BEFORE THE PUBLIC SERVICE COMMISSION
STATE OF MISSOURI

In the Matter of Missouri Gas Energy's Tariff Sheets Designed to Increase Rates for Gas Service in the Company's Missouri Service Area	))))	Case No. GR-2009-0355

MISSOURI GAS ENERGY'S APPLICATION FOR REHEARING

COMES NOW Southern Union Company ("Southern Union") d/b/a Missouri Gas Energy ("MGE"), a division of Southern Union, by and through the undersigned counsel, pursuant to RSMo §386.500, 4 CSR 240-2.080, and 4 CSR 240-2.160, and for its Application for Rehearing respectfully states as follows to the Public Service Commission of the State of Missouri (the "Commission"):

1. On February 10, 2010, the Commission issued its Report and Order in the above-captioned case, to be effective February 20, 2010 (the "Order").

COST OF CAPITAL

2. At page 7 of the Order, the Commission states its conclusion of law that it must set just and reasonable rates, meaning that the Commission must set a rate "that is fair to both the utility and its customers" and that will "insure to the investors a reasonable return upon funds invested." Despite this conclusion of law, as a result of the Commission's findings and conclusions with regard to issues concerning cost of capital, the rates authorized by the Commission in this case for MGE are unlawful, unreasonable, unjust, arbitrary, capricious, and confiscatory, and are not "just and reasonable" as required by law.

The Appropriate Capital Structure

3. The cost of capital issues in this case concern the appropriate capital structure to be utilized by the Commission in setting rates for MGE as well as the cost of the various

components of that capital structure. Underlying this is the requirement that MGE be given an opportunity to earn a fair return. MGE has no discretely identifiable capital structure of its own and is a division of Southern Union, a corporation with diverse interests that is now considered primarily a "natural gas transmission company." Accordingly, an appropriate capital structure must be calculated in the setting of MGE's rates to ensure that MGE is not judged by the capital structures of other, differing enterprises or ventures that have significantly different risk characteristics, but rather is judged on the capital structures of companies comparable to MGE.

4. Southern Union, with a 38.66% common equity ratio, has a capital structure with greater financial risk than is representative of the risk reflected in a capital structure of a typical local gas distribution company ("LDC") such as MGE. Southern Union's existing diversified businesses preclude the treatment of its capital structure as an appropriate proxy for MGE. Furthermore, because Southern Union's market prices are not reflective of the risks associated with a LDC such as MGE, Southern Union cannot properly be utilized as the standard for how MGE's rate base should be financed. To satisfy the constitutional mandate that the Commission afford MGE an opportunity to earn a fair return, the Commission is required to view MGE as a stand-alone entity, separate from its relationship to Southern Union.

<u>How to Address the Risk of the Southern Union Capital Structure</u>

5. In the ratemaking process, in accordance with intellectually sound economic practice, the greater risk associated with Southern Union's capital structure could have been addressed by the Commission in this case in essentially one of two ways. First, a risk premium or financial risk adjustment say, for example, in the amount of at least 25 basis points could be added to the return on common equity ("ROE") derived through analysis of a group of proxy companies which, on average, possess a higher common equity ratio than that of Southern

Union. Alternatively, a more balanced, more representative, more conservative hypothetical capital structure could be used instead of Southern Union's actual corporate capital structure. (In this regard, the Public Counsel's cost of capital witness, upon whom the Commission relied, agreed that MGE's proposed capital structure with 48 percent common equity compares "quite favorably" to equity ratios in the natural gas utility industry.)[1] Because the Commission failed to take either of these steps and instead simply utilized Southern Union's corporate capital structure for the purpose of setting MGE's rates in this case, the Commission erred. In this regard, the Order is not based on competent and substantial evidence, is not supported by the record, and does not comply with the mandates established by the courts, particularly the holdings of *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944), and *Bluefield Water Works v. Public Service Commission*, 262 U.S. 679 (1922).

6. At page 12 of the Order, the Commission correctly finds and/or concludes that "a capital structure that includes a high percentage of debt is more risky for shareholders. The shareholders will consequently demand a higher rate of return to compensate them for the increased risk caused by the high level of debt." Despite this statement, the Commission did not authorize a "higher rate of return" but instead, with regard to capital structure found, at pages 14-15, as follows:

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[1] There is an additional conceptual error with the Commission's reliance on the Public Counsel witness regarding capital structure. In violation of the Supreme Court's directive found in *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944), that authorized returns must be "commensurate with returns on investments in other enterprises having corresponding risks," the Public Counsel witness relied upon his proxy group of gas distribution companies in formulating a recommended ROE for MGE, but then failed to rely on this same proxy group with regard to capital structure. Instead, he applied his common equity cost rate derived from his 12 proxy companies – with an average equity ratio of 54.25 percent for 2009 – to the amount of equity in Southern Union's capital structure – 38.66 percent. To compensate for this low equity, intellectually sound economic practice required a financial risk adjustment to this ROE recommendation. The Public Counsel witness failed to do this, in spite of his admissions that an "equity ratio of about 39% is below the gas industry average" and "reflects higher financial risks" for MGE. (Ex. 69, Lawton Dir., p. 49) The financial risk adjustment which the Public Counsel witness and Commission should have made would have increased the required ROE for MGE. (Ex. 14, Hanley Reb., p. 35)

- The Commission finds the testimony of OPC witness Lawton to be the most credible for this issue.
- Actual capital structure is appropriate as long as the utility is still investment grade, which SUG is.
- Using a hypothetical capital structure would allow MGE to recover revenues in excess of costs.
- Using rate base of $609 million, MGE would have a return requirement of $71.4 million under a hypothetical capital structure and $66.6 under actual capital structure.
- Employing MGE's proposed hypothetical capital structure would allow MGE to earn a return on some capital that was financed by debt.
- The difference between the $71.4 million revenue requirement under a hypothetical capital structure and a $66.6 million under an actual capital structure would be added earnings.

Thereafter, at pages 16-17 of the Order, the Commission purports to state its conclusions of law on the issue of capital structure. In reality, however, the Commission simply refers to the mandates of the United States Supreme Court, as stated in *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944), and then ignores those mandates. The Commission states no legitimate conclusions of law on this issue. Instead, the Commission recites its prior decisions on the issue of a proper capital structure for MGE and states that there are two instances when the Commission has the discretion to impose a hypothetical capital structure. At page 17 of the Order, the Commission states its decision that it should use Southern Union's actual capital structure for purposes of setting rates for MGE. The above-stated findings, conclusions, and decision are in error.

The Commission's Order in Case No. GM-2003-0238 Requires the Removal of Panhandle Debt from the Southern Union Capital Structure

7. The use of Southern Union's actual capital structure is also erroneous and unlawful for another compelling reason. That is the fact that Southern Union's capital structure includes the debt (and related cost) of Panhandle Eastern Pipeline Company ("PEPL") and

pursuant to the terms at page 5 of the acquisition Stipulation and Agreement approved by the Commission in Case No. GM-2003-0238, the PEPL debt must be non-recourse to MGE.

8. By way of background, in 2003 Southern Union sought authority from the Commission to acquire PEPL. The matter was resolved by a Stipulation and Agreement, approved by the Commission by Order issued March 27, 2003, which, among other things, contains terms designed to insulate Southern Union's MGE operating division from the PEPL business. That Stipulation and Agreement at page 5 provides:

> **III. Conditions of Approval**
>
> 2. INSULATION OF SOUTHERN UNION'S MGE OPERATING DIVISION FROM PANHANDLE BUSINESS
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> To insulate MGE from the Transaction, Southern Union agrees that:
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> Southern Union Panhandle Corporation ("SUPC") and Successor Entities or any direct or indirect subsidiary of Southern Union that acquires or owns any equity interests in Panhandle, will be owned and operated as a separate subsidiary of Southern Union. Southern Union and MGE will not, directly or indirectly, allow any Panhandle debt to be recourse to them.; pledge Southern Union or MGE equity as collateral or security for the debt of any Panhandle entity; give, transfer, invest, contribute or loan to any Panhandle entity, any equities or cash without Commission approval. . . . (Emphasis added)

There is absolutely no question that the Commission's decision in this case, to utilize the capital structure of Southern Union without removing the PEPL debt and cost, is contrary to and in violation of the Commission's Order in Case No. GM-2003-0238.

The Commission's Decision in this Case is Inconsistent With Prior Rate Orders

9. In addition, the Commission's treatment of the PEPL debt in this case, by including it in the capital structure for ratemaking purposes, is totally inconsistent with the Commission's treatment of this same debt in Case No. GR-2004-0209, Report and Order issued

September 21, 2004. What follows is the Commission's discussion of this issue at pages 15 and 16 of that Report and Order.

> 2. Embedded Cost of Long-Term Debt
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> Issue Description: What is the appropriate cost of long-term debt in calculating MGE's cost of capital?
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> The cost of long-term debt is determined simply by reviewing the interest rates specified in the debt issued by Southern Union. The only issue between the parties concerns which debt should be included in the calculations. MGE and Public Counsel agree that the long-term debt to be counted is the debt of Southern Union <u>excluding the long-term debt associated with Southern Union's Panhandle Eastern subsidiary</u>. Based on that assumption, MGE set the cost of long-term debt, as of April 30, 2004, at 7.4342%. Public Counsel used a cost of long-term debt of 7.397%. The slight difference was attributed to rounding differences in the calculations. Staff, however, includes the debt issued by Panhandle Eastern when calculating Southern Union's cost of long-term debt. As a result, Staff recommends use of a cost of long-term debt of 6.151%.
>
> Panhandle Eastern's debt is the debt of a subsidiary company and is not the debt of Southern Union. That debt was raised by Panhandle Eastern for its own purposes and is rated separately by the rating agencies. Furthermore, that debt is non-recourse to Southern Union. That means that the debt restricts the assets that the debt holders can use to satisfy the debt. In other words, if Panhandle Eastern were to default on its debt, the debt holders would not be able to seize the assets of Southern Union to collect the debt. <u>In addition, a stipulation and agreement entered into by Southern Union, Staff, Public Counsel, and other parties in Case No. GM-2003-0238 – the case in which this Commission approved Southern Union's acquisition of Panhandle Eastern – provides that MGE is to be insulated from the impact of the acquisition of Panhandle Eastern. For all these reasons, the Commission finds that the cost of long-term debt of Panhandle Eastern is properly excluded from the calculation of Southern Union's cost of long-term debt.</u>
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> Since the differences between the cost of long-term debt as calculated by MGE and Public Counsel is simply based on rounding differences, the Commission will split the difference between the two percentages and use 7.4155% as the cost of long-term debt. (Emphasis added)

10. More recently, in Case No. GR-2006-0422, Report and Order issued March 22, 2007, the Commission's decision granting MGE a rate increase was based on a 7.65% embedded cost of long-term debt <u>which excluded the PEPL debt</u>.

Cost of Debt Impact

11. By adjusting the capital structure to remove the PEPL debt and cost (and related Trunkline debt and cost), Southern Union's embedded cost of debt increases from 6.258% to 7.761%[2] and its debt ratio decreases.

12. At page 20 of the Order, the Commission states that based on actual Southern Union costs, the long-term cost of debt for MGE is 6.258% and the short-term cost of debt is 5.92%. These findings and conclusions are the result of the Commission's decision to use the capital structure of Southern Union for ratemaking purposes for MGE without removing the PEPL debt and cost (and related Trunkline debt and cost) as required by the Commission's Order in Case No. GM-2003-0238. As such, the Commission's findings, conclusions, and decisions on the cost of debt issues are in error.

Return on Equity

13. With regard to the authorized ROE, despite its statement at page 12 of the Order concerning the need for a higher return, at pages 27-34 of the Order, the Commission makes the following findings of fact:

- The Commission finds OPC witness Lawton's testimony the most persuasive on this issue.
- Lawton's use of the largest proxy group in this case means that his proxy group is less vulnerable to selection bias and the average derived from his group should more closely approximate the average of the group.
- The result of Mr. Lawton's analysis is . . . a reasonable estimate of MGE's equity costs.
- Mr. Hanley applied an arbitrary adjustment to his Risk Premium Analysis.
- Rather than eliminate this obvious unreliable result, Mr. Hanley simply assigns an arbitrary weighting of 20% and includes 20% of the outlier in his analysis.
- The result is that Mr. Hanley's risk premium analysis is substantially overstated and cannot be relied upon for establishing ROE for MGE.

[2] See Hanley Surrebuttal Schedule FJH-37.

- MGE's analysis cannot be supported as a sound basis for setting just and reasonable rates.
- Mr. Lawton corrected Mr. Hanley's analysis by removing the forecasted returns and the results explain why Mr. Hanley felt the need to apply arbitrary adjustments.
- Without the inflated forecasted returns, Mr. Hanley's DCF analysis yields a 9.2% ROE, his Risk Premium analysis yields a 10.18%, and his CAPM analysis yields a 9-9.5% ROE. The average of these three models is 9.5%, which is consistent with Mr. Lawton's analysis and the analysis performed by Staff witness Murray.
- Using a risk premium of 3.89% based on historical risk premium calculations, instead of Hanley's 4.66% based on a less reliable estimated risk premium calculations, Lawton arrived at an ROE of 10.17%.
- Without the inflated forecasted returns, Mr. Hanley's Risk Premium analysis yields a 10.18% ROE.

Thereafter, at pages 34-37 of the Order, the Commission purports to state its conclusions of law on the ROE issue. Once again, the Commission refers to the court-ordered mandates, ignores those mandates, and states no case-specific conclusions of law on this issue. At page 37 of the Order, the Commission states its decision that the appropriate return on equity is 10 percent. The above-stated findings, conclusions, and decision are in error, taken both separately and/or in conjunction with the Commission's findings, conclusion, and/or decisions on the cost of capital issues.

14. To the extent that the Commission failed to make an upward ROE adjustment to compensate for Southern Union's thin equity ratio and/or did make a downward adjustment to the authorized ROE for the continuation of the Straight Fixed-Variable ("SFV") rate design, because of perceived decrease in risk related to the continuation of said rate design, the Order is unlawful and confiscatory and in violation of *Hope* and *Bluefield.* The relevant analysis in determining whether the continuation of the SFV rate design has an impact on MGE's authorized ROE is not properly derived by looking at MGE's risk with and without the rate design in place, but rather by comparing MGE's risk profile with SFV in place relative to the proxy group of

comparable LDCs, the bulk of which have in place revenue stabilization rate designs akin to SFV.

15. For the above-stated reasons, MGE respectfully submits that with regard to the cost of capital issues the Order is unlawful, unjust, unreasonable, arbitrary, capricious, confiscatory, involves an abuse of discretion, is unsupported by competent and substantial evidence upon the whole record, is in excess of statutory authority, is made upon unlawful procedure, is inadequately explained, and is unconstitutional, all in material matters of fact and law, individually and/or cumulatively.

CARRYING COST RATE APPLICABLE TO ENERGY EFFICIENCY FUNDING PROVIDED BY THE COMPANY

16. In addressing the issue of Energy Efficiency ("EE"), the Commission made the following finding at page 60 of the Order regarding MGE's proposal that the same short-term interest rate determined in the case should be applied to any unspent amounts previously collected in rates on a going-forward basis[3]:

> 152. Ratepayers should be properly compensated when they supply monies to the utility via the regulatory process. The overall cost of capital is the appropriate rate to use when calculating interest on the energy efficiency funds so that all ratepayer supplied funds are treated consistently with all other monies supplied by ratepayers in the regulatory process.

17. It is apparent that the Commission has drawn an equivalency between the unexpended EE funding authorized in the 2006 rate case and included as an expense item in rates, with the up to $1.5 million of additional annual EE funding to be supplied by MGE that has been ordered by the Commission in this case[4] by referring to "all other monies supplied by ratepayers" in the context of addressing an overall return on invested capital. The Order should

[3] See findings numbers 127 and 153.

[4] See Report and Order pp. 62-63. "The Commission orders that MGE's annual funding amount shall not be included as an ongoing expense in rates.

provide that the weighted cost of capital be applied symmetrically, that is, the overall cost of capital as determined in this case also should be used to calculate interest on the $1.5 million per year of EE funding to be supplied by MGE (as well as any additional funding as recommended by the EEC and approved by the Commission) and to be deferred as a regulatory asset for ratemaking purposes.[5]

18. Application of a carrying cost to the EE funding supplied by the Company would be consistent with a recent situation where a regulatory asset has been used to address the funding of energy efficiency and demand side management programs. The regulatory asset maintained by Laclede Gas Company provides, in part, that "[a]ny monies advanced in rates by customers or by Laclede prior to rate base inclusion for such programs shall accumulate interest at Laclede's short term debt cost as of March 31, 2007." *In Re Laclede Gas Company,* Case No. GR-2007-0208, Unanimous Stipulation and Agreement, p. 15-16 (approved by Commission Order issued on July 19, 2007).

19. Failure to provide MGE with carrying costs in this situation, would represent an unconstitutional and unlawful confiscatory and discriminatory result. There is simply no legitimate, principled rationale for a different carrying cost applicable to unexpended funds currently on hand and future company-funding accounted for as a regulatory asset. To the extent the Commission concurs, this matter should be reconsidered and/or reheard such that any such unlawful result can be examined and remedied or, alternatively, the Commission can grant clarification as requested by MGE in a motion for clarification filed concurrently herewith.

[5]As the Commission may recall, MGE took the position that the appropriate carrying cost rate to be applied to unexpended funds provided by ratepayers is the short-term debt rate determined by the Commission in this proceeding. To the extent that the Commission determines that symmetry is appropriate in this instance (i.e., the carrying cost rate applicable to ratepayer-provided funds should be equal to the carrying cost rate applicable to shareholder-provided funds), but that the more appropriate carrying cost rate to be applied to both ratepayer and shareholder provided funds is the cost of short-term debt adopted by the Commission in this proceeding (i.e., 5.92%), MGE hereby indicates its concurrence in that result.

EFFECTIVE DATE OF COMPLIANCE TARIFF SHEETS

20. Finally, the Order and the dates set out therein will permit the Commission to issue an Order Approving Compliance Tariffs effective on or before February 28, 2010, the operation of law date in this case. MGE is concerned, however, that implementation of the compliance tariffs may be delayed beyond the operation of law date in light of the press release issued by the Commission on February 11, 2010, a copy of which is attached as Appendix A, which states in part that "The rate change is expected to take effect in mid-March." For the reasons set out in MGE's Motion For Expedited Treatment and Approval of Tariff Sheets previously filed in this docket a delay of the effective date of compliance tariffs beyond the operation of law date until sometime in mid-March would be unlawful and unreasonable.

21. Section 393.150.1, RSMo, authorizes the Commission to suspend the effectiveness of rate schedules for a period of one hundred and twenty days beyond the proposed effective date. In addition, the Commission "... may, in its discretion, extend the time of suspension for a further period not exceeding six months." Section 393.150.2. As a creature of statute, the Commission has only such powers as are expressly conferred by the statutes and those reasonably incidental thereto. *State ex rel. Kansas City Transit, Inc. v. Public Service Commission*, 406 S.W.2d 5 (1966). The Commission therefore has no authority to suspend the effectiveness of rate schedules for a period longer than one hundred and twenty days plus six months beyond the proposed effective date.

22. MGE initiated this rate proceeding on April 2, 2009, by the filing of tariff sheets that bore a proposed effective date of May 2, 2009. The Commission suspended the effectiveness of those tariff sheets until February 28, 2010, the full suspension period permitted

under the law. Accordingly, unless the Commission approves the revised tariff sheets filed by MGE to be effective as requested on February 28, 2010, Section 393.150 will be violated.

23. The Commission itself has an extended history of acting in accordance with this interpretation of Section 393.150. *See In re Missouri Gas Energy*, Report and Order, Case No. GR-96-285, p. 81, issued January 22, 1997; *In re St. Louis County Water Company*, 4 MPSC 3d 94, 119 (1995); *In re Capital City Water Company*, 3 MPSC 3d 333, 349 (1995); *In re Missouri Public Service* 2 MPSC 3d 206, 220 (1993; *In re Kansas Power & Light Company*, 1 MPSC 3d 235, 253 (1992); *In re St. Louis County Water Company*, 29 MPSC (N.S.) 425, 452 (1988); and, *In re Missouri Gas Energy*, Report and Order, Case No. GR-2004-0209, Report and Order issued September 21, 2004. MGE therefore requests nothing more than compliance with the law and past Commission precedent and practice.

24. MGE has requested that the revised tariff sheets be authorized to become effective on February 28, 2010, as this would be consistent with the requirements of the law and long-standing Commission custom, practice and precedent. Should the Commission delay the effectiveness of the revised tariff sheets beyond February 28, 2010, MGE will be denied recovery of a certain portion of the rate relief to which the Commission has already found MGE to be entitled, to-wit: more than $40,000 for each and every day of delay beyond February 28, 2010. Once lost, this revenue will never be recovered by MGE. Such an outcome would be unlawful, unjust, unreasonable, confiscatory and, in MGE's opinion, a result not intended by the Commission.

WHEREFORE, Missouri Gas Energy, a division of Southern Union Company, respectfully requests that the Missouri Public Service Commission grant rehearing with respect to its Report and Order issued in the above-captioned case on February 10, 2010, as requested herein, and upon rehearing and reconsideration of the issues raised herein issue a new Report and Order consistent with this pleading. MGE requests such other and further relief as the Commission deems just and proper under the circumstances.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I do hereby certify that a true and correct copy of the foregoing document has been sent by electronic mail this 19TH day of February, 2010, to:

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