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**

POST-HEARING REPLY BRIEF OF STAFF

Kevin A. Thompson
Chief Staff Counsel
Missouri Bar No. 36288

Jeffrey A. Keevil
Senior Staff Counsel
Missouri Bar No. 33825

Akayla J. Jones
Legal Counsel
Missouri Bar No. 64941

Attorneys for the Staff of the
Missouri Public Service Commission
P. O. Box 360
Jefferson City, MO 65102

** **Denotes Highly Confidential Information** **

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INTRODUCTION

In their initial post-hearing briefs, other parties to this case – particularly Liberty Utilities (Midstates Natural Gas) Corp. d/b/a Liberty Utilities ("Liberty," "Liberty Utilities," or "Company") and Noranda Aluminum, Inc. ("Noranda") – have made arguments on certain issues to which Staff is replying in this brief. However, that Staff may not address any particular statement or matter contained in the initial briefs of any other party (including Liberty and Noranda) should not be construed as agreement or acquiescence by Staff, unless Staff explicitly states its agreement or acquiescence. Furthermore, unless Staff explicitly states otherwise, the initial briefs of the other parties have not caused Staff to deviate from the positions and recommendations it presented to the Commission in its initial brief on any issue, and Staff continues to urge the Commission to adopt Staff's positions and recommendations on the issues presented for the Commission's determination during the evidentiary hearing in this case for the reasons set forth in detail in both this and Staff's initial brief.

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ARGUMENT

1. Cost of Capital / Rate of Return:

Introduction

SUMMARY OF RECOMMENDATIONS			
CAPITAL STRUCTURE:			
Witness	**Party**	**Equity**	**Debt**
Hevert	Liberty	**58.34%**[1]	**41.66%**[2]
Marevangepo	Staff	* *	* *
COST OF DEBT:			
Hevert	Liberty	**4.50%**[5]	
Marevangepo	Staff	* *	
COST OF EQUITY:			
Hevert	Liberty	**10.0 to 10.5, 10.50**[7]	
Marevangepo	Staff	**8.20 to 9.20, 8.70**[8]	
Table 1.			

At issue in this case are the capital structure, the cost of debt and the cost of equity; that is, everything in the rate of return area. Table 1, above, sets out the positions of the parties on these three issues. The rate-of-return issues concern the profit margin that the Commission must allow to the private owners of the assets that Liberty uses to serve the public.[9] This profit margin is Liberty's *Weighted Average Cost*

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[1] Ex. 5, *Hevert Direct,* pp. 44-49.
[2] *Id.*
[3] Ex. 13, *Staff's Cost of Service Report,* p. 7.
[4] *Id.*
[5] Ex. 5, pp. 44-49.
[6] Ex. 31, *Marevangepo Rebuttal,* pp. 2-3, 6.
[7] Ex. 5, pp. 44-49.
[8] Ex. 13, p. 7.
[9] ***St. ex rel. Missouri Public Service Co. v. Fraas,*** 627 S.W.2d 882, 886 (Mo. App., W.D. 1981): "There can be no argument but that the Company and its stockholders have a constitutional right to a fair and reasonable return upon their investment. That right carries as a corollary the duty by the Commission to consider all relevant factors including the effects of inflation."

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of Capital ("WACC"), calculated by multiplying the quantity of each element of the capital structure by its cost and summing the results.[10] Generally, the relative quantity of equity and debt and the cost of the latter are a matter of record and only the cost of equity remains as a contentious issue, to be determined by the Commission based on the conflicting testimony of expert financial analysts. However, there are times when it is not appropriate to use a utility's actual capital structure and cost of debt for ratemaking purposes. This is one of those times.

<u>Capital Structure and Cost of Debt</u>

The Missouri Court of Appeals for the Western District has remarked that "[i]t appears to be an accepted regulatory practice to disregard the actual book capital structure of a utility when it is deemed to be in the public interest to do so."[11] The Court explained that there are two circumstances in which it is appropriate for the Commission to use a hypothetical capital structure.[12] First, "when the utility's actual debt-equity ratio is deemed inefficient and unreasonable because it contains too much equity and not enough debt, necessitating an inflated rate of return."[13]

> The second circumstance that justifies adopting a hypothetical construct occurs when the utility is part of a holding company system. In such situations, the utility's book capital structure and capital costs may not be a true reflection of the system's capital costs with respect to a particular operating company. Double leveraging represents one approach utilized by regulatory agencies to account for a utility's status as a subsidiary in a holding company system. Moreover, it is only the parent's alleged use of its low cost debt to purchase stock in its subsidiary that serves as the principle behind the application of double leveraging.[14]

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[10] Ex. 13, p. 6.
[11] ***State ex rel. Associated Natural Gas Co. v. Public Service Com'n of Missouri,*** 706 S.W.2d 870, 878 (Mo. App., W.D. 1985).
[12] *Id.*
[13] *Id.*
[14] *Id.,* pp. 878-879.

In the present case, Staff's recommended capital structure is *not* a hypothetical one, but rather is the actual capital structure of Liberty's direct parent, LUCo. Liberty is part of a holding-company system; its book capital structure and capital costs are not a true reflection of the system's capital costs with respect to Liberty; and Staff considers that it is in the public interest to use the parent company's actual capital structure and cost of debt in this case.[15]

Staff recommends that the Commission use LUCo's capital structure and embedded cost of debt for ratemaking purposes because LUCo is the entity that drives Liberty's cost of capital.[16] Liberty itself does not have a credit rating;[17] does not issue equity;[18] does not issue long-term debt; and does not raise its own short-term debt.[19] All of these things occur at the LUCo level or, indeed, at the level of LUCo's parent, APUC.[20] Staff is unable "to verify whether the funds that are ultimately pushed down from APUC, through LUCo, to Liberty Midstates are true equity infusions or simply debt capital invested as equity."[21] "Although Liberty Midstates has been assigned debt and equity, its capital structure is not market tested and is not relied on by investors in determining a required return because there are no direct investments, debt or equity, in

[15] Based on the information presented by Algonquin Power & Utilities Corporation's (APUC) Chief Executive Officer – Ian Robertson during meetings in the acquisition case (GM-2012-0037) and also confirmed by the Company's response to Staff's Data Request No. 0177.2 in this rate case, LUCo issues long-term debt to debt investors and equity to its parent company (APUC); and then allocates portions of this capital to the operations that need capital at the time. Thus, Liberty Midstates' capital structure is defined as an allocated capital structure. Ex. 31, p. 4.
[16] Ex. 13, pp. 18-19.
[17] *Id.,* p. 16.
[18] *Id.,* pp. 18, 19.
[19] *Id.,* p. 19.
[20] *Id.*
[21] *Id.* This is the "double leveraging" issue discussed by the Court in ***Associated Natural Gas,*** *supra.* Staff notes (Ex. 13, p.20) that it "did not audit all of the equity infusions APUC made into LUCo to determine whether these funds were raised through debt or equity capital issuances by APUC."

Liberty Midstates.[22] Consequently, Liberty's capital structure is irrelevant to the cost of capital required by investors.[23] Since Liberty's capital structure and cost of debt are fictitious and irrelevant to investors, it is simply not appropriate to use them for ratemaking, particularly since doing so would cost the ratepayers more money.

Liberty argues that the Commission should use its purported "actual" capital structure and cost of debt for ratemaking purposes. Liberty asserts that these, at * * equity and * * debt, * * cost of debt, are "highly consistent" with the average values for the proxy groups used by both experts.[24] For example, Liberty asserts that Staff's proxy group had equity ratios ranging from 48.97% to 68.49% and debt ratios ranging from 51.03% to 31.51%[25] and that "Liberty's actual equity ratio of 58.34% is also highly consistent with the 57.00% equity ratio Staff notes for Liberty's ultimate parent, APUC, which is the source of both LUCo and Liberty equity and the ultimate driver of their credit ratings."[26]

Liberty just doesn't get it. Staff recommends that the Commission use LUCo's capital structure and cost of debt because (1) it is LUCo that drives Liberty's cost of capital, because (2) it will relieve any lingering concerns about double leveraging, and (3) because LUCo's capital structure is managed based on the business risk of its regulated utility assets. As the Western District Court of Appeals pointed out, these are appropriate reasons to use a capital structure other than the actual capital structure of the subject utility.[27]

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[22] *Id.,* p. 20.
[23] *Id.,* p. 19.
[24] *Liberty's Initial Brief*, p. 7.
[25] *Id.,* pp. 6-7.
[26] *Id.,* p. 8.
[27] ***Associated Natural Gas,*** *supra.*

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Why is double leveraging bad? To recapitulate, double leveraging refers to a scheme whereby debt capital acquired at the parent level is infused into the operating company's capital structure as equity. Since equity gets a higher return than debt, the return realized on this purported equity covers the cost of the associated debt and yields a tidy profit. To put it bluntly, it is a way to loot the captive ratepayers. While Staff has no facts indicating double leveraging in the present case, the use of LUCo's capital structure for ratemaking rather than Liberty's makes the issue irrelevant.

The Commission has routinely used the parent company capital structure and cost of debt in situations in which the subsidiary utility is not viewed by investors as a separate and investable entity. In Case No. GR-2009-0355, the Commission used the capital structure of Southern Union Company for ratemaking because its Missouri operating division, Missouri Gas Energy ("MGE"), did not have a credit rating; did not issue debt; and relied on Southern Union for its capital needs. Additionally, MGE's capital costs were based on Southern Union's consolidated risk profile and MGE's ability to attract capital was based on Southern Union's capital structure and cash flow metrics. This case is closely analogous to the present case.

Liberty is a wholly-owned operating subsidiary of LUCo and its capital structure is an accounting fiction; it is not an accurate reflection of how debt and equity capital are actually used to fund its operations. "Based on the understanding of this internal allocation process, Staff views Liberty Midstates' capital structure as a mere internally assigned capital structure that has no bearing on the cost of capital for Liberty Midstates."[28] LUCo issues debt and provides debt capital to Liberty. APUC issues equity and provides equity capital to LUCo and, ultimately, to Liberty. LUCo's capital

[28] Ex. 32, p. 2.

structure and cost of debt are therefore the most appropriate to use for ratemaking purposes. Liberty's capital structure, by contrast, "has no bearing on the cost of capital required by investors."[29]

What about the cost of debt? Liberty does not issue debt.[30] LUCo issues debt, through a financing subsidiary, and passes the debt capital out to its operating subsidiaries as needed.[31] Therefore, **it is actually Liberty that is advocating that the Commission use a hypothetical cost of debt.** Liberty has no debt; it is LUCo that issues the debt. "Staff understands that the debt and debt cost reported on Liberty Midstates' books are products of the debt allocation process performed by LUCo for all its United States operations."[32] That is to say, it is an **assigned** debt cost, *not* an **actual** debt cost. "Consequently, this debt cost does not capture the dynamic nature associated with LUCo's centralized management of its capital structure and its corresponding debt costs."[33]

The use of the appropriate ratemaking capital structure is important because, in a holding company system, the capital structure of an operating subsidiary is susceptible to manipulation in order to extract greater profits from captive customers. Using LUCo's actual capital structure and cost of debt, as advocated by Staff, avoids three types of impermissible manipulations: the disguising of debt capital as higher-priced equity capital (double leveraging); management's subjective assignment of capital based on its internal accounting; and the substitution of an assigned cost of debt for the actual cost of debt.

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[29] *Id.*
[30] Ex. 13, p. 18.
[31] *Id.,* p. 19.
[32] *Id.,* p. 21.
[33] *Id.*

Return on Equity

Liberty is not a bit happy with Staff's return on equity ("ROE") recommendation, which it calls "stunningly low" and a "drastic outcome."[34] Liberty devotes sixteen pages of its brief to (1) how very extensive Mr. Hevert's qualifications are compared to those of Mr. Marevangepo and (2) how very low Staff's analytical results and recommendation are compared to theirs.[35] Again, Liberty just doesn't get it.

Turning first to Liberty's wholly unnecessary *ad hominem* attack on Mr. Marevangepo, Liberty fails to acknowledge in its brief that, in addition to his academic training, Staff's expert has received, by competitive examination, the coveted designation of Certified Rate of Return Analyst ("CRRA") awarded by the Society of Utility and Regulatory Financial Analysts ("SURFA").[36] While Mr. Marevangepo is not as old as Mr. Hevert and does not have as much experience, he is fully qualified to provide expert financial analysis in this case. He has contributed to an impressive list of cases since he joined the Commission Staff.[37]

Why should the Commission disregard Mr. Hevert's ROR recommendation? First, because general economic conditions do not support the sort of exorbitant return on equity that he recommends. Debt capital remains cheap.[38] And, as Mr. Marevangepo points out, "lower cost of debt is indicative of lower cost of capital, all else

[34] *Id.,* pp. 7 and 14.
[35] Liberty emphasizes that Staff's range of 8.20% to 9.20%, MP 8.70%, is lower than any rate of return authorized by a regulatory agency in more than 34 years. *Liberty Initial Brief,* pp. 14, 15, 22.
[36] Ex. 14, p. 22.
[37] *Id.,* pp. 23-24.
[38] Ex. 13, p. 12: "On August 13, 2013, Laclede Gas Company issued $450 million of first mortgage bonds 3.34 percent (average) debt series ($100 million 5-year term 2.00 percent series debt, $250 million 10-year term 3.40 percent series debt and $100 million 30-year term 4.625 percent series debt) compared with Laclede Gas Company's 6.5 percent $25 million first mortgage bonds paid at maturity on October 15, 2012. On August 19, 2013, Northwest Natural Gas Company issued 3.542 percent $50 million first mortgage bonds with a 10-year maturity. Another example is AGL Resources, which issued $500 million in 30-year senior notes with a fixed interest rate of 4.4 percent on May 16, 2013."

being equal."[39] Last March, the average spread between 30-year T-bonds and average utility bond yields was 42 basis points below the average of such yields displayed in the period since 1980.[40] Utility bond yields remain at levels not experienced since the 1960s.[41] Conversely, utility stock prices have risen, outperforming the broader market through the first half of 2013.[42] Investors have shown that they continue to value dividend-paying stocks, such as utility stocks, over growth stocks.[43] While Staff's natural gas proxy group lagged behind the S&P 500 for the twelve months ended March 31, 2014, the returns were still well above expected earnings growth, demonstrating that investors do not presently require a very high return to invest in gas utility companies.[44] In other words, investors want gas utility stocks right now, making the cost of equity capital low. Given that the whole point of ROE expert analysis is to divine the return required by investors, the Commission should keep this point firmly in mind.

Second, the constitutionally-based principle of the commensurate return does not support the sort of exorbitant return on equity sought by Liberty. A review of the range of ROEs developed by the Constant Growth DCF for Staff's proxy group, 6.57% to 9.49% (Table 2), reveals that Staff's recommended ROE range for Liberty of 8.20% to 9.20% **is well-within the proxy group results.[45]** On the other hand, all of Mr. Hevert's proposed range, 10.0% to 10.5%, is *significantly above* the range of proxy group ROEs. The guiding principles announced by the United States Supreme Court in ***Hope*** and

[39] *Id.,* p. 13.
[40] *Id.*
[41] *Id.*
[42] *Id.,* pp. 13-14.
[43] *Id.,* p. 13.
[44] *Id.,* p. 15.
[45] The top of Staff's range, 9.20%, is 29 basis points below the top of the proxy company range (9.49%), while the bottom of Staff's range, 8.20%, is 163 basis points above the bottom of the proxy company range (6.57%).

Bluefield require a result *within* the range of proxy group results; that is, not lower than 6.57% and not higher than 9.49%.[46] Just as the Due Process Clause is violated by an ROE award that is lower than those of companies with comparable risks, so too it is violated by an award that is higher.[47]

RANGE OF PROXY COMPANY DCF RESULTS[48]

Company	Projected Dividend Yield	Growth Rate	Return on Equity
AGL Resources	4.04%	4.0% - 5.0%	8.04% - 9.04%
Atmos Energy	3.23%	4.0% - 5.0%	7.23% - 8.23%
Laclede Group	3.93%	4.0% - 5.0%	7.93% - 8.93%
New Jersey Resources	3.74%	4.0% - 5.0%	7.74% - 8.74%
Northwest Nat. Gas	4.36%	4.0% - 5.0%	8.36% - 9.36%
Piedmont Nat. Gas	3.76%	4.0% - 5.0%	7.76% - 8.76%
Southwest Gas	2.57%	4.0% - 5.0%	6.57% - 7.57%
WGL Holdings	4.49%	4.0% - 5.0%	8.49% - 9.49%
Average for Proxy Group:	3.80%	4.0% - 5.0%	7.80% - 8.80%

Table 2.

In his rebuttal testimony, Mr. Hevert commented on Mr. Marevangepo's DCF results: "As a preliminary matter, I note that Mr. Marevangepo's analysis produces DCF results ranging from 7.80 percent to 8.80 percent. I strongly disagree that a DCF result as low as 7.80 percent is relevant in determining the Company's Cost of Equity."[49] And yet, the low end of Mr. Marevangepo's DCF results are well within the range of ROEs calculated for Staff's proxy group (Table 2): 7.80% is 123 basis points *above* the low end of the ROE range calculated for Staff's proxy group. Mr. Hevert's comment

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[46] ***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).

[47] A public utility shareholder "has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures." ***Bluefield,*** *supra,* 262 U.S. at 692-93, 43 S.Ct. at 679, 67 L.Ed. at 1182-1183.

[48] Ex. 15, Sch. 11. The Projected Dividend Yield found on that schedule for each of Staff's proxy companies was added to Staff's Growth Rate to produce the ROE for each proxy company.

[49] Ex. 6, p. 11.

exposes how entirely unreliable his expert testimony actually is.[50] Mr. Hevert went on to note, "[n]ot only is Mr. Marevangepo's highest DCF result 89 basis points below the average authorized ROE for natural gas utilities since the beginning of 2013, there has not been a single case in which an ROE as low as 8.80 percent (the high end of Mr. Marevangepo's range) was authorized for a gas utility since at least 1980." But why did Mr. Hevert compare Mr. Marevangepo's results to authorized ROEs rather than to ROEs calculated using the DCF analysis? Simple – because an apples-to-apples comparison, such as Staff presented with Table 2, would have confirmed Staff's results, which is not the outcome Mr. Hevert wanted. All of Mr. Hevert's testimony is flawed in this way and should be disregarded.

Third, Mr. Hevert's inflated results were obtained, as is usual in these cases, by blatant manipulation of the growth rates that he used. Mr. Marevangepo testified that the "main driver" of Mr. Hevert's recommended ROE is his "inflated and unrealistic" perpetual GDP growth rate of 5.71%.[51]

COMPARATIVE GROWTH RATES		
	Marevangepo	**Hevert**
Quarterly DCF	--	5.34[52]
Constant DCF	4.0-5.0[53]	5.34[54]
3rd Stage	--	5.71[55]
Table 3.		

Table 3 sets out the growth rates used by Mr. Marevangepo and by Mr. Hevert. Since all of the growth rates used by Mr. Hevert are *higher* than those used by Mr.

[50] *Id*.
[51] Ex. 32, p. 16.
[52] Ex. 31, p. 11.
[53] Ex. 13, p. 31.
[54] Ex. 31, p. 11.
[55] *Id.,* p. 12.

Marevangepo, it follows that the results of any analyses using growth rates would be higher for Mr. Hevert than for Mr. Marevangepo. Growth rates are used in the various species of the DCF analysis. Mr. Marevangepo relied on the Constant Growth DCF analysis, in which a growth rate *extending to perpetuity* is added to the dividend yield.[56] Given that natural gas is a finite resource that, despite its present resurgence due to new recovery technologies, will one day run out, there is a logical limit on the perpetual growth that can be expected of a natural gas distribution utility. Certainly, demand for natural gas is experiencing strong growth *today,* but where will it be in 100 years? A growth rate reflective of *all* future expected growth can sensibly be no more than that expected of the national economy as a whole; and that is the growth rate that Mr. Marevangepo used.

Also, as this Commission is keenly aware, it has been the intent of the gas distribution industry through rate decoupling mechanisms to remove the effect that a growth in natural gas consumption may have on the earnings of LDCs, including Liberty. Liberty has not offered any evidence in this case that it is experiencing customer growth at the lofty growth rates offered by Mr. Hevert. If Liberty did have this sort of exceptionally high growth, it likely would not have had to seek for a rate increase from its current captive customers.

A growth rate reflective of *all* future expected growth is sensibly no more than that expected of the national economy as a whole, and that is the growth rate that Mr. Marevangepo used. In fact, Mr. Hevert actually agrees with Mr. Marevangepo on this point, stating in his rebuttal testimony, ". . . I agree that it is reasonable to assume that gas distribution utilities' earnings will generally grow at the same rate as GDP over the

[56] Ex. 13, p. 24.

long-term . . . ."[57] Nonetheless, Mr. Hevert used excessive growth rates, even in his Constant Growth and Quarterly Growth DCF analyses, which require *perpetual growth rates,* in order to emphasize near-term earnings growth and thereby support a high ROE.[58]

Mr. Hevert, for all his experience and impressive-looking analyses, has clearly abandoned the task that expert financial analysts are supposed to perform in a rate case. That task, quite simply, is to determine the return on equity required by equity investors.[59] Rather, Mr. Hevert – who works exclusively for utilities seeking the highest ROE award they can get – always finds a way to produce a high recommendation; which is, after all, what his clients require.

Mr. Hevert emphasizes the ROEs recently awarded by other utility regulatory commissions ("PUC's") to other utilities in other states. Likewise, Liberty argues in its *Initial Brief* that the Commission should use these awards as benchmarks in setting Liberty's ROE. There is a fallacy and a danger in that practice, however, that Liberty is careful not to mention. It assumes relevance where no relevance has been demonstrated -- that the ROE awarded in another state by another PUC to an unfamiliar company on the basis of utterly unknown evidence somehow provides a useful guide to this Commission in its understanding of the evidence presented in this case.

Another problem inherent in the practice of benchmarking recommended by Liberty is circularity. If all of the PUCs are setting ROEs in consideration of what other states are doing, then awarded ROEs will not reflect the utility's actual cost of capital,

[57] Ex. 6, p. 12.
[58] Mr. Hevert explained, "it is my view that forward-looking earnings growth estimates are the relevant measure of growth." *Id.*
[59] Ex. 32, p. 14.

but rather trends in administrative decision-making. It is for this reason that awarded ROEs have not been very volatile, despite the great volatility of the capital markets since 2007.

> Allowed ROEs, as authorized by commissions, [are] just one component of the aggregate revenue requirement used by investors to model cash flows to determine the intrinsic value of the regulated utility assets. Hence, the higher the authorized ROE, the greater the chance that the book value ROE will be higher that the market required return, i.e. the cost of equity. Again, using an average of historical allowed ROEs as a benchmark of what the commissions are likely to authorize in the future is an ex-post approach that seeks to hold everything else equal and assume that utilities are entitled to continue to receive such regulatory support for reasons not related to the cost of capital.[60]

In conclusion, Staff urges the Commission to set Liberty's ROE pursuant to the guidelines announced by the United States Supreme Court in ***Hope*** and ***Bluefield.*** Those guidelines require thoughtful consideration of the current state of the capital markets and the analyses provided by the experts. The fact is that the cost of both debt and equity capital is low for utilities at the present time. That reality is accurately reflected by the recommendations of Staff's expert witness, Zephaniah Marevangepo.

2. Contract Customers:

Reply to Liberty[61]

As expected, Liberty's primary argument in support of the discounted rates contained in its special contracts with Noranda and General Mills is based on the stipulation and agreement in Case No. GR-2010-0192. As stated in Staff's initial brief, paragraph 7 of the stipulation and agreement in Case No. GR-2010-0192 provided that:

[60] Ex. 32, p. 14.
[61] See also last paragraph under Reply to Noranda.

> The Signatories agree that revenues associated with special contracts shall not be imputed in this case. The Signatories agree that Atmos[62] 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.[63]

Liberty's brief focuses on the third sentence of the foregoing paragraph, but pays far less attention to the last sentence *which specifically permits renegotiation* of the special contracts. Liberty also puts little focus on the fact that *authorization for the contracts expires as of the effective date of rates approved in this rate case*, pursuant to the second sentence of the foregoing paragraph. Since the authority for the contracts expires with this rate case, Liberty knew (or should have known) that they needed to have new contracts in place at least by the effective date of rates approved in this case.

In fact, Liberty did sign a new contract with Noranda during the course of this case. **

[64]

[62] Atmos was Liberty's predecessor.
[63] Ex. 13 HC, Staff Revenue Requirement Cost of Service Report, p. 54, lines 3-12; Ex. 23 HC, Cox Surrebuttal, Schedule KC-1.
[64] Ex. 3 HC, Krygier Rebuttal, Schedule CDK-R6 HC Exhibit "A" and Ex. 2 HC, Krygier Direct, Schedule CDK-4 HC Exhibit "A".

** The Commission should also keep in mind, as stated in Staff's initial brief, that the purpose of this case is to set rates going forward. The Commission is not bound by the actual test year revenues (*i.e.,* not bound to use the contract rates for purposes of determining revenues in this case) and can make the necessary adjustments related to the special contracts for purposes of setting rates going forward.

Liberty's brief makes passing reference to what it refers to as Noranda's and General Mills' "capability to bypass;" however, it does not refer to any evidence in the record that the special contracts were necessary to avoid *imminent* bypass, because there is no such evidence. Furthermore, it should be remembered that Noranda is, at a minimum, several miles from the nearest interstate pipeline, making imminent bypass unlikely.[65]

While Liberty did a fine job at the hearing of confusing the contract customer issue, the Commission should not allow confusion to substitute as evidence. Despite any implication by Liberty to the contrary, as the party seeking the rate increase it is

[65] Ex. 30 HC, Imhoff Surrebuttal, p. 1 lines 22-23.

Liberty – not Staff – that bears the burden of proof to show that its proposed increased rate is just and reasonable.[66] It is Liberty – not Staff – that is "required to show by full, complete, substantial and competent evidence that the [special contract] arrangement 1) was necessary to avoid imminent bypass, [and] 2) recovers variable costs plus a reasonable contribution to fixed costs."[67] Liberty has not done so, and its initial brief does not prove otherwise.

Beginning on page 48 of its initial brief, Liberty refers quite "briefly" to testimony of Robert Hevert regarding the alleged financial impact of what Liberty refers to as "Staff's revenue imputation adjustments." Mr. Hevert's argument on this point can be summarized, or paraphrased, as follows: If Staff's proposed "adjustments" are adopted by the Commission, the Company will not receive as much of a rate increase as the Company claims it should receive and therefore will not make as much money as it claims it is entitled to make which would be a negative financial impact – at least from the Company's perspective. However, this is true of any adjustment which goes against[68] a utility company in any rate case; that is the nature of adjustments. There is nothing inherently unique about the proposed contract customer adjustments which would cause these adjustments to have more "financial impact" than any other adjustments. Also, as discussed above and in even greater detail in Staff's initial brief, the Commission should remember that ** ______________________________

[66] See *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.
[67] *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)].
[68] The Commission should keep in mind that some adjustments go against the company and some adjustments work in the company's favor.

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Regarding the SourceGas contract, on page 47 of its initial brief Liberty claims that it **

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__________ **[69] (emphasis added)

On page 46 of its initial brief Liberty touts that it was "successful in negotiating a rate that is ** __________ ** than charged by Atmos [to SourceGas]." However, as stated in Staff's initial brief, ** ____

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____ [70] __________

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[69] *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. and, in Connection Therewith, Certain Other Related Transactions*, Order Approving Unanimous Stipulation and Agreement, Exhibit A, issued March 14, 2012.
[70] Tr. Vol. 14 HC, p. 490 lines 17-22.
[71] Ex. 39 HC, Sommerer Surrebuttal, p. 4 lines 12-22.

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Reply to Noranda

Not surprisingly, Noranda's initial brief relies heavily on Mr. Brubaker's purported "cost of service analysis." However, as Commissioner Hall correctly noted during the evidentiary hearing, Staff's witness Mr. Imhoff has "a number of concerns about [Mr. Brubaker's] analysis"[72] and there are a lot of other variables in a proper class cost of service study other than the few mentioned by Mr. Brubaker.[73] As one example of these concerns, as stated in Mr. Imhoff's written testimony, Mr. Brubaker relied on a study performed in Atmos' rate case GR-2006-0387 which had a test year ending September 30, 2005, with an update period of June 30, 2006 – in other words, the data was stale and based on costs of Atmos.[74] Staff was unable to perform a class cost of service study in this case due to a lack of data in Liberty's possession, and Liberty did not perform a class cost of service study either.[75] Therefore, the information relied on by Mr. Brubaker does not include accurate data that Liberty (or Atmos) needed to provide.[76] By not having a reliable, complete class cost of service study, no intra-class study such as that purportedly performed by Mr. Brubaker can be performed with any degree of reliability.[77] It is also interesting that Mr. Brubaker contends that Noranda is only responsible for ** ___________ ** out of the approximately $10.8 million of revenue requirement cost of service for Liberty's SEMO district, yet Noranda accounted for approximately ** ______ ** of the total throughput in the SEMO district.[78] For these reasons, not only should Mr. Brubaker's alleged "cost of service analysis" be rejected,

[72] Tr. Vol. 13, p. 438, lines 9-10. *See also* Tr. Vol. 13, pp. 437-440.
[73] Tr. Vol. 13, p. 439 line 22 through p. 440 line 3.
[74] Ex. 30 HC, Imhoff Surrebuttal, p. 2 lines 15-19.
[75] *Id.* at p. 2 line 20 through p. 3 line 3.
[76] *Id.* at p. 3 lines 3-4.
[77] *Id.* at p. 3 lines 4-7.
[78] See *Id.* at p. 2 lines 10-14.

but Noranda's alternative suggestion in its initial brief that the Commission develop a new customer class consisting solely of Noranda should also be rejected without a complete, company-wide class cost of service study based on reliable, current data.

Noranda's statement in its initial brief that it "purchases interruptible transportation service" is somewhat misleading. ** ______________________

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In referring to the previous Atmos rate case on page 3 of its initial brief Noranda states that the Commission has already determined the contract rate was "just and reasonable." Liberty makes a similar argument on page 36 of its initial brief. As discussed in much greater detail in Staff's initial brief, the treatment of the revenues associated with the special contracts in the prior Atmos case was specifically limited to *that case*, pursuant to the stipulation in that case. However, even apart from the plain language of the stipulation in that case, if the argument of Noranda and Liberty was taken to its logical conclusion Liberty could never change its rates from those determined to be "just and reasonable" in the prior Atmos case. This is because the

[79] Ex. 60 HC, Noranda response to data request number 7.
[80] Ex. 55 HC, Liberty response to data request number 276.
[81] Ex. 60 HC, Noranda response to data request number 9.

Commission found *all* the resulting rates to be just and reasonable in that case – as it does in every rate case decision – as part of a settlement of multiple issues, not only the special contract rates. Obviously, Liberty does not believe it is bound to the old Atmos rates forever or it would not have filed a rate case.

Contract Customers Conclusion

For the reasons set forth herein and in Staff's initial brief, the Commission should adopt Staff's position on each issue and sub-issue set forth on the *List of Issues* under the Contract Customers issue.

3. Depreciation:

Reply to Liberty

The two main arguments Liberty Utilities makes with respect to the depreciation rate assigned to the disputed accounts is that (1) Staff and the Company have used the 14.29% and 18.89% rate in the last two Atmos rate cases, and as such, those rates should be ordered in this case; and that (2) twenty-one years (4.75%), the rate recommended by Staff, is an unrealistically long useful life for network and PC hardware and software assets.

Liberty Utilities has emphasized, either on the stand, or in testimony that they have continued to the use the rates that they utilized in the two prior Atmos rate cases, and stated that Staff has utilized those rates as well.[82] In the last rate case for Atmos in 2010, Staff's audit was performed by a contracted outside auditor under Staff's supervision. Staff did utilize the 14.29% depreciation rate for system and network hardware and software, and the 18.98% depreciation rate for personal computer

[82] Tr. Vol. 13, pp. 571-572, lines 21-1.

hardware and software in the calculation of its revenue requirement in the 2010 Atmos rate case, however, these rates were only used in the workpapers for Staff and it is unclear whether the auditor knew that a few of the rates had not officially been authorized by the Commission. Despite this, and as was explained by Mr. Fallert on the stand, in order for depreciation rates to be used by a Company they must not only be utilized by the parties in preparation of their cases, but ultimately authorized by the Commission in a Report and Order.[83] The 14.29% and 18.98% rates were never ordered by the Commission.[84] The 2010 rate case was stipulated to as part of a "black box" settlement and the Order was silent on not only the depreciation rates for the disputed accounts, but on the issue of depreciation in general.[85]

As part of this case, Staff reviewed the depreciation rates being used by Liberty Utilities. Through discovery, Staff became aware that without Commission authorization the accounting and depreciation records transferred from Atmos to Liberty, as part of the sale, were consolidated into three divisions from the seven that had depreciation rates ordered.[86] As was explained by Staff in its Revenue Requirement Cost of Service Report, this consolidation, without an existing order, is inconsistent with the accounting required to use the ordered depreciation rates.[87] Since records do not exist to segregate the consolidated divisions back into the districts for which ordered depreciation rates exist, Staff recommended accepting the consolidation for depreciation purposes.[88]

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[83] Tr. Vol. 13, p. 564, lines 16-18.
[84] Tr. Vol. 13, pp. 572-573, lines 22-1.
[85] Ex. 36, Robinett Surrebuttal, p. 2-3, lines 4-6.
[86] Ex. 13 HC, Staff Revenue Requirement Cost of Service Report, p. 73, lines 13-19.
[87] *Id.*
[88] *Id.*

As was stated by Mr. Fallert on the stand, prior to the consolidation of the rate districts, the currently ordered depreciation rates for account 399 for the seven rate districts were 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.[89] Since Liberty Utilities chooses to book the its network hardware and software in sub-accounts of account 399[90], then the 399 general plant account depreciation rate should be used to account for the hardware and software. Staff recommends that a rate be ordered of 4.75% to reflect the currently-ordered depreciation rate for the former Butler and Kirksville districts since this is the common rate for all three current Liberty Utility rate districts. Staff's purpose in supplementing the existing schedule JAR(DEP)-1 that listed the current depreciation rates ordered for each general plant account was simply to provide to the Commission a schedule that reflected Staff's recommendation for the corporate allocated accounts in dispute as well.

Liberty Utilities argues that twenty-one years (4.75%) is an unrealistically long useful life for hardware and software assets.[91] It was emphasized by Company counsel during opening statements that cell phones and computers become obsolete and outdated only after a few years.[92] While that may be true for particular assets due to technological innovation and increase customer demand for the "latest craze", utility system network hardware and software, more specifically main frames (account 399.3), have the ability to last for a substantial amount of time. In fact, the hardware and software that Laclede used before implementation of its new enterprise information

[89] Tr. Vol. 13, p. 566, lines 19-23.
[90] Tr. Vol. 13, p. 563, lines 8-11.
[91] Tr. Vol. 13, p. 572, lines 7-10.
[92] Tr. Vol. 13, p. 596, lines 8-16.

management computer system (EIMS) was up to thirty years old before being replaced. In the Laclede case, Staff concluded that the useful life of the EIMS was in the range of fifteen to twenty years which is significantly longer than the seven year expected use life recommended by Liberty Utilities for a similar asset.[93]

The total of the network hardware and software that Liberty Utilities implemented is about 16 million at the Midstates level, with roughly 10 million (65%) allocated down to Missouri.[94] Staff believes that it is highly unrealistic for Liberty Utilities to assume that an investment of this magnitude would last less than ten years. It is far more reasonable to assume that the assets useful life would be significantly longer than what the Company is recommending be approved. Finally, it must be noted that the reasonableness of the 4.75% rate that Staff is recommending can be evaluated in the context of the Company's next depreciation study.

Absent a depreciation study being performed to determine what rates are most appropriate for each account, Staff recommends that the Commission order a rate of 4.75% for corporate allocated plant accounts 399.1, 399.3, 399.4 and 399.5 under general plant account 399 because the current Commission order provides strong evidence that this rate is not only appropriate but reasonable.

CONCLUSION

WHEREFORE, Staff continues to request the Commission to adopt the Staff's position on each of the contested issues presented for the Commission's determination

[93] GO-2012-0363, *In the Matter of Laclede Gas Company's Application to Establish Depreciation Rates for Enterprise Computer Software Systems*, Ex. 5, Surrebuttal Testimony of John Robinett, p. 2, lines 11-12.
[94] Tr. Vol. 13, pp. 557-558, lines 19-2.

during the evidentiary hearing in this case for the reasons set forth in detail in both this and Staff's initial brief.

Respectfully submitted,

STAFF OF THE MISSOURI PUBLIC SERVICE COMMISSION

/s/ Jeffrey A. Keevil
Jeffrey A. Keevil
Senior Staff Counsel
Missouri Bar No. 33825

Kevin A. Thompson
Chief Staff Counsel
Missouri Bar No. 36288

Akayla J. Jones
Legal Counsel
Missouri Bar No. 64941

Attorneys for the Staff of the
Missouri Public Service Commission
P. O. Box 360
Jefferson City, MO 65102
(573) 526-4887 (Telephone)
(573) 751-9285 (Fax)
jeff.keevil@psc.mo.gov

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 31st day of October 2014.

/s/ Jeffrey A. Keevil