorman arrived at "the utility's actual mix of debt and equity capital used to support their investment in the utility rate-based assets."[33]

The second step was to examine both his proposed capital structure and Spire's proposed capital structure from the perspective of whether they would maintain financial integrity and credit standing at the lowest possible cost to customers. He found that both his capital structure and the company's would indeed maintain financial integrity and credit standing, but that the Spire proposed capital structure would do so at a much greater cost to customers than necessary.[34] The result of both of these steps was to re-affirm the reasonableness of Mr. Gorman's capital structure and the unreasonableness of Spire's.

To further support the reasonableness of his proposed capital structure, Mr. Gorman examined the common equity ratios of natural gas distribution companies generally over the period of 2010-2017. Over that period, he found that the industry average and median common equity ratios were generally about 51 percent, well below the 54.2 percent that Spire proposes in this case.[35]

Mr. Gorman also observed that Spire's proposed capital structure contains more common equity than needed to support its bond rating. He testified that:

> In 2016, Laclede/MGE's actual capital structure, including all investor capital, and reflecting off-balance sheet debt obligations indicates that Laclede/MGE's adjusted debt ratio at my proposed capital structure is 54.2% and reasonably consistent with industry median adjusted debt ratio range for other utilities with Laclede/MGE's current A- bond rating of 52.2%.[36]

C. REVENUE STABILIZATION MECHANISM

[32] Transcript, page 1373.
[33] Transcript, page 1374.
[34] Transcript, page 1375.
[35] Exhibit 414, Gorman Rebuttal, pages 11-12.
[36] *Ibid*., at page 13.

In his Rebuttal Testimony, MIEC witness Greg Meyer opposed the use of a Revenue Stabilization Mechanism (RSM). Mr. Meyer noted that the primary purposes of the RSM are to ensure Spire's recovery of its profits, and to mitigate the impact of weather on revenues.[37] Neither of those are valid reasons to implement the RSM. Mr. Meyer also notes that another reason advanced by Spire in favor of the RSM is that it will provide more rate stability for residential and commercial customers. Noting that the proposed RSM would require a change in rates once each year and allow up to three additional changes per year, Mr. Meyer dismisses this claim as entirely unconvincing.[38]

In addition to these significant problems with the RSM proposal, Mr. Meyer also testified that it would constitute single issue ratemaking in that it would allow Spire to change rates based upon changes in just one factor without an examination of all relevant factors.[39] The RSM effectively allows revenues to be trued up to the revenue level established in the preceding rate case without looking at any aspects of the costs of providing service. Even if the cost of providing service has dropped by fifteen percent since rates were last examined in a rate case, if revenues drop by five percent, the RSM allows a rate increase to recover that five percent revenue drop even though an examination of all relevant factors would dictate a decrease of ten percent.

D. SURVEILLANCE

On the day that this issue was to be heard, the Staff, OPC and Spire reached an agreement whereby Staff and OPC would receive quarterly financial surveillance data. Although the exact format of the surveillance reports is unclear, Staff witness Lisa Ferguson testified that the

[37] Exhibit 753, Meyer Rebuttal, page 23.
[38] *Ibid*., at page 24.
[39] *Ibid*.

information to be provided is generally the same as is provided by the electric utilities under the provisions of the Fuel Adjustment Clause (FAC) rules.[40]

The only remaining issue with respect to surveillance reporting is whether it is to be provided only to the Staff and OPC, or whether it should also be provided to parties granted intervention in Spire's rate case, like MIEC. Spire is the only party that has opposed allowing rate case parties like the MIEC access to the surveillance reporting. Spire witness Glenn Buck attempted to explain the reasons for Spire's opposition in response to Chairman Hall's questions, and although the reasons seemed to generally involve confidentiality concerns, Mr. Buck's explanation was quite vague.[41]

Moreover, the Commission has an elaborate series of rules designed to protect and preserve the confidentiality of exactly the type of information that Spire will be submitting in its surveillance reports. These rules are part of the regulatory scheme that governs FACs, and the Commission took administrative notice of them at the hearing.[42] Spire witness Buck was unable to offer a single reason why adequate protections for confidential information could not be implemented. In fact, he conceded that "it certainly could be."[43] And finally, neither Spire witness Buck nor Staff witness Ferguson (the only two witnesses to offer testimony on this issue) could identify a single instance in which an intervenor like the MIEC had abused or mishandled confidential information. Indeed, it seems that Mr. Buck's vague concerns about confidentiality were driven entirely by a single incident in which he claims that the Staff mishandled confidential information.[44]

[40] Transcript, pages 1572-1573.
[41] Transcript, pages 1564-1565.
[42] Transcript, page 1571.
[43] Transcript, page 1565.
[44] Transcript, page 1559.

E. TRACKERS

Spire has proposed to implement a tracker for the costs to comply with federal, state or local environmental compliance requirements. The Commission generally has found that the use of trackers should be avoided except in extraordinary circumstances:

> 114. In Missouri, rates are usually established based upon a historical test year where the company's expenses and the rate base necessary to produce the revenue requirement are synchronized. The deferral of costs from a prior period results in costs associated with the production of revenues in one period being charged against the revenues in a different period, which violates the "matching principle" required by Generally Accepted Accounting Principles (GAAP) and the Uniform System of Accounts approved by the Commission. The matching principle is a fundamental concept of accrual basis accounting, which provides that in measuring net income for an accounting period, the costs incurred in that period should be matched against the revenue generated in the same period. Such matching creates consistency in income statements and balance sheets by preventing distortions of financial statements which present an unfair representation of the financial position of the business. One type of deferral accounting, a "tracker", has the effect of either increasing or decreasing a utility's earnings for a prior period by increasing or decreasing revenues in future periods, which violates the matching principle.
>
> 115. A tracker is a rate mechanism under which the amount of a particular cost of service item actually incurred by a utility is tracked and compared to the amount of that item currently included in a utility's rate levels. Any over-recovery or under-recovery of the item in rates compared to the actual expenditures made by a utility is then booked to a regulatory asset or liability account and would be eligible to be included in the utility's rates in its next general rate proceeding through an amortization to expense.
>
> 116. The broad use of trackers should be limited because they violate the matching principle, tend to unreasonably skew ratemaking results, and dull the incentives a utility has to operate efficiently and productively under the rate regulation approach employed in Missouri.[45]

In this case, Spire provided almost no evidence to support its request for an environmental cost tracker. It does not present evidence to show that environmental costs are a significant expense, nor that they are volatile -- both criteria by which the Commission evaluates whether to grant extraordinary ratemaking treatment. MIEC witness Meyer summarizes the MIEC position on Spire's requested environmental cost tracker:

[45] ER-2014-0370, *In the Matter of Kansas City Power & Light Company's Request for Authority to Implement a General Rate Increase for Electric Service*, Report and Order issued September 22, 2015, pages 50-51.

> The Companies have done nothing to support their request for an environmental tracker. They have not provided any analysis of environmental laws, rules or mandates that have been in force in the past. They have provided no testimony about the historic levels of costs. I have shown that these costs are not material to the total operations of each utility. The Companies have not met their burden to receive a tracker for these costs.[46]

F. CONCLUSION

For the reasons set forth herein, the Commission should:

1) Authorize a return on equity of 9.2 percent;

2) Set rates based on a capital structure of 47.2 percent equity and 52.8 percent long term debt;

3) Deny Spire's request to implement a Revenue Stabilization Mechanism;

4) Order Spire to provide to the MIEC, and other intervenors in this case that request it, the surveillance reports that it has agreed to provide to Staff and OPC subject to the same confidentiality provisions that apply to surveillance reports provided under the Fuel Adjustment Clause regulations; and

5) Deny Spire's request to establish a tracker for environmental compliance costs.

Respectfully submitted,

BRYAN CAVE, LLP

By: */s/ Lewis Mills*
Lewis Mills, #25375
Edward F. Downey, #28866
221 Bolivar Street, Suite 101
Jefferson City, MO 65109
Telephone: (573) 556-6622
Facsimile: (573) 556-7442
Email: lewis.mills@bryancave.com
Email: efdowney@bryancave.com

[46] Exhibit 753, Meyer Rebuttal, page 18.

Diana M. Vuylsteke, # 42419
211 N. Broadway, Suite 3600
St. Louis, Missouri 63102
Telephone: (314) 259-2543
Facsimile: (314) 259-2020
Email: dmvuylsteke@bryancave.com

Attorneys for the
Missouri Industrial Energy Consumers

CERTIFICATE OF SERVICE

I do hereby certify that a true and correct copy of the foregoing document has been emailed this 9th day of January, 2018, to all counsel of record.

/s/ Lewis Mills