BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Laclede Gas Company's Request to Increase Its Revenue for Gas Service	)))	**File No. GR-2017-0215**
In the Matter of Laclede Gas Company d/b/a Missouri Gas Energy's Request to Increase Its Revenues for Gas Service	)))	**File No. GR-2017-0216**

INITIAL POSTHEARING BRIEF

OF

MIDWEST ENERGY CONSUMERS GROUP

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COME NOW the Midwest Energy Consumers' Group ("MECG") by and through the undersigned counsel, pursuant to the Commission's May 24, 2017 *Order Adopting Procedural Schedule and Delegating Authority,* and provides its initial post-hearing brief. In this brief, MECG will brief the following issues: (1) Return on Common Equity; (2) Capital Structure; and (3) Revenue Stabilization Mechanism. While it wanted to brief the issue of surveillance reports being provided to all interested customers, MECG ran out of time to complete that section. Therefore, MECG simply supports the position advanced by MIEC. Finally, MECG reserves the right to address other issues, including issues raised at the January 3, 2018 true-up hearing, in its reply brief.

I. INTRODUCTION

On April 22, 2017, Laclede Gas Company ("Laclede"), and Missouri Gas Energy ("MGE"), both wholly-owned subsidiaries of Spire, Inc., filed rate cases. Specifically, as initially filed, Laclede sought a rate increase of $58.1 million and MGE sought a rate increase of $50.4 million. In both cases, the requested amount includes the collection of revenues already collected through each company's Infrastructure System Replacement Surcharge ("ISRS"). Upon approval of tariffs in this case, these ISRS revenues would instead be collected through base rates.[1]

While Laclede / MGE initiated this case, the Commission needs to realize that this is effectively a rate reduction case. In fact, Staff has thoroughly audited Laclede's earnings and concluded that the Commission should order a reduction in Laclede's overall revenues. Specifically, while it recommends that base rates be increased $15.4 million,[2] Staff expressly notes that this recommendation assumes that $32.6 million of revenues currently being collected through the ISRS will be rolled into base rates.[3] As such, Staff recommends a reduction in total revenues for Laclede of approximately $17.2 million.

Similarly, while Staff recommends a base rate increase for MGE of $9.9 million,[4] this includes the roll-in of $16.4 million of ISRS revenues.[5] Therefore, Staff recommends a decrease in overall rates of $6.5 million for MGE.

The fact that Laclede is likely over-earning is supported by Laclede's own statements and actions. The requirements of the ISRS statute require periodic rate filings

[1] Exhibit 28, Noack Direct, page 2.
[2] Exhibit 296, Staff Accounting Schedules, page 1.
[3] Exhibit 207, Myers Direct, page 3.
[4] Exhibit 297.
[5] Exhibit 207, Myers Direct, page 3.

such as the immediate case. "The ISRS Statute requires a gas utility to file a rate case within three years of initiating the surcharge to begin recovering costs for replacement of critical infrastructure identified by the statute for accelerated replacement for safety purposes."[6] Indeed, except for the ISRS statute requirement, "I think we would have ultimately not come in at this time."[7] It's not surprising then, given its desire to protect its overearnings situation for another two years, that Laclede / MGE has recently sought legislative changes to extend the ISRS rate case filing requirement to five years.[8]

[6] Exhibit 4, Lindsey Direct, page 15. See also, Exhibit No. 28, Noack Direct, page 4.
[7] Tr. 478.
[8] Tr. 476-477.

II. OVERVIEW OF POSITIONS

RETURN ON EQUITY: In his direct testimony, OPC / MIEC Witness Gorman recommended that the Commission authorize a return on equity of 9.2% (range of 8.9% - 9.4%). Gorman's recommendation is based upon several return on equity methodologies (DCF, risk premium, CAPM) that the Commission has found to be persuasive. Moreover, the 9.2% is logically consistent with the 9.5% return on equity authorized for Ameren and KCPL in the last year. Recognizing that Laclede / MGE has a higher credit rating than either Ameren or KCPL, it stands to reason that Laclede / MGE shareholders require a lower return on equity. As such, the authorized return on equity in this case should be lower than the 9.5% recently authorized for Ameren and KCPL. Finally, as Laclede / MGE both readily acknowledge, it is well established that natural gas utilities are less risky than electric utilities. As such, the Laclede / MGE return on equity should be less than the 9.5% authorized for Ameren and KCPL.

CAPITAL STRUCTURE: MECG believes that the Commission should utilize the capital structure recommended by OPC / MIEC witness Gorman. That capital structure consists of 47.2% equity and 52.8% long-term debt. This capital structure is a result of simply eliminating $210 million of equity capital supporting a goodwill asset that was created when Laclede acquired MGE. The elimination of $210 million of goodwill common equity is consistent with customer protection contained in the stipulation agreed to by Laclede / MGE and approved in GM-2013-0254. Furthermore, the elimination of goodwill from the capital structure represents a solid ratemaking policy as represented by the decisions of numerous other state utility commissions.

REVENUE STABILIZATION MECHANISM: MECG asserts that the Commission should reject Laclede / MGE's request to implement a revenue stabilization mechanism on the basis that the mechanism is not necessary for Laclede / MGE to have a "sufficient opportunity to earn a fair return on equity." Instead, contrary to Section 386.266.4(1), the mechanism will provide Laclede / MGE a tremendous opportunity to earn above its authorized return. In the event, however, that the Commission authorizes such a mechanism, it should: (1) ensure that the authorized mechanism complies with the statute and only accounts for "variations in either weather, conservation, or both"; (2) only extends to residential and small general service classes; and (3) includes an explicit reduction in return on equity as provided by the statute.

III. BURDEN OF PROOF

Section 393.150(2) provides that, in any rate increase proceeding, the burden of proof is on the party seeking the increased rate. The burden of proof is also on the proponent of a new Rate Stabilization Mechanism. Section 386.266.4 clearly provides that the Commission may only approve such a mechanism in a "general rate proceeding" after considering "all relevant factors." Recognizing that Section 393.150.2 places the burden of proof in such a case on the utility, it necessarily stands that the General Assembly envisioned that the burden of proof regarding the Rate Stabilization Mechanism is also on the utility.

As it applies to Commission proceedings, the Supreme Court has told us: (1) that burden of proof is a "substantial right" of the customers and (2) that burden of proof should be "rigidly enforced" by the Commission.

> The rules as to burden of proof are important and indispensable in the administration of justice, and constitutes a substantial right of the party of whose adversary the burden rests; they should be jealously guarded and rigidly enforced by the courts.[9]

The Supreme Court has also provided definition for the burden of proof.

> The burden of proof meaning the obligation to establish the truth of the claim by a preponderance of the evidence, rests throughout upon the party asserting the affirmative of the issue. The burden of proof never shifts during the course of the trial.[10]

As such, the burden of proof means that the proponent of higher rates in a Commission proceeding (the utility) has the "obligation to establish the truth" of its need for the higher rates. In this regard, customers are given the benefit of the doubt that the utility only needs the lower rate and that the utility must "prove" that the higher rate is

[9] *Highfill v. Brown*, 320 S.W.2d 493 (Mo. 1959).
[10] *Clapper v. Lakin*, 123 S.W.2d 27 (Mo. 1938).

necessary. Therefore, if there is any question regarding the legitimacy of a cost or expense; if the Commission does not adequately understand an issue; or if the Company fails to adequately explain its need for the higher rate, then the utility has failed to meet its burden of proof.

Finally, the Supreme Court has provided insight as to the implications of a party failing to meet its burden of proof: "the failure of the plaintiff to sustain such burden ***is fatal*** to his or her relief or recovery."[11]

[11] *Id.*

IV. RETURN ON COMMON EQUITY

Position: In his direct testimony, OPC / MIEC Witness Gorman recommended that the Commission authorize a return on equity of 9.2% (range of 8.9% - 9.4%). Gorman's recommendation is based upon several return on equity methodologies (DCF, risk premium, CAPM) that the Commission has found to be persuasive. Moreover, the 9.2% is logically consistent with the 9.5% return on equity authorized for Ameren and KCPL in the last year. Recognizing that Laclede / MGE has a higher credit rating than either Ameren or KCPL, it stands to reason that Laclede / MGE shareholders require a lower return on equity. As such, the authorized return on equity in this case should be lower than the 9.5% recently authorized for Ameren and KCPL. Finally, as Laclede / MGE both readily acknowledge, it is well established that natural gas utilities are less risky than electric utilities. As such, the Laclede / MGE return on equity should be less than the 9.5% authorized for Ameren and KCPL.

A. INTRODUCTION AND OVERVIEW OF THE RECOMMENDATIONS

It is well established that public utility commissions have several basic objectives. Foremost among these objectives is to ensure adequate earnings for the utility while preventing excessive (monopoly) profits.[12] Absent regulatory control, the utility will inevitably seek to extract monopoly profits from the many (the ratepayers of Missouri) for the benefit of the few (the Spire shareholders scattered across the nation).

The attempt to extract monopoly profits in this case is best seen in Laclede / MGE's return on equity recommendation. Rather than simply seek that level of return

[12] Phillips, Charles F. Jr., *The Economics of Regulation*, Rev. Ed. (1969) at page 124.

that is "sufficient to ensure confidence in the financial soundness of the utility,"[13] the companies instead seeks to bolster corporate profits through an inflated return. As the Supreme Court has pointed out, however, the utility has no "right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures."[14]

In this case, Laclede / MGE request a profit margin (the return on equity) of 10.35%.[15] In support of this request, the companies present the flawed testimony of Pauline Ahern. Laclede / MGE's inflated recommendation stands in stark contrast to the return on equity recommendations provided by the other two experts in this case.[16] Specifically, OPC / MIEC present the expert testimony of Michael Gorman who arrives at a return on equity range of 8.90% to 9.40% with a recommended return on equity of 9.20.[17] In addition, Staff provided the expert testimony of David Murray who concludes that a return on equity of 9.25% is reasonable.[18] Clearly then, Laclede / MGE's recommendation (10.35%) is significantly higher than those recommended by the other return on equity experts (9.20% and 9.25%).[19]

As this brief demonstrates, Laclede / MGE's recommendation is inflated because it is fundamentally flawed. Laclede / MGE's witness Ahern employed numerous questionable methodologies all designed to inflate the recommended return on equity.

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[13] *Bluefield Water Works and Improvement Co. v. Public Service Comm'n*, 262 U.S. 679, 692-693 (1923).
[14] *Id.*
[15] Exhibit 38, Ahern Direct, page 3. Specifically, Ms. Ahern's return on equity analysis results in a return on equity of 10.0%. She then inflates the 10.0% result through the inclusion of both a: (1) size / business risk and (2) flotation cost adder. *Id.* at pages 47-53.
[16] The difference between the Laclede / MGE recommended return on equity (10.35%) and that recommended by Staff (9.25%) is worth approximately $17.0 million. Specifically, for the Laclede case, this difference is worth $10.5 million. (See, Reconciliation filed November 30, 2017 in GR-2017-0215). For the MGE case, this difference is worth $6.5 million. (See, Reconciliation filed November 30, 2017 in GR-2017-0216).
[17] Exhibit 407, Gorman Direct, page 50.
[18] Exhibit 359, Staff Cost of Service Report, page 5.
[19] The Commission has previously looked at the proximity of the various return on equity recommendations in rejecting outliers like the current Ahern recommendation. See, *Report and Order*, Case No. ER-2011-0028, issued July 13, 2011, at page 70, paragraph 22.

Furthermore, she utilized two misplaced adders to further inflate the return on equity. Finally, where she did use a well-established methodology (the discounted cash flow methodology), she subsequently asserted that its results were of minimal value.

B. GORMAN CREDIBILITY AND OBJECTIVE ANALYSIS

In its consideration of the return on equity issue in recent rate cases, the Commission has frequently been presented with the expert analysis of Michael Gorman. Given the reasonableness of his approach, the Commission has repeatedly relied upon Mr. Gorman's methodology. In a recent Ameren decision, the Commission pointed out that Mr. Gorman was "a reliable rate of return expert."[20] In other decisions, the Commission's findings as to Mr. Gorman's reliability and credibility were even more glowing.

> [T]he Commission finds Michael Gorman to be the ***most credible and most understandable*** of the three ROE experts who testified in this case.[21]
>
> Michael Gorman, the witness for SIEUA, AG-P and FEA, did the ***best job of presenting the balanced analysis*** the Commission seeks.[22]
>
> In particular, the Commission accepts as credible the testimony of MIEC's witness, Michael Gorman. . . . Of the witnesses who testified in this case, Michael Gorman, the witness for MIEC, does the ***best job of presenting the balanced analysis*** that the Commission seeks.[23]

In this case, Mr. Gorman presents the same "credible" and "balanced" analysis relied upon by the Commission in those recent cases. As a starting point, Mr. Gorman employs a proxy group that is largely the same as that utilized by Laclede / MGE witness Ahern. Specifically, the proxy group consists of public utilities deriving over 50% of net

[20] Case No. ER-2014-0258, *Report and Order*, issued April 29, 2015, at page 66.
[21] Case No. ER-2012-0166, *Report and Order*, issued December 12, 2012, at page 70 (emphasis added).
[22] Case No. ER-2007-0004, *Report and Order*, issued May 17, 2007, at page 62 (emphasis added).
[23] Case No. ER-2007-0002, *Report and Order*, issued May 22, 2007, at pages 40-41 (emphasis added).

income from regulated natural gas operations.[24] That said, however, Mr. Gorman did exclude Chesapeake Utilities on the basis that it did not have an assigned bond rating from S&P or Moody's. As such, it is impossible "to determine whether or not the credit rating agencies have found that [the Chesapeake Utilities] investment risk is reasonably similar to that of the Companies."[25] Mr. Gorman's proxy group has an average S&P credit rating of A- and Moody's credit rating of A2. This compared favorably to the Companies' credit rating of A- and A1 respectively. Therefore, the "proxy group is reasonably comparable in investment risk to the Companies."[26]

After establishing a proxy group, and in light of the Commission's interest in considering the results of multiple return on equity analyses, Mr. Gorman provided the results of five different analyses: (1) a constant growth discounted cash flow (DCF) analysis using analysts' 3-5 year growth rates; (2) a sustainable growth DCF analysis; (3) a multi-stage growth DCF analysis which relies on a long-term growth rate equal to the consensus analysts' projection of gross domestic product; (4) a risk premium analysis and (5) a Capital Asset Pricing Model (CAPM) analysis.[27] The average of all of these analyses results in a recommendation of 8.90-9.40%.[28] Mr. Gorman's results can be summarized as follows:

[24] Exhibit 38, Ahern Direct, pages 15-16.
[25] Exhibit 407, Gorman Direct, page 21. Importantly, Ms. Ahern did not rebut Mr. Gorman's decision to exclude Chesapeake Utilities from the proxy group. (See, Exhibit 39, Ahern Rebuttal). Therefore, any differences in the proxy group are not material to the return on equity analysis.
[26] *Id.* at page 22.
[27] *Id.* at pages 22-27 (constant growth DCF); pages 27-29 (sustainable growth DCF); pages 29-37 (multi-stage growth DCF); pages 37-43 (risk premium analysis); and pages 43-49 (CAPM analysis).
[28] Exhibit 407, Gorman Direct, page 50.

MODEL		RESULT
DCF	Constant Growth	8.93%[29]
	Sustainable Growth	9.05%[30]
	Multi-Stage Growth	7.39%[31]
Risk Premium		9.20%[32]
CAPM		9.40%[33]
Recommendation		**8.90% - 9.40%**[34]

Ultimately, the Commission should agree that a 9.20% return on equity is appropriate for Laclede and MGE. Mr. Gorman's recommended return on equity is based upon the "balanced" analysis that this Commission has previously found to be helpful. Mr. Gorman's analysis is based upon several ROE methodologies and is consistent with recent return on equity decisions from other state utility commissions as well as those from this Commission. Finally, consistent with the dictates of the Hope and Bluefield decisions, the recommended 9.20% return on equity "(1) preserves the Companies' investment grade bond rating; (2) maintains their financial integrity and access to external capital; and (3) does so at reasonable cost to customers."[35] Given this, the Commission should authorize Laclede / MGE a return on equity of 9.20%.

C. AHERN INFLATED ANALYSIS AND UNJUSTIFIED ADDERS

In recent years, this Commission has repeatedly criticized the methodologies utilized by Ms. Ahern's colleague - Mr. Hevert.[36] Furthermore, the Commission has concluded that the return on equity produced by his flawed methodologies were

[29] *Id.* at page 26 and Schedule MPG-5.
[30] *Id.* at page 29 and Schedule MPG-8.
[31] *Id.* at page 36 and Schedule MPG-10.
[32] *Id.* at page 43.
[33] *Id.* at page 49.
[34] *Id.* at page 50.
[35] Exhibit 407, Gorman Direct, page 2.
[36] Both Mr. Hevert and Ms. Ahern are employed by ScottMadden, Inc. (See, Exhibit 38, Ahern Direct, page 1 and Exhibit 37, Hevert Surrebuttal, page 1.

"excessive" and "too high." In many cases, the Commission identified and discussed specific problems with Mr. Hevert's methodology.

> Case No. ER-2014-0370: KCPL's expert witness, Robert Hevert, supports an increased return on equity at 10.3 percent. ***The Commission finds that such a return on equity would be excessive***. Hevert's return on equity estimate is high because 1) his constant growth DCF results are based on excessive and unsustainable long-term growth rates, 2) his multi-stage DCF is based on a flawed accelerated dividend cash flow timing and an inflated gross domestic product growth estimate as a proxy for long-term sustainable growth, 3) his CAPM is based on inflated market risk premiums, and 4) his bond yield plus risk premium is based on inflated utility equity risk premiums.[37]
>
> Case No. ER-2014-0258: Ameren Missouri's expert witness, Robert Hevert, supports an increased ROE at 10.4 percent. ***The Commission finds that such an ROE would be excessive***. In large part, Hevert's ROE estimate is high because he based his multi-stage DCF analysis calculations on an optimistic nominal long-term GDP growth rate outlook of 5.71 percent. As Gorman explains, that growth rate is substantially higher than consensus economists' forward-looking real GDP growth outlooks. Adjusting Hevert's optimistic growth rate outlook to the consensus economist level reduces his multi-stage growth DCF return from 10.02 percent to 8.80 percent for his proxy group.[38]
>
> Case No. ER-2012-0166: However, ***Hevert's estimation of an appropriate ROE is too high***. MIEC's witness, Michael Gorman explains that Mr. Hevert relied on long-term sustainable growth rate estimates in his DCF models that are higher than the growth outlook of the economy as a whole. As he explained, it is not rational to expect that utilities can grow faster than the demand of the economies they serve.[39]
>
> Case No. ER-2011-0028: Hevert's recommended return on equity is higher than the other recommendations in large part because he over-estimates future long-term growth in his various DCF analyses, making them ***too high*** to be reasonable estimates of long-term sustainable growth. When Hevert's long-term growth rates are adjusted to use more sustainable growth estimates based on published analyst's projections, his multi-stage DCF analysis produces a rate of return more in line with the estimates of LaConte and Gorman.[40]

[37] Case No. ER-2014-0370, *Report and Order*, issued September 15, 2015, pages 19-20 (emphasis added).
[38] Case No. ER-2014-0258, *Report and Order*, issued April 29, 2015, at page 66 (emphasis added).
[39] Case No. ER-2012-0166, *Report and Order*, issued December 12, 2012, at pages 69-70. (emphasis added).
[40] Case No. ER-2011-0028, *Report and Order*, issued July 13, 2011, at page 23. (emphasis added).

The criticisms leveled by this Commission against the methodologies employed by Mr. Hevert are relevant here because many of the same infirmities have been repeated by his colleague - Ms. Ahern. In fact, just as Mr. Hevert's recommendation is consistently inflated, Ms. Ahern's recommendation has also been found to be inflated. For instance, a quick review of the Lexis public utility database reveals several cases in which Ms. Ahern's recommendation was significantly higher than that ultimately authorized by the state utility commission. In fact, on average, in the seven reported cases, Ms. Ahern's recommendation was 111 basis points higher than the return that was actually authorized.

Utility	Docket No.	Date	Proposed ROE	Authorized ROE	Difference
Suez Water Delaware	16-0163	02/16	10.40%	9.75%	65
Artesian Water	14-132	04/14	10.90%	9.75%	115
Tidewater Utilities	13-466	11/13	10.95%	9.75%	120
Illinois – American	11-0767	10/11	11.25%	9.34%	191
Illinois – American	09-0319	05/09	10.90%	10.38%	52
Indiana – American	44450	01/14	11.05%	9.75%	130
Iowa – American	RPU-2011-0001	04/11	11.35%	10.30%	105

Thus, if the same 111 basis point historical inflator is applied to her recommendation in this case, Ms. Ahern's recommendation would be reduced from 10.35% to 9.24% - virtually identical to the 9.20% recommended by Mr. Gorman and the 9.25% recommended by Mr. Murray.

The reasons underlying Ms. Ahern's inflated recommendations are apparent when one digs further into her flawed methodologies. As the following demonstrates, Ms. Ahern's CAPM; risk premium; and non-regulated proxy group analyses are all flawed and designed to produce inflated return on equity recommendations. Furthermore, Ms.

Ahern's ultimate return on equity recommendation is further inflated when she decides to largely disregard the results of her DCF analysis.

1. Capital Asset Pricing Model (CAPM)

In her direct testimony, Ms. Ahern conducts a "traditional" CAPM analysis. This CAPM 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 risk premium associated with the specific security is expressed mathematically as:

Bi x (Rm - Rf) where:

Bi = Beta - Measure of the risk for stock
Rm = Expected return for the market portfolio
Rf = Risk-free rate[41]

This "traditional" methodology results in a recommended return on equity for the gas proxy group of 8.81%.[42]

Undoubtedly unsatisfied with the results of the "traditional" CAPM analysis, Ms. Ahern then employs two untraditional CAPM analyses: (1) an Empirical CAPM ("ECAPM") analysis and (2) a non-regulated proxy group CAPM analysis.[43] As Mr. Gorman demonstrates, both untraditional CAPM analyses are flawed.

As Mr. Gorman describes it, the ECAPM conducted by Ms. Ahern relies on two risk premiums that are weighted 3:1. Specifically, Ms. Ahern utilizes a "75% weighted risk premium based upon a 0.75 utility beta and a 25% weighted risk premium based on a beta equal to the overall market beta of 1.0." The result of this weighting is to produce a

[41] Exhibit 407, Gorman Direct, page 44.
[42] Exhibit 38, Ahern Direct, Schedule PMA-D5 (page 1 of 2).
[43] MECG calls these two analyses untraditional for the simple reason that, in over 25 years of practice, counsel does not believe that the Commission has ever had to consider these untraditional methodologies.

beta estimate of 0.77. This is noticeably higher than the actual *Value Line* utility beta of 0.69.[44] Recognizing that the risk premium and the ultimate return on equity both increase proportionally to an increase in beta, it is not surprising that the ECAPM has the practical effect of inflating the CAPM result from 8.81% to 9.40%.[45]

As Mr. Gorman points out, Ms. Ahern's use of an adjusted beta in her ECAPM is misplaced. "Importantly, I am not aware of any research that was subjected to peer review that supports Ms. Ahern's proposed use of an adjusted beta in an ECAPM study. Therefore, Ms. Ahern's proposal to use an 'adjusted' beta in an ECAPM is neither based on sound academic principles, nor is it supported by the academic community, and should be rejected."[46]

2. Risk Premium Analysis

In addition to the flawed ECAPM analysis, Ms. Ahern also conducted two versions of a risk premium analysis: (1) the Predictive Risk Premium Model ("PRPM") and (2) the prospective utility risk premium approach.[47] As Mr. Gorman details, both analyses are flawed.

The PRPM attempts to calculate a risk premium for the natural gas proxy group by taking "the historical returns" for the proxy group and subtracting "the historical monthly yield on long-term U.S. Treasury securities. This risk premium of 7.78% is then added to a "forecasted" risk-free rate of 3.65% to produce an average risk premium return on equity of 11.43%.[48]

[44] Exhibit 414, Gorman Rebuttal, page 30.
[45] Exhibit 38, Ahern Direct, Schedule PMA-D4 (page 1 of 2).
[46] Exhibit 414, Gorman Rebuttal, page 31.
[47] Exhibit 38, Ahern Direct, pages 26-36.
[48] *Id.* at page 28.

The utilization of "historical returns" for the proxy group is flawed and serves to bias the risk premium upward. Ms. Ahern's analysis fails to consistently account for the return volatility created by capital gains and losses. More specifically, while Ms. Ahern "reflects the increased return volatility for stocks based on capital gains and losses", she then "ignores this significant investment return component for bond yields" in the risk free element.[49]

> 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. This methodology simply is not balanced, and does not reflect an accurate measurement of market risk premium.[50]

The prospective utility risk premium approach is also flawed as a result of its reliance on "expected" utility bond yields. This methodology applies an average proxy group risk premium of 4.62% to an "expected" A-rated utility bond yield of 4.89% to arrive at a risk premium return on equity of 9.51%.[51] The fundamental problem with this "prospective" utility risk premium approach is found in the use of an "expected" bond yield. In this case, Ms. Ahern utilized an "expected" bond yield of 4.89%. Interestingly, however, this "expected" bond yield is significantly higher than "**current** observable A-rated utility bond yields of 4.16%.[52] More telling, the 13-week average A-rated utility yield is approximately 3.90%.[53] Replacing Ms. Ahern's "expected" utility bond yield

[49] Exhibit 414, Gorman Direct, page 28.
[50] *Id.*
[51] Exhibit 38, Ahern Direct, page 36.
[52] Exhibit 414, Gorman Rebuttal, page 28.
[53] *Id.* at page 29.

with either the current or 13-week average utility yield would reduce Ms. Ahern's risk premium recommendation by 73 to 100 basis points.[54]

3. Non-Regulated Proxy Group Analysis

Next, Ms. Ahern attempts to further inflate the results of her various analyses by disregarding her natural gas utility proxy group and applying the DCF, CAPM, and risk premium methodologies to a group of 16 non-price regulated companies.[55] This non-regulated proxy group was constructed based largely on the company beta[56] and includes competitive companies like AutoZone; Dr. Pepper Snapple; Eli Lilly; Target; and Smuckers.[57] This non-regulated proxy group analysis produces a return on equity of 10.45%.[58]

As Mr. Gorman points out, however, there is no real attempt to show that the non-regulated proxy group is "risk comparable" to Laclede and MGE.[59] As such, the non-regulated proxy group analysis should be "disregarded."

> While these companies may have comparable beta estimates, [Ms. Ahern] has not shown that they face comparable business and operating risk to a low-risk regulated gas utility company. To draw a valid comparison between Laclede / MGE and any proxy group, it is necessary to show that these companies have comparable risk factors that are commonly used by investment professionals to compare investment risk between different investment alternatives. Because she has not shown that these companies are indeed risk comparable to Laclede / MGE, her estimated return on this proxy group is not reliable and should be disregarded.[60]

[54] *Id.*
[55] Exhibit 38, Ahern Direct, pages 42-46.
[56] *Id.* at page 43.
[57] *Id.* at page 44.
[58] *Id.* at page 46.
[59] Exhibit 414, Gorman Rebuttal, page 32.
[60] *Id.* at pages 32-33.

4. Discounted Cash Flow Analysis

While Ms. Ahern utilized numerous flawed methodologies (the ECAPM; the Predictive risk premium model; the prospective utility risk premium model; and the non-regulated proxy group analysis), she did provide one meaningful return on equity analysis – the discounted cash flow ("DCF") analysis. This methodology adds the dividend yield and the dividend growth rate for each natural gas proxy company to arrive at a return on equity recommendation.[61] In her analysis, Ms. Ahern uses an average growth rate for the proxy group of 5.80%.[62] This leads to an average DCF return on 8.68%.[63]

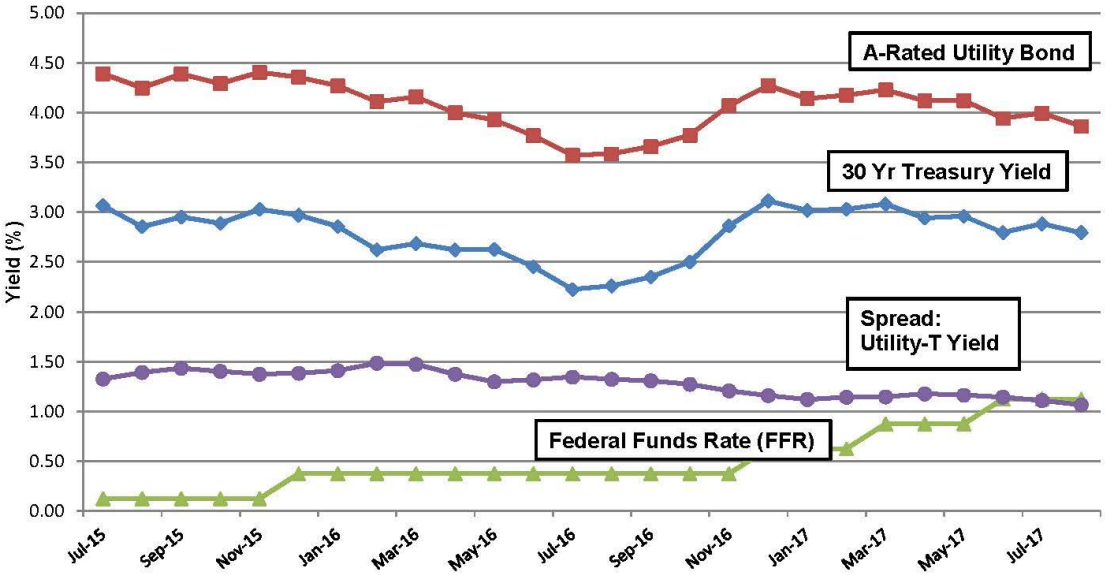
Despite the reasonableness of her methodology, Ms. Ahern then attempts to undermine the actual result. Specifically, Ms. Ahern suggests that the 8.68% DCF result is questionable as a result of the recent rise in market prices, the use of accounting measures as proxies for capital appreciation, and the alleged dramatic rise in interest rates and capital costs.[64] For this reason, Ms. Ahern claims that the DCF result "should be given only very limited weight in deriving a reasonable return on equity in this proceeding."[65]

As Mr. Gorman explains, however, Ms. Ahern's rationale for disregarding the results of the DCF analysis is utterly erroneous. Of primary importance, there has not been a "dramatic rise in interest rates in response to Federal Reserve comments and

[61] Exhibit 407, Gorman Direct, page 403.
[62] As Mr. Gorman notes, the use of a 5.80% growth rate is problematic in that it is "substantially higher than the consensus economists' projected growth rate for the economy (4.2%)." (Exhibit 414, Gorman Rebuttal, page 24). Given the inflated nature of the growth rate used in Ms. Ahern's DCF analysis, the results of that analysis provides a "reasonable high-end DCF result." (*Id.*). It would be unreasonable to attempt to formulate a DCF analysis that goes above this "high-end" result.
[63] Exhibit 38, Ahern Direct, Schedule PMA-D3.
[64] *Id.* at pages 23-26.
[65] *Id.* at page 47.

actions."[66] As the following chart shows, while the Federal Reserve has increased the Federal Funds rate four times in the last two years, the Treasury bond yield and utility bond yields have actually declined. As Mr. Gorman concludes, while the Federal Funds rate has increased, capital costs "have remained flat, to declining."[67]

Timeline of Federal Funds Rate Increases



Fed FFR Actions:

December 2015	0.25	→	0.50
December 2016	0.50	→	0.75
March 2017	0.75	→	1.00
June 2017	1.00	→	1.25

Source: Exhibit 407, Gorman Direct, Schedule MPG-2.

Clearly, Ms. Ahern's justification for placing less reliance on the DCF analysis is misplaced. As Mr. Gorman concludes, the DCF analysis "produces reasonable and accurate estimates of the current market cost of equity for the utility companies of similar investment risk."[68]

[66] Exhibit 414, Gorman Rebuttal, page 24.
[67] *Id.* at page 25.
[68] *Id.*

5. Unjustified Adders

After employing misplaced methodologies and questionable inputs, Ms. Ahern arrives at a return on equity of 10.0%.[69] Apparently not satisfied with this return quantification, Ms. Ahern then applies two questionable adders: (1) a flotation cost increase in the magnitude of 16 basis points[70] and (2) a 20 basis point increase for alleged business risk.[71] As this brief demonstrates, neither adder is justified.

Flotation Costs: As Ms. Ahern correctly points out, "flotation costs are those costs associated with the sale of new issuances of common stock."[72] Claiming that these costs are not treated elsewhere in the ratemaking process, Ms. Ahern improperly alleges that they must be treated within the quantification of return on equity.[73] Given this, Ms. Ahern modifies the results of the DCF analysis "to provide a dividend yield that would reimburse investors for issuance costs."[74] Specifically, her flotation cost methodology speculates that, if they were publicly traded, Laclede / MGE would have had three equity issuances over the period of May 2013 through May 2016.[75] These phantom equity issuances would have caused the incurrence of $58.7 million of flotation costs.[76] These phantom flotation costs equate to a 16 basis point increase in the dividend yield and the DCF return on equity.[77]

[69] Exhibit 38, Ahern Direct, page 47.
[70] *Id.* at pages 47-50.
[71] *Id.* at pages 50-52.
[72] *Id.* at page 47.
[73] *Id.* at page 48.
[74] *Id.* at page 50.
[75] Laclede / MGE provided Ms. Ahern with 3 phantom equity issuances: (1) 10,005,000 shares issued on May 23, 2013 at a price of $44.50 / share; (2) 10,350,000 shares issued on June 6, 2014 at a price of $46.25 / share; and (3) 2,186,000 shares issued on May 13, 2016 at a price of $63.05 / share. (Exhibit 38, Ahern Direct, Schedule PMA-D8 (page 1).
[76] *Id.* at Schedule PMA-D8 (page 1).
[77] *Id.* at page 50 and Schedule PMA-D8 (page 1).

As Mr. Gorman correctly points out, however, a flotation cost adjustment is inappropriate. As an initial matter, it is important to recognize that neither Laclede nor MGE are publicly traded.[78] Rather, the common stock of both companies is wholly-owned by the parent company – Spire, Inc. As such, neither Laclede nor MGE issues stock or incurs flotation costs. All stock issuance costs are incurred by Spire and then allocated for recovery by the subsidiaries like Laclede and MGE.[79]

Moreover, even if Laclede and MGE were publicly traded and responsible for fulfilling equity capital needs, it is apparent that the companies would not be entirely dependent on stock issuances to meet those needs. Rather, since both companies generate profits in excess of dividends, a significant amount of the companies' equity needs would be met through retained earnings. As Mr. Gorman notes, "a significant amount of equity is built through retained earnings, and certain transactions that increase common equity do not incur public stock issuance [i.e., flotation] costs."[80] In fact, had Ms. Ahern adjusted her methodology to account for the equity impact of retained earnings, her flotation cost adjustment would have been reduced from 16 basis points to less than one basis point (0.6 basis points).[81]

Market Capitalization Risk: Next, Ms. Ahern further tries to inflate her return on equity recommendation by claiming that the return on equity should be increased by 20 basis points as a result of greater risk resulting from the reduced size of Laclede and MGE as reflected in each company's hypothetical market capitalization. Ms. Ahern alleges, "[b]ecause the Companies are collectively smaller in size relative to the Natural

[78] Exhibit 414, Gorman Rebuttal, page 20.
[79] *Id.* at page 23.
[80] *Id.*
[81] *Id.*

Gas Proxy Group, as previously discussed and measured by their estimated market capitalization, they have greater business risk than the average company in the Natural Gas Proxy Group."[82] Ms. Ahern then quantifies the impact of this small market capitalization as 20 basis points.[83]

As an initial matter it should be pointed out that, in formulating her business risk adjustment, Ms. Ahern is entirely inconsistent in her view of Laclede and MGE relative to the natural gas proxy group. Of utmost concern, Ms. Ahern seeks to ignore the corporate parent company structure of Spire in order to view Laclede and MGE on a stand-alone basis. She then, however, compares the stand-alone Laclede and MGE subsidiaries to the parent company entities in her natural gas proxy group. The inconsistency arises from the fact that, while she unbundles the Spire corporate organization, she then compares the stand-alone subsidiaries to holding companies in the proxy group. In order to get an accurate assessment of Laclede / MGE's size relative to other utilities, Ms. Ahern should either: (1) compare the unbundled Laclede / MGE subsidiaries to the unbundled subsidiaries of the proxy group entities or (2) she should company the holding company (Spire) to the holding companies in the proxy group. It is inappropriate to unbundle one holding company and then claim the unbundled companies are smaller than the holding companies in the proxy group.

The evidence indicates that, while Spire operates through the Laclede and MGE subsidiaries, virtually all of the other natural gas proxy companies also operate through subsidiaries and divisions. For instance, Atmos is a holding company of numerous natural gas utilities structured into six divisions: (1) Louisiana; (2) West Texas; (3) Mid-

[82] Exhibit 38, Ahern Direct, pages 50-51.
[83] *Id.* at page 52.

Texas; (4) Mississippi; (5) Colorado – Kansas; and (6) Kentucky / Mid-States.[84] Similarly, New Jersey Resources provides gas service in numerous states "from Gulf Coast to New England"[85] and Northwest Natural Gas provides gas service in Oregon and Washington.[86] Bottom line, it is inappropriate to compare the size of Spire subsidiaries with the publicly-traded parent companies in the proxy group.

As Mr. Gorman further points out, it is illogical to ignore the services provided by the much larger publicly-traded parent company. "Laclede / MGE enters into a service agreement with Spire, Inc. (via Spire Shared Services) in order to receive services from its parent company structure."[87] The costs for the services provided by the parent company are allocated to the subsidiaries and recovered in rates.[88] "These service company transactions mitigate Laclede / MGE'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."[89] Ms. Ahern ignores the significant services provided by the parent company and paid for by ratepayers.

> Ms. Ahern's proposal for a return on equity premium ignores this service company relationship, and the costs incurred by retail customers of Laclede / MGE for the costs and benefits of this holding company structure. The holding company structure is designed to mitigate operating affiliates' stand-alone investment risk. For these reasons, Ms. Ahern's proposed small company risk adder to the return on equity should be rejected.

Given the services provided by the parent company, a more accurate indicator would be to compare the market capitalization of all of the publicly-traded parent

[84] Exhibit 38, Ahern Direct, Schedule PMA-D3 (page 3).
[85] *Id.* at page 5.
[86] *Id.* at page 6.
[87] Exhibit 414, Gorman Rebuttal, page 20.
[88] *Id.* at page 21.
[89] *Id.* at page 20.

companies. That apples to apples comparison of natural gas parent companies clearly reveals that Spire is one of the largest of the proxy companies.

Proxy Company	Market Capitalization
Atmos Energy	$7.6 billion
Southwest Gas	$3.5 billion
Spire, Inc.	$3.0 billion
New Jersey Resources	$2.9 billion
South Jersey Industries	$2.6 billion
Northwest Natural Gas	$1.6 billion

Source: Exhibit 38, Ahern Direct, Schedule PMA-D3

Clearly, both of the return on equity adders proposed by Ms. Ahern are misplaced and simply designed to inflate the return on equity for her client at the expense of Missouri ratepayers.

6. Corrected Ahern Analysis

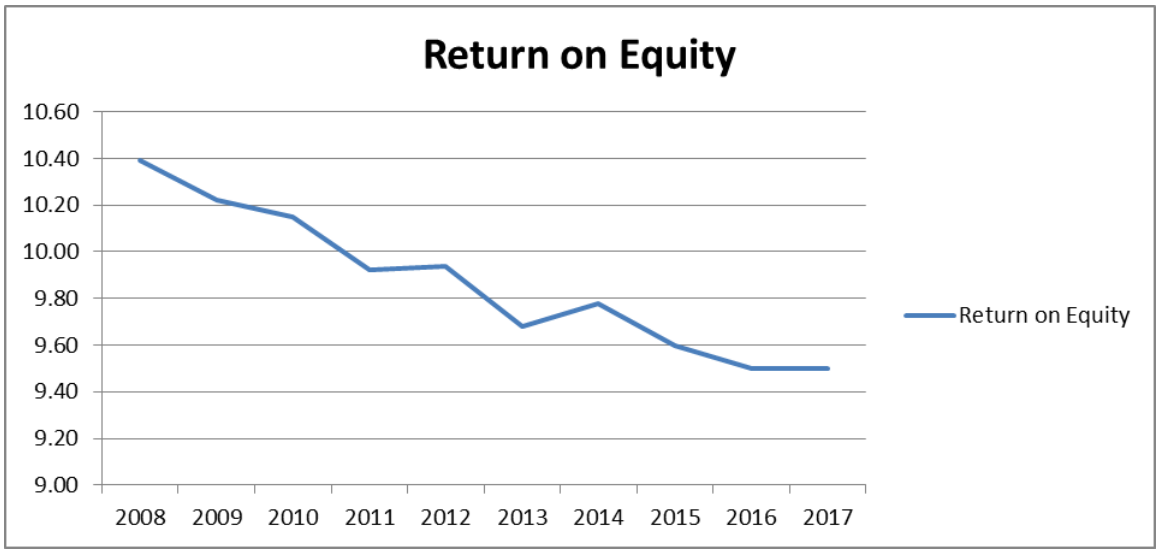
While Mr. Gorman correctly points out several of the flaws in Ms. Ahern's analysis, he also attempts to derive as much value out of her analysis as possible. Specifically, in his testimony, Mr. Gorman made reasonable adjustments, where possible, to correct Ms. Ahern's flawed inputs and methodologies. That corrected analysis results in a modified return on equity of 8.80%.[90] This is very consistent with the 8.90% to 9.40% return on equity range provided by Mr. Gorman.

D. OTHER CONSIDERATIONS

The reasonableness of Mr. Gorman's recommendation is also supported by two external considerations. ***First***, the evidence indicates that the return on equity decisions of state utility commissions are either declining or remaining stable. For instance, in his testimony, Mr. Gorman provides the average return on equity decision for gas utilities over the past three decades. In the last 10 years, state utility commission return on equity

[90] Exhibit 414, Gorman Rebuttal, page 18.

decisions have shown a dramatic decline. As Mr. Gorman concludes, "the authorized returns on equity for gas utilities and even electric utilities have been relatively flat over the last 18 to 24 months."[91] Given this, Ms. Ahern's recommended 10.35% return on equity recommendation is clearly excessive.



Source: Exhibit 407, Schedule MPG-12. Transcript 1366-1367.

Second, Mr. Gorman's recommended 9.20% return on equity is supported by recent Missouri Commission return on equity decisions in electric cases. As was repeatedly referenced, the Missouri Commission authorized a 9.50% return on equity for KCPL earlier this year.[92] This followed a return on equity of 9.53% for Ameren in 2014.[93]

As Mr. Gorman and Mr. Murray both testify, given these recent decisions, the return on equity for Laclede / MGE must be lower. This is dictated by two important considerations. First, it is well established that gas utilities, like Laclede and MGE, have

[91] Tr. 1367.
[92] *Report and Order*, Case No. ER-2016-0285, issued May 3, 2017, at page 22.
[93] *Report and Order*, Case No. ER-2014-0258, issued April 29, 2015, at page 68.

much lower risk than electric utilities like KCPL and Ameren. This fact is readily acknowledged by the Laclede / MGE witness.

> Q. Generally, what is the relationship of risk between vertically integrated electric utilities and gas utilities?
>
> A. Generally, all else equal, vertically integrated utilities, because they are in a production process, are riskier than transmission LDCs or electric transmission companies.[94]

Recognizing that the return required by equity shareholders decreases as risk decreases, it stands to reason that the return on equity for the less risky gas utilities like Laclede / MGE must be lower than the 9.5% authorized for KCPL and Ameren. In fact, in its testimony, Staff quantified the differential between electric and gas utilities at 50 basis points.[95]

The second consideration that mandates a lower return for Laclede / MGE relative to KCPL and Ameren is that Laclede / MGE has a higher credit rating. While Laclede / MGE has an S&P credit rating of A-, KCPL and Ameren both have a lower BBB+ credit rating. The impact of this lower credit rating for the electric utilities was clearly explained by Mr. Gorman when he concluded that the lower risk gas utility [Laclede / MGE] should have a lower return on equity than the higher risk electric utilities [Ameren and KCPL]. "[A] higher bond rating is an indication of lower investment risk for both debt -- in equity investments and an indication of lower investment risk would -- it would be appropriate to have a lower return on equity."[96]

[94] Tr. 1141.
[95] Exhibit 359, Staff Cost of Service Report, page 8.
[96] Tr. 1365.

Interestingly, the Laclede / MGE witness didn't know the Ameren and KCPL credit ratings.[97] In fact, despite the fact that equity shareholders have opportunities to invest in many utility stocks, she claimed that such credit ratings were "irrelevant" to her analysis.[98] Despite her inexplicable lack of awareness of the credit rating of the two largest Missouri utilities, the Laclede / MGE witness nevertheless agreed that the higher credit rating of Laclede / MGE dictated a lower return on equity for Laclede / MGE relative to the higher risk Ameren and KCPL electric utilities. In fact, she quantified the return on equity difference, based solely on credit rating variation between the A- rated Laclede / MGE and the BBB+ rated Ameren / KCPL, as worth approximately 9 basis points.[99]

Throughout the hearing in this matter, Laclede / MGE continually attempted to push the Commission to a higher return on equity by making comparisons to a 2014 Liberty Utilities rate case in which the Commission authorized a return on equity of 10.0%.[100] The evidence developed at the hearing clearly indicates that such a comparison is not on point.[101]

Unlike the comparison with the Ameren and KCPL decisions in which a clear comparison was made between the utilities' relative credit ratings, no evidence was provided regarding the Liberty Utilities credit rating and how it compares to Laclede / MGE. Absent such evidence, it is impossible to determine whether the Liberty Utilities 10.0% return on equity represents an accurate comparison. Laclede / MGE's failure to

[97] Tr. 1171. Importantly, Laclede / MGE's witness on this issue is employed by the same firm that provides capital structure / return on equity services to both Ameren and KCPL.
[98] Tr. 1174.
[99] Tr. 1175-1176.
[100] See, Tr. 1101.
[101] Interestingly, while Laclede / MGE seek to draw comparisons to the 2014 Liberty Utilities decision, the Laclede / MGE was not aware of how interest rates have changes since 2014. See, Tr. 1169.

provide the Liberty Utilities' credit rating is undoubtedly a result of the fact that Liberty Utilities is significantly riskier than Laclede and MGE. In fact, the evidence indicates that Liberty Utilities is significantly more leveraged than the Spire capital structure.[102] Recognizing that the leveraged nature of the Liberty Utilities capital structure provides greater risk to its investment, *vis-a-vis* Spire, Inc., it stands to reason that Laclede and MGE should receive a much lower return on equity than Liberty.

Finally, it is important to recognize that the return on equity authorized by state utility commissions for natural gas utilities has continued to decline since 2014. As such, the return on equity authorized by this Commission in 2014 would be significantly inflated if applied to a gas utility today.

E. CONCLUSION

As reflected in this brief, the Commission has historically found Mr. Gorman to be its most credible return on equity witness. Consistent with the methodologies previously relied upon by this Commission, Mr. Gorman recommends a return on equity of 9.20% (range of 8.90% to 9.40%). This equity return is logically consistent with the 9.5% return recent authorized for Ameren and KCPL. Recognizing that Laclede / MGE have a higher credit rating than either Ameren or KCPL, it stands that Laclede / MGE should also have a lower return on equity. Most importantly, a 9.2% return on equity "preserves the Companies' investment grade bond rating and maintains their financial integrity and access to external capital."[103] Given this, the Commission should authorize a return on equity of 9.2%.

[102] Tr. 1347.
[103] Exhibit 407, Gorman Direct, page 2.

V. CAPITAL STRUCTURE

Position: MECG believes that the Commission should utilize the capital structure recommended by OPC / MIEC witness Gorman. That capital structure consists of 47.2% equity and 52.8% long-term debt. This capital structure is a result of simply eliminating $210 million of equity capital supporting a goodwill asset that was created when Laclede acquired MGE. The elimination of $210 million of goodwill common equity is consistent with customer protection contained in the stipulation agreed to by Laclede / MGE and approved in GM-2013-0254. Furthermore, the elimination of goodwill from the capital structure represents a solid ratemaking policy as represented by the decisions of numerous other state utility commissions.

A. THE LACLEDE / MGE PROPOSED CAPITAL STRUCTURE IS EQUITY RICH.

In its opening statement, MECG pointed out that this proceeding truly amounts to a rate reduction case.[104] For instance, in its latest revenue requirement calculation, Staff recommends that Laclede receive an increase in base rates of $15.4 million.[105] Recognizing that this revenue requirement includes the inclusion of $32.6 million of ISRS revenues,[106] Staff essentially recommends a rate reduction of $17.2 million.[107]

As MECG noted in its opening statement, the playbook for utilities facing a revenue reduction is well-established. In addition to inflating the recommended return on equity (see the previous section), one of the most important steps in defeating a rate

[104] Tr. 443-452.
[105] Exhibit 296 (at midpoint return on equity of 9.25%).
[106] Exhibit 207, Myers Direct, page 3.
[107] Similarly, while Staff recommends a base rate increase for MGE of $9.9 million (Exhibit 297), this includes the roll-in of $16.4 million of ISRS revenues. (Exhibit 207, Myers Direct, page 3). Therefore, Staff recommends an overall revenue decrease of $6.5 million for MGE.

reduction is to recommend a capital structure that includes a greater amount of expensive common equity.[108]

In this case, Laclede / MGE recommend the following equity-rich capital structure:

Common Equity:	54.2%
Long-Term Debt:	45.8%[109]

The equity-rich nature of the Laclede / MGE recommended capital structure is immediately apparent in three ways. ***First***, while Laclede and MGE propose to utilize an equity-rich capital structure, its parent company (Spire) is very highly leveraged (includes very little equity).[110] As Mr. Gorman points out, "Spire's balance sheet actually represents a more leveraged company."[111] Specifically, Spire's equity ratio is approximately 41.7%.[112] Interestingly, Spire readily acknowledges its highly leveraged position. In its 10K filed on November 15, 2017, Spire references its "substantial indebtedness" as a shareholder risk factor.[113]

Second, the equity-rich nature of Laclede / MGE's proposed capital structure is made apparent by comparing it to the common equity ratio utilized by other state utility commissions. As SNL reports, over the past five years, the equity ratio for ratemaking purposes has fluctuated between 50.33% and 51.99%.[114] In fact, over the past eight years, the average equity ratio has not come close to the 54.2% equity ratio proposed by Laclede / MGE.

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[108] Tr. 447-448.
[109] Buck True-Up Direct, page 2.
[110] It is inexplicable why the Laclede / MGE capital structure should contain so much more equity when it carries an identical A- credit rating as the parent company Spire.
[111] Exhibit 414, Gorman Rebuttal, page 6.
[112] *Id.* at Schedule MPG-R-3.
[113] Exhibit 701, page 12.
[114] Exhibit 414, Gorman Rebuttal, page 12.

Third, the equity-rich nature of the proposed Laclede / MGE capital structure is more dramatic when compared to the equity ratio of the gas proxy group. As Mr. Gorman points out, "the proxy group companies have an average capital structure of approximately 51% debt and 49% equity."[115] As such, the Laclede / MGE proposed 54.2% common equity ratio is clearly much greater than the proxy group.

The impact of utilizing an equity-rich capital structure is obvious. The equity component of the capital structure is not only more expensive,[116] it also does not carry the tax-deductibility of debt capital.[117] As the Commission has previously pointed out:

> The portion of common equity in a company's capital structure is important for ratemaking purposes because common equity is the most expensive form of capital. The cost differential between common equity and debt is even greater when the income tax treatment of debt is considered. Interest expense of the cost of debt is tax-deductible, while dividends to shareholders are not.[118]

B. THE EQUITY-RICH CAPITAL STRUCTURE PROPOSED BY LACLEDE / MGE IS THE RESULT OF THE INCLUSION OF GOODWILL EQUITY.

In this case, the Laclede / MGE proposed capital structure is equity-rich solely as a result of Laclede / MGE's decision to include goodwill as equity in the capital structure. Specifically, Laclede / MGE seek to include $210 million of goodwill, resulting from the premium associated with Laclede's acquisition of MGE, as equity in the capital structure.[119]

Importantly, the Commission is not bound to accept Laclede / MGE's proposed capital structure. Rather, in situations where the capital structure contains excessive

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[115] *Id.* at page 9.
[116] In this case, the cost of equity is roughly 9.0% to 10.35% (see section on return on equity). In contrast, the cost of debt is approximately 4.159%. (See, Exhibit 407, Gorman Direct, page 19).
[117] Including the tax deductibility effects of debt, Mr. Gorman quantifies the difference as 4.159% for debt and 14.4% for equity. Thus, equity is three times more expensive than debt. (See, Exhibit 414, Gorman Rebuttal, page 10).
[118] *St. Joseph Light & Power*, 2 Mo.PSC 3d 248 (June 25, 1993).
[119] Exhibit 414, Gorman Rebuttal, page 5.

equity, the Commission has historically sought to use a more-balanced capital structure "to protect ratepayers from a management decision."[120] In fact, the authority for the Commission to adopt a more-balanced capital structure is well-established, even to the extent of adopting a completely hypothetical capital structure.[121]

In this case, MECG does not ask the Commission to utilize a hypothetical capital structure. Rather, as pointed out in the following section, MECG simply asks that the Commission enforce the terms of the stipulation in Case No. GM-2013-0254 and exclude goodwill equity (the acquisition premium associated with the purchase of MGE) from the Laclede and MGE ratemaking capital structure. Exclusion of goodwill equity from the capital structure also represents good ratemaking policy. Numerous other states have already addressed this issue and excluded the equity used to finance goodwill, a paper asset without economic value, from the ratemaking capital structure. As Mr. Gorman shows, simply by taking this one simple step (excluding goodwill from the capital structure), the Laclede / MGE capital structure becomes much more reasonable for setting rates.[122]

Mr. Gorman's proposed capital structure is:

Common Equity:	47.2%
Long-Term Debt:	52.8%[123]

[120] See, *Missouri Gas Energy*, 12 Mo.PSC 3d 581, 589 (September 21, 2004). See also, *St. Joseph Light & Power*, 2 Mo.PSC 3d 248 (June 25, 1993); *Empire District Electric Company*, 13 Mo.PSC 3d 350, 370 (March 10, 2005);

[121] See, *State ex rel. Associated Natural Gas Company v. Public Service Commission*, 706 S.W.2d 870 (Mo.App. 1985).

[122] Exhibit 414, Gorman Rebuttal, Schedule MPG-R-2. This schedule shows that Mr. Gorman's capital structure was derived via a two-step process: (1) the addition of $170 million of new debt and (2) the elimination of $210 million of goodwill equity. The addition of the $170 million of new debt is not in dispute as the issuance of new debt occurred prior to the true-up and was included in Laclede / MGE's proposed procedural schedule. (See, Buck True-up Direct, page 2). Therefore, following this true-up change, the only difference between the Laclede / MGE capital structure and that proposed by Mr. Gorman is the elimination of the goodwill equity.

[123] Exhibit 414, Gorman Rebuttal, page 15.

The difference between Laclede / MGE's capital structure with 54.2% common equity and Mr. Gorman's recommended capital structure with 47.2% common equity is significant. In its reconciliation in the Laclede rate case, Staff quantifies the difference between these two positions at $11.6 million.[124] In the MGE rate case, Staff quantifies the difference at $7.4 million.[125]

C. THE INCLUSION OF GOODWILL EQUITY IN THE RATEMAKING CAPITAL STRUCTURE IS CONTRARY TO A PREVIOUSLY-APPROVED STIPULATION.

In GM-2013-0254, the Commission considered Laclede's application to acquire the assets of Missouri Gas Energy. In that case, the Parties executed a stipulation that precludes "either direct or indirect rate recovery or recognition" of the premium that Laclede paid for the MGE assets.

> **3. PREMIUM AND ACQUISITION COSTS**
>
> a. Premium. The acquisition premium is the total purchase price above net book value. The amount of any acquisition premium paid for MGE in connection with the Transaction shall not be recovered in retail distribution rates. Nothing herein shall preclude any party to this Agreement from taking a position in any future ratemaking proceedings involving the Laclede or MGE Divisions in Missouri regarding the ratemaking measures and adjustments necessary to ensure no impact from the acquisition premium on rates. ***Neither Laclede Gas nor its MGE division shall seek either direct or indirect rate recovery or recognition of any acquisition premium in any future general ratemaking proceeding in Missouri***.[126]

Despite this commitment, Laclede now seeks to indirectly recover the acquisition premium financing cost in its cost of service by including the goodwill equity in the

[124] See, Reconciliation filed November 30, 2017 in GR-2017-0215.
[125] See, Reconciliation filed November 30, 2017 in GR-2017-0216.
[126] See, *Order Approving Unanimous Stipulation and Agreement*, Case No. GM-2013-0254, issued July 17, 2013, at page 2 and Stipulation pages 8-9.

ratemaking capital structure as phantom equity. It is phantom equity because the goodwill equity capital was not used to fund investments in utility plant and equipment.

In the recent past, the Commission has emphasized the importance of enforcing stipulations.

> GPE's position is troublesome from a public policy perspective. At the time of the 2001 Agreement, the Commission and the parties relied on KCPL's and GPE's assurances that Section 7 authorized the Commission's oversight over the future holding company. The Commission ordered the parties to comply with the terms of the agreement. ***Were the Commission to agree with GPE's analysis, it would render the terms of a negotiated stipulation and agreement meaningless and unenforceable; a result that should be avoided. For public policy reasons, all sides have a vested interest in maintaining trust in the settlement process. Parties must be confident that when they enter into a settlement agreement, each party can be relied upon to comply with the terms included, and that the Commission will indeed enforce all conditions. Should trust in the settlement process falter, the ultimate victims will be the ratepayers who will be forced to pay for the resulting lengthy litigation***.[127]

In this case, Laclede / MGE seek to do what they expressly agreed not to do. Specifically, Laclede / MGE seek to indirectly recover the acquisition premium by including that premium as equity in the capital structure. As the Commission noted, the "victims" of the Laclede / MGE request are the "ratepayers who [are] forced to pay for the resulting lengthy litigation."

D. THE INCLUSION OF GOODWILL AS EQUITY IN THE CAPITAL STRUCTURE CONSTITUTES BAD RATEMAKING POLICY.

In addition to the fact that the inclusion of goodwill in the capital structure violates the stipulation in GM-2013-2054, the inclusion of goodwill in the capital structure also represents poor ratemaking policy.

> Goodwill is a paper asset that is recorded at the time of acquisitions. Essentially, it represents the amount of acquisition premium that Spire or

[127] *Report and Order*, Case No. EC-2017-0107, issued February 22, 2017, page 20 (emphasis added).

> Laclede/MGE have paid for other utilities above their prevailing book value. It essentially represents a transaction between Spire or Laclede/MGE's investors, and the investors of the entity which is being acquired. ***This acquisition premium recorded as goodwill does not represent capital received from investors and used to invest in utility plant and equipment***. Rather, it represents acquisition premiums for transactions between utility shareholders.[128]

For this reason, a goodwill asset has no economic value and, unlike utility infrastructure investment, does not produce any cash flow.[129] Given that the goodwill asset produces no cash flow, it is subject to an annual impairment test to determine if the asset should be written off / down.[130] In fact, in filings with the SEC, Laclede / MGE have recognized this important fact.[131]

The poor ratemaking policy represented by including goodwill equity in the capital structure is best represented by the fact that most, if not all, other states have expressly excluded inclusion of goodwill in the capital structure in rate cases and acquisition proceedings. For instance, the Massachusetts Department of Telecommunications and Energy has stated, "[b]ecause goodwill is not directly associated with a utility's tangible plant assets, it is appropriate to exclude goodwill from capitalization."[132] Similarly, the Wisconsin Public Service Commission has stated, "[i]t is reasonable that the amount of equity recorded on the books of the company be reduced by the amount of goodwill recorded on the books for the purpose of determining the

[128] Exhibit 414, Gorman Rebuttal, page 7 (emphasis added).
[129] *Id.*
[130] *Id.*
[131] Exhibit 701, page 13 ("In connection with acquisitions, Spire Missouri and Spire recorded goodwill and long-lived assets that could become impaired and adversely affect its financial condition and results of operations.").
[132] *Boston Gas Company d/b/a KeySpan Energy Delivery New England*, Case No. D.T.E. 03-40, issued October 31, 2003 (citing to D.T.E. 02-27, at 12; Southern Union Company, D.T.E. 01-52, at 11 (2001); D.T.E. 00-53, at 8-9).

equity level within the financial and ratemaking capital structures."[133] Still again, the Connecticut Department of Public Utility Control has held, "[t]he Department believes that by not reducing common stock equity by the accumulated amortization of goodwill, the Company is overstating the equity portion of its capital structure."[134] Finally, the Maine Public Utilities Commission has stated:

> Therefore, including any of this $40 million [of goodwill] in CMP's capital structure in this or any other proceeding implicitly allows the recovery of some portion of the acquisition premium paid by Energy East in the acquisition of CMP. As noted previously, the Commission's Order in Docket No. 99-411 expressly forbids any such recovery absent certain findings made by the Commission. The Commission has not made any such finding, nor has it been presented any basis upon which to do so.[135]

The following list represents several cases in which state utility commission have disallowed inclusion of goodwill equity in the ratemaking capital structure.

State	Utility	Date	Case / Citation
Arizona	Unisource Energy	August 12, 2014	315 PUR4th 353
Connecticut	Southern Connecticut Gas	July 17, 2009	276 PUR4th 1
Connecticut	Connecticut Natural Gas	June 30, 2009	274 PUR4th 345
Connecticut	Consolidated Edison	October 19, 2000	205 PUR4th 182
Connecticut	Energy East	January 19, 2000	Case No. 99-08-09
Delaware	Delmarva Power & Light	June 2, 2015	Case No. 14-193
District of Columbia	Exelon Corp.	February 26, 2016	Case No. 1119
Illinois	Commonwealth Edison	September 11, 2017	Case No. 17-0312
Illinois	Commonwealth Edison	August 15, 2017	Case No. 17-0287
Illinois	Commonwealth Edison	December 18, 2013	Case No. 13-0318
Illinois	Commonwealth Edison	November 26, 2013	Case No. 13-0553
Illinois	Commonwealth Edison	May 29, 2012	Case No. 11-0271
Illinois	Commonwealth Edison	May 24, 2011	Case No. 10-0467
Illinois	Commonwealth Edison	July 26, 2006	250 PUR4th 161
Illinois	Ameren Illinois	December 9, 2015	Case No. 15-0305
Illinois	Ameren Illinois	December 10, 2014	317 PUR4th 371

[133] *Wisconsin Public Service Corp.*, Wisconsin Public Service Commission Case No. 6690-UR-113, 218 PUR4th 381 (2002).
[134] *Southern Connecticut Gas Company*, Connecticut Department of Public Utility Control, Case No. 08-12-07, issued July 17, 2009, 276 PUR4th 1.
[135] *Central Maine Power Company*, Maine Public Utilities Commission, Docket No. 2004-339, issued December 17, 2004.

Illinois	Ameren Illinois	December 9, 2013	Case No. 13-0301
Illinois	Ameren Illinois	September 19, 2012	Case No. 12-0001
Illinois	North Shore Gas	January 10, 2012	Case No. 11-0280
Kansas	Western Resources	July 25, 2001	211 PUR4th 8
Maine	Central Maine Power	December 17, 2004	Case No. 2004-339
Maryland	First Energy	January 18, 2011	287 PUR4th 284
Massachusetts	UIL Holdings	December 15, 2015	327 PUR4th 50
Massachusetts	New England Gas	February 2, 2009	271 PUR4th 1
Massachusetts	Berkshire Gas Company	February 18, 2004	DTE Case No. 03-89
Massachusetts	Boston Gas	October 31, 2003	DTE Case No. 03-40
Montana	Northwestern Energy	July 8, 2008	267 PUR4th 151
Montana	Northwestern Energy	July 31, 2007	259 PUR4th 493
New Jersey	Jersey Central Power & Light	December 12, 2016	ER16040383
New Jersey	Southern Company	June 29, 2016	331 PUR4th 84
New York	Central Hudson	June 26, 2013	306 PUR4th 167
Pennsylvania	Metropolitan Edison	January 11, 2007	102 Pa.PUC 1
Rhode Island	Narragansett Electric	April 11, 2013	Case No. 4323
Virginia	Southern Company	February 23, 2016	PUE-2015-00113
West Virginia	Monongahela Power	October 7, 2013	308 PUR4th 415
West Virginia	Monongahela Power	December 16, 2010	Case 10-0713-E-PC
Wisconsin	Wisconsin Electric Power	January 17, 2008	262 PUR4th 433
Wisconsin	Wisconsin Public Service	December 19, 2003	230 PUR4th 229
Wisconsin	Wisconsin Public Service	June 21, 2002	218 PUR4th 381

Clearly, a significant number of state utility commissions have held that it represents poor ratemaking to include goodwill equity in the ratemaking capital structure.

E. MR. GORMAN'S PROPOSED CAPITAL STRUCTURE IS CONSISTENT WITH THAT RECOMMENDED BY STAFF.

In this case, Staff proposes a capital structure similar to that recommended by Mr. Gorman. Specifically, Staff proposes the following capital structure:[136]

Common Equity:	45.56%[137]
Long-Term Debt:	47.97%
Short-Term Debt:	6.47%

[136] Exhibit 264, Murray Surrebuttal, page 4.

[137] At page 31, MECG references testimony from Mr. Gorman which indicates a consolidated Spire capital structure equity ratio of 41.7%. The difference between the 41.7% equity ratio referenced by Mr. Gorman and the 45.56% equity referenced by Staff in its consolidated capital structure is a result of timing differences as well as Staff's exclusion of a significant amount of short-term debt used to support construction projects.

As with the Laclede / MGE proposed return on equity, the Laclede / MGE capital structure proposal is clearly a significant outlier as compared to other recommendations.

Party	Equity Ratio
Laclede / MGE	54.20%
OPC / MIEC	47.20%
Staff	45.56%

While Mr. Gorman arrives at his recommended capital structure by simply eliminating $210 million of goodwill from the equity component of the capital structure, Staff arrives at a similar capital structure in a different manner. Specifically, Staff recommends that the Commission "use Spire, Inc.'s capital structure with an average level of short-term debt in setting the authorized ROR for LAC and MGE."[138]

Admittedly, the use of a consolidated capital structure is attractive for several reasons. As Staff points out, since neither Laclede nor MGE are publicly traded, it is the Spire consolidated capital structure that is considered by investors when making investment decisions. Similarly, it is the Spire capital structure evaluated by Moody's and S&P when setting corporate credit ratings.

> S&P evaluates Spire, Inc.'s consolidated credit profile when assigning corporate credit ratings to all of Spire, Inc.'s companies. Therefore, Spire, Inc's more leveraged capital structure is the most consequential for purposes of investors' determination of their required rate of return on debt and equity.[139]

Indeed, for purposes of establishing a return on equity in this case, all of the return on equity analysts chose proxy companies on the basis of their comparability to Spire, Inc.[140] It is illogical then to use Spire and its consolidated capital structure for purposes of establishing a return on equity and then apply that return on equity to a

[138] *Id.* at page 21.
[139] Exhibit 359, Staff Cost of Service Report, page 22.
[140] See, Exhibit 359, Staff Cost of Service Report, pages 29-31; Exhibit 38; Ahern Direct, pages 15-18; Exhibit 407; Gorman Direct, pages 21-22.

Laclede or MGE specific capital structure. Logically, the return on equity should correlate to the capital structure.

Moreover, Staff notes, that since there are no meaningful insulation measures between Spire and its operating subsidiaries, it is illogical to attempt to distinguish between the Spire and the subsidiary capital structures. In fact, S&P has expressly noted this lack of separation in establishing identical credit ratings for Spire and Laclede. "Because there are no meaningful insulation measures in place that protect Laclede Gas Co. from its parent, the issuer credit rating on the company [Spire] is A-, in line with the group credit profile of Laclede of A-."[141] Indeed, the lack of "meaningful insulation measures" has been specifically relied upon by the Commission in rejecting the subsidiary capital structure in favor of the consolidated capital structure in recent KCPL and GMO rate cases.[142]

Finally, prior to this case, all parties have historically utilized the consolidated capital structure for ratemaking purposes. "Both the Company and Staff have historically recommended the use of the parent company's consolidated capital structure for LAC [Laclede] for ratemaking purposes."[143] While Spire has acquired additional subsidiary gas utilities since the last case, the same basic reasons for utilizing the consolidated capital structure continue to exist.

In addition to utilizing a consolidated capital structure for Laclede, the Commission has routinely turned to the consolidated capital structure for ratemaking purposes for other major Missouri utilities. As Staff points out, in numerous KCPL and

[141] Exhibit 414, Gorman Rebuttal, page 7.
[142] See, *Report and Order*, Case No. ER-2016-0285, issued May 3, 2017, page 20 ("There are no meaningful insulation measures in place that protect KCPL and GMO from their parent.").
[143] Exhibit 359, Staff Cost of Service Report, page 22.

GMO rate cases, the Commission has relied upon a consolidated capital structure.[144] In fact, the Commission expressly rejected the KCPL subsidiary capital structure in favor of the consolidated capital structure for the same reason that it would be appropriate to reject it here – to avoid an equity-rich subsidiary capital structure. "One danger of using a subsidiary capital structure for ratemaking is that the holding company may artificially create an equity-rich subsidiary capital structure to create value for shareholders."[145]

Thus, it is understandable that the consolidated capital structure may be attractive to parties and the Commission in this case. Ultimately, whether the Commission accepts the Staff's consolidated capital structure of the subsidiary capital structure with the goodwill eliminated, either will lead to a reasonable capital structure for ratemaking purposes.

[144] See, *Report and Order*, Case No. ER-2016-0285, issued May 3, 2017, page 19 ("In past rate cases, KCPL and its affiliate, KCPL Greater Missouri Operations Company ("GMO"), have both proposed the use of Great Plains Energy's ("GPE") consolidated capital structure for ratemaking purposes.").
[145] *Id*. at page 20.

VI. REVENUE STABILIZATION MECHANISM

Position: MECG asserts that the Commission should reject Laclede / MGE's request to implement a revenue stabilization mechanism on the basis that the mechanism is not necessary for Laclede / MGE to have a "sufficient opportunity to earn a fair return on equity." Instead, contrary to Section 386.266.4(1), the mechanism will provide Laclede / MGE a tremendous opportunity to earn above its authorized return. In the event, however, that the Commission authorizes such a mechanism, it should: (1) ensure that the authorized mechanism complies with the statute and only accounts for "variations in either weather, conservation, or both"; (2) only extends to residential and small general service classes; and (3) includes an explicit reduction in return on equity as provided by the statute.

A. THE LACLEDE / MGE PROPOSED REVENUE STABILIZATION MECHANISM GOES BEYOND THE AUTHORITY PROVIDED BY SECTION 386.266.3.

In 2005, the General Assembly enacted Senate Bill 179. Among other things, that bill provided the statutory authorization for the Commission to implement a fuel adjustment clause. Relevant to this case, the bill provided statutory authority for the Laclede / MGE proposed revenue stabilization mechanism.

> Subject to the requirements of this section, any gas corporation may make an application to the commission to approve rate schedules authorizing periodic rate adjustments outside of general rate proceedings to reflect the nongas revenue effects of increases or decreases in residential and commercial customer usage due to variations in either weather, conservation, or both.[146]

In this case, Laclede / MGE seek to implement a revenue stabilization mechanism. While the statutory authority extends to usage changes resulting from

[146] Section 386.266.3.

"variations in either weather, conservation, or both," the Laclede / MGE mechanism goes much further. Specifically, the proposed mechanism seeks to capture the revenue effects caused by variations resulting from any factor – not simply weather or conservation.

As indicated in the implementing tariff, the proposed revenue stabilization mechanism is not limited solely to variations caused by weather or conservation, but extends to all "increases or decreases in customer usage."

> Revenue variations subject to adjustment through the RSM shall include those base revenue variations from those base revenue levels authorized in the Company's most recent general rate proceeding ***due to increases or decreases in customer usage in the Residential and Small General Service rate classes*** on a billing month basis.[147]

The fact that the proposed revenue stabilization mechanism is overly broad is confirmed by Staff.

> Q. Does LAC/MGE's proposal conform to this statute?
>
> A. No. LAC/MGE's revenue stabilization mechanism would adjust for all changes in average customer use, not solely due to variations in weather and/or conservation. For example, this mechanism would also make adjustments due to fuel switching, rate switching, new customers with non-average usage, and due to economic factors.[148]

While Laclede / MGE attempt to downplay the magnitude of any variations resulting from factors other than weather and conservation, it is apparent that variations from other sources are very real. In its 10K filed with the SEC, Laclede / MGE enumerate several risk factors to shareholder investment. Confirming Staff's concern with the over-reaching nature of the proposed revenue stabilization mechanism, Laclede / MGE specifically note that economic factors may also affect average customer usage.

> Periods of ***slowed economic activity*** generally result in decreased energy consumption . . . As a consequence, national or regional recessions or

[147] See, proposed Laclede tariff P.S.C. Mo. No. 5 consolidated, thirteenth revised sheet No. 10.
[148] Exhibit 238, Stahlman Rebuttal, page 6.

> other ***downturns in economic activity*** could adversely affect the Utilities' revenues and cash flows or restrict their future growth.[149]

Furthermore, the 10-K also confirms Staff's belief that it experiences usage variations resulting from energy efficiency.[150]

> However, significantly warmer-than-normal weather conditions in the Utilities' service areas and other factors, such as climate change, alternative energy sources ***and increased efficiency of gas furnaces and other appliances***, may result in reduced profitability and decreased cash flows attributable to lower gas sales.[151]

In addition to usage variations caused by economic conditions and increased efficiency of appliances,[152] Laclede / MGE warn that it experiences decreased usage resulting from fuel switching.

> In addition, the promulgation of regulations by the U.S. Environmental Protection Agency (EPA), particularly those regulating the emissions of greenhouse gases, and by the U.S. Department of Energy supporting higher efficiency for residential gas furnaces and other gas appliances or the potential enactment of congressional legislation addressing global warming and climate change may decrease customer usage, ***encourage***

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[149] Exhibit 701, Spire Inc. 10-K, page 16 (emphasis added).

[150] Staff notes that energy efficiency is distinct from conservation. (Exhibit 238, Stahlman Rebuttal, page 7 (citing to U.S. Energy Information Administration, *Energy Efficiency and Conservation* (2016))).
"The terms energy efficiency and energy conservation have distinct meanings:

- Energy efficiency is using technology that requires less energy to perform the same function. Using a compact fluorescent light bulb that requires less energy instead of using an incandescent bulb to produce the same amount of light is an example of energy efficiency.
- Energy conservation is any behavior that results in the use of less energy. Turning the lights off when leaving the room and recycling aluminum cans are both ways of conserving energy."

[151] *Id.* at page 18 (emphasis added).

[152] There is a distinction between reduced usage resulting from conservation and reduced usage caused by increased efficiency in appliances. As Staff notes, the replacement of an older furnace with a more efficient unit is not conservation.

> Q. So, if I have a house that has a 30-year-old furnace and I need to replace it, and even if I go out and buy the least efficient furnace there is out there, it still may be more efficient than the furnace I'm replacing; is that correct?
> A. Correct.
> Q. And that's not through any conservation effort on my part, is it?
> A. No. That would be considered an efficiency improvement. (Tr. 2422; See also, footnote 147).

> ***fuel switching from gas to other energy forms***, and may result in future additional compliance costs that could impact the Utilities' financial conditions and results of operations.[153]

Clearly then, Laclede / MGE experience usage variations resulting from sources beyond simply weather and conservation. By developing a revenue stabilization mechanism that shields it from usage variations caused by economic downturns, energy efficiency and fuel switching, Laclede / MGE has clearly exceeded the scope of the statute. As such, the Commission should reject the proposed revenue stabilization mechanism.[154]

B. THE LACLEDE / MGE PROPOSED REVENUE STABILIZATION MECHANISM IS NOT DESIGNED TO PROVIDE THE UTILITY WITH A SUFFICIENT OPPORTUNITY TO EARN A FAIR RETURN ON EQUITY.

Prior to authorizing a revenue stabilization mechanism, the statute provides that the Commission must find that the proposed mechanism "is reasonably designed to provide the utility with a sufficient opportunity to earn a fair return on equity."[155] Given its past financial performance, it is apparent that Laclede / MGE already have a "sufficient opportunity to earn a fair return on equity." As such, the implementation of the proposed revenue stabilization mechanism will likely result in a situation in which Laclede / MGE actually earn above its authorized return on equity.

The last rate increase for Laclede was December 9, 2011.[156] This is the second rate increase since that time. In 2013, Laclede filed a rate case as required by the ISRS

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[153] *Id.* (emphasis added).

[154] In the event that the Commission seeks to authorize a revenue stabilization mechanism that complies with the statute, Staff has developed a mechanism that tracks usage variations caused by weather. Because of difficulty, if not impossibility, of tracking variations resulting from conservation, Staff limits its proposed mechanism to simply usage variations resulting from weather. (See, Exhibit 281).

[155] Section 386.266.4(1).

[156] See, *Order Approving Tariff with Expedited Effective Date*, Case No. GR-2010-0171. See also, Exhibit No. 4, Lindsey Direct, page 15; Exhibit No. 28, Noack Direct, page 3.

legislation. Ultimately, that case settled with no rate increase. Instead, all ISRS revenues were rolled into base rates and the ISRS balance reset to zero.[157]

Now, in this case, Staff has audited Laclede's earnings and concluded that the Commission should order a reduction in Laclede's revenues. Specifically, while it recommends that base rates be increased $15.4 million,[158] Staff expressly notes that this recommendation assumes that $32.6 million of ISRS revenues be rolled into base rates.[159] As such, Staff recommends a revenue reduction for Laclede of approximately $21.2 million.

The fact that Laclede is likely over-earning is supported by Laclede's own statements. The requirements of the ISRS statute require periodic rate filings. "The ISRS Statute requires a gas utility to file a rate case within three years of initiating the surcharge to begin recovering costs for replacement of critical infrastructure identified by the statute for accelerated replacement for safety purposes."[160] Indeed, except for the ISRS statute requirement, "I think we would have ultimately not come in at this time."[161] Not surprisingly then, given its desire to protect its overearnings situation for another two years, Laclede has recently sought to extend the ISRS filing requirement to five years.[162]

Recognizing Laclede's overearning status, as well as the steps that it has recently taken to try to protect its overearnings from a general rate case, it is seemingly impossible for the Commission to find that a revenue stabilization mechanism is "reasonably

[157] Exhibit 208, Staff Cost of Service Report, page 3 ("The Commission last authorized a general rate increase for LAC on June 26, 2013, in Case No. GR-2013-0171, with new rates effective on July 8, 2013. In that case the Commission approved a Unanimous Stipulation and Agreement authorizing LAC to transfer into its Missouri jurisdictional base rate revenues the $14,811,000 related to its ISRS revenues that previously were approved by the Commission and which LAC had already been collecting.").
[158] Exhibit 296, Staff Accounting Schedules, page 1.
[159] Exhibit 207, Myers Direct, page 3.
[160] Exhibit 4, Lindsey Direct, page 15. See also, Exhibit No. 28, Noack Direct, page 4.
[161] Tr. 478.
[162] Tr. 476-477.

designed to protect the utility with a sufficient opportunity to earn a fair return on equity."[163] Instead, any revenue stabilization mechanism will instead be used to derive earnings in excess of a "fair return on equity." As such, the Commission should reject Laclede / MGE's proposed mechanism.

C. IF THE COMMISSION IMPLEMENTS THE PROPOSED REVENUE STABILIZATION MECHANISM, IT SHOULD BE EXPRESSLY LIMITED TO THE RESIDENTIAL AND SMALL GENERAL SERVICE CLASSES.

The statute which authorizes a revenue stabilization mechanism expressly limits its application to residential and commercial classes.

> Subject to the requirements of this section, any gas corporation may make an application to the commission to approve rate schedules authorizing periodic rate adjustments outside of general rate proceedings to reflect the nongas revenue effects of increases or decreases ***in residential and commercial customer usage*** due to variations in either weather, conservation, or both.[164]

While the definition of residential customers is pretty self-explanatory, there is no readily available definition for "commercial customers." The problem is amplified by the fact that Laclede / MGE do not have a "commercial customer" tariff. Instead, Laclede has a small general service; large general service; and a large volume service rate schedule.[165] Given the lack of a "commercial" rate schedule, the issue arises as to which rate schedules could be affected by a potential revenue stabilization mechanism.

In this case, Laclede / MGE has only sought to extend the revenue stabilization mechanism to the residential and small general service rate schedules.[166] MECG's concern is that Laclede / MGE may eventually seek to extend the revenue stabilization

[163] Section 386.266.4(1).
[164] *Id.* (emphasis added).
[165] Exhibit 209, Staff Class Cost of Service Report, pages 13-14.
[166] See, proposed Laclede tariff P.S.C. Mo. No. 5 consolidated, thirteenth revised sheet No. 10. ("The purpose of this Revenue Stabilization Mechanism ("RSM") is to stabilize customers' utility bills and reduce over and under-recoveries of the base revenues authorized in the Company's most recent general rate proceeding due to changes in residential and small general service customer usage.").

mechanism to the Large General Service and Large Volume rate schedule under the premise that those schedules serve "commercial" customers. Recognizing that those schedules also serve industrial customers, it would be inappropriate to extend the revenue stabilization mechanism beyond the "small general service" rate schedule. As such, in the event that the Commission authorizes a revenue stabilization mechanism, it should expressly find that, for purposes of Laclede and MGE's rate schedules, the word "commercial" as used in Section 386.266.3 only extends to the small general service rate schedule.

D. IF THE COMMISSION IMPLEMENTS A REVENUE STABILIZATION MECHANISM, IT SHOULD CONSIDER THE REDUCTION IN LACLEDE / MGE'S BUSINESS RISK AND LOWER THE AUTHORIZED RETURN ON EQUITY.

In the event that the Commission authorizes a revenue stabilization mechanism, the statute expressly encourages the Commission to "take into account any change in business risk to the corporation resulting from implementation of the adjustment mechanism in setting the corporation's allowed return in any rate proceeding."[167]

The fact that a revenue stabilization mechanism would reduce risk is irrefutable. As mentioned, Spire, Inc.'s 10-K sets forth risk factors that expressly warn shareholders that investment in the company carries risk associated with usage variations resulting from weather changes.

> To the extent that climate change results in warmer temperatures, financial results could be adversely affected through lower gas volumes and revenues.[168]
>
> Significantly warmer-than-normal weather conditions, the effects of climate change, legislative and regulatory initiatives in response to climate change or in support of increased energy efficiency, and other factors that

[167] Section 386.266.7.
[168] Exhibit 701, Spire Inc. 10-K, page 14.

> influence customer usage may affect the Utilities' sale of heating energy and adversely impact their financial position and results of operations.[169]
>
> [S]ignificantly warmer-than-normal weather conditions in the Utilities' service areas and other factors . . . may result in reduced profitability and decreased cash flows attributable to lower gas sales.[170]

Recognizing that the revenue stabilization mechanisms alleviates or mitigates each of the enumerated risk factors, it is unquestioned that the mechanism will result in a "change in business risk to the corporation." As such, as directed by Section 386.266.7, the Commission should take this "change in business risk" into account when it establishes the "allowed return" in this case.

In an effort to "have its cake and eat it too",[171] Laclede / MGE argue for the establishment of the revenue stabilization mechanism, but seek to avoid the attendant reduction in "allowed return." Laclede / MGE postulates that, since other companies in the proxy group already have a revenue stabilization mechanism,

> [T]he majority of the operating subsidiaries of my Natural Gas Proxy Group operate under an RSM. Therefore, any investor perception of risk related to an RSM is already reflected in the market data of the group and hence any common equity cost rate derived from that data. Therefore, should the MOPSC approve the Companies' proposed RSM, there is no need for a reduced authorized ROE as a result.[172]

Laclede / MGE's argument fails to properly understand how the return on equity is established in a rate case.

In setting a return on equity, the analyst selects a proxy group of companies. In order to comply with the directives of *Bluefield Water Works*, the proxy group of companies must have "corresponding risks and uncertainties" to the public utility.

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[169] *Id.* at page 18.
[170] *Id.*
[171] In this analogy, the "cake and eat it too" is the revenue sufficiency mechanism and the inflated return on equity.
[172] Exhibit 41, Ahern Surrebuttal, page 39.

> A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties.[173]

Thus, in establishing the proxy group in this case, the proxy group of companies must all be comparable to Laclede / MGE with its current "risks and uncertainties." Thus, the proxy group companies in this case are comparable to Laclede / MGE without the proposed revenue stabilization mechanism.

In the event that the Commission authorizes a revenue stabilization mechanism, then Laclede / MGE's business risk will change and the composition of the proxy group must also change. So, while Laclede / MGE currently has an S&P credit rating of A-, the "proxy group [also] has an average corporate credit rating from S&P of A-."[174] As detailed, *infra*, the implementation of a revenue stabilization mechanism will alleviate / mitigate a significant number of the enumerated risk factors for Laclede and MGE. With the reduction of Laclede / MGE's business risk comes a likely increase in Laclede / MGE's credit rating. Therefore, return analysts may no longer use the same proxy group of companies to establish a return on equity. Instead, the new proxy group, caused by the implementation of a revenue stabilization mechanism, may have an average corporate credit rating from "A" instead of A-. With this change in proxy group companies comes a reduction in the necessary return on equity. As can be seen then, Laclede / MGE's argument that "the majority of the operating subsidiaries of my Natural Gas Proxy Group [already] operate under an RSM" is irrelevant since they won't comprise the new proxy group once Laclede / MGE is already authorized a revenue stabilization mechanism.

[173] *State ex rel. Bluefield Water Works v. West Virginia Public Service Commission*, 262 U.S. 679, 692 (1923).
[174] Exhibit 407, Gorman Direct, page 22.

During cross-examination, one expert analogized to the appraisal process when buying a home.[175] Under the analogy, a buyer is purchasing a home with three bedrooms and an unfinished basement. The value of the home is reached by comparing to other comparable homes. In this case, the comparable group may include two bedroom homes with finished basements. If the seller finishes the basement, it is not appropriate to say that it added no value to the home simply because the other homes in the comparable group already had finished basements. Instead, the completion of the finished basement would result in a new group of comparable homes with higher values. As the witness concludes, "if that individual were to, say, finish their basement, right, then by default, you'd be putting yourself in a different proxy group. Right. You'd be adding on to the value of that individual home."[176]

Similarly, if a revenue stabilization mechanism is approved in this case, then risk is reduced and a new proxy group established. As the witness concludes, "if the company were given Commission approval for a weather mitigating and economic mitigating and efficiency mitigating, well, you know, the realm of risk possibilities, if you're collectively reducing that, then all of the sudden that proxy group has changed."

Given that Laclede / MGE's business risk will be reduced by the implementation of a revenue stabilization mechanism, then it is important that the Commission explicitly recognize a lower return on equity.

[175] Tr. 2480-2481.
[176] Tr. 2480.

VII. CONCLUSION

MECG respectfully requests that the Commission issue its Report and Order consistent with the positions advanced herein. Specifically, MECG asks that the Commission adopt the following positions:

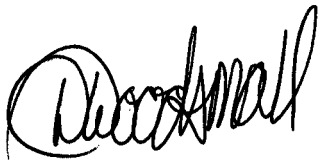
1. Authorize a return on equity of 9.2% (range of 8.9% to 9.4%) as recommended by OPC / MIEC witness Gorman.

2. Utilize a capital structure for Laclede / MGE that eliminates all goodwill equity as agreed to by Laclede / MGE in the stipulation in Case No. GM-2013-0254.

3. Reject Laclede / MGE's proposed revenue stabilization mechanism on the basis that the mechanism is not necessary for Laclede / MGE to have a "sufficient opportunity to earn a fair return on equity." Instead the mechanism will provide Laclede / MGE a tremendous opportunity to earn above its authorized return. In the event, however, that the Commission authorizes such a mechanism, it should: (1) ensure that the authorized mechanism only accounts for "variations in either weather, conservation, or both"; (2) only extends to residential and small general service classes; and (3) includes an attendant reduction in return on equity.

Respectfully submitted,

WOODSMALL LAW OFFICE



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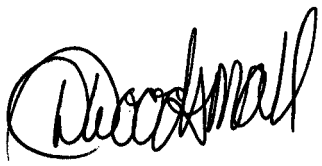
CERTIFICATE OF SERVICE

I HEREBY CERTIFY that I have this day served the foregoing pleading by email, facsimile or First Class United States Mail to all parties by their attorneys of record as provided by the Secretary of the Commission.



David L. Woodsmall

Dated: January 9, 2018