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**

JOINT STATEMENT OF POSITION OF THE MIEC AND MECG

Issue I. LAC-MGE Common Issues

a. Cost of Capital

i. Return on Common Equity – What is the appropriate return on common equity to be used to determine the rate of return?

Position: In past cases, the Commission has repeatedly recognized Mr. Gorman to be a credible rate of return witness and has repeatedly relied on his analysis in determining an appropriate return on equity.

> [T]he Commission finds Michael Gorman to be the most credible and most understandable of the three ROE experts who testified in this case.[1]
>
> Michael Gorman, the witness for SIEUA, AG-P and FEA, did the best job of presenting the balanced analysis the Commission seeks.[2]

In this case, Mr. Gorman has prepared a return on equity analysis that relies upon a proxy group of six natural gas public utilities. This proxy group is consistent with that relied upon by Laclede / MGE witness Ahern except that Mr. Gorman excluded Chesapeake Utilities Corp. "because it was not rated by S&P or Moody's." (Gorman Direct, page 21). As Mr. Gorman notes, exclusion of Chesapeake is necessary because, absent such a rating, it is impossible to know if Chesapeake is a true proxy for Laclede / MGE.

> Because Chesapeake Utilities does not have a bond rating from S&P or Moody's, it is not possible to determine whether or not the credit rating agencies have found that its investment risk is reasonably similar to that of the Companies or any of the other proxy group companies. (Gorman Direct, page 21).

The proxy group utilized by Mr. Gorman is a good fit for conducting a return on equity analysis for Laclede / MGE. As Gorman points out, "[t]he proxy group has an average corporate credit

[1] Case No. ER-2012-0166, *Report and Order*, issued December 12, 2012, at page 70.
[2] Case No. ER-2007-0004, *Report and Order*, issued May 17, 2007, at page 62.

rating from S&P of A-, which is identical to the Companies' credit rating. The proxy group has an average corporate credit rating from Moody's of A2, which is a notch lower than the Companies' credit rating of A1." (Gorman Direct, page 22).

Based upon financial metrics for this proxy group, Mr. Gorman has prepared and presented a return on equity analysis that relies upon several different forms of the discounted cash flow, risk premium, and capital asset pricing models. Specifically, Mr. Gorman provided the results of three versions of the discounted cash flow model resulting in a return on equity of 8.9% (Gorman Direct, pages 22-37). Additionally, Mr. Gorman conducted a risk premium analysis that results in a return on equity of 9.2%. (Gorman Direct, pages 37-43). Finally, Mr. Gorman conducted a capital asset pricing model analysis resulting in a return on equity of 9.4%. (Gorman Direct, pages 43-49). As Mr. Gorman concludes, his "recommended return on equity of 9.20% is at the approximate midpoint of my estimated range of 8.90% to 9.40%." (Gorman Direct, page 50).

In contrast, Laclede / MGE Witness Ahern provides a flawed return on equity analysis. Ms. Ahern "estimates a return on equity of 10.00%." The 10.00% return on equity is then inflated to 10.35% by "adding a business risk adjustment of 20 basis points, and a flotation cost adder of 16 basis points." (Gorman Rebuttal, page 16). Not only is Ms. Ahern's return on equity analysis flawed, but her proposed inflationary adjustments for business risk and flotation costs are misplaced.

As Mr. Gorman points out, Ms. Ahern's DCF analysis relies on an average growth rate of 5.80% that "is substantially higher than the consensus economists' projected growth rate for the economy (4.2%)." (Gorman Rebuttal, page 24). As Mr. Gorman concludes then, Ms. Ahern's DCF analysis is acceptable as a "reasonable <u>high-end</u> DCF result." (*Id.*). That said, Ms. Ahern rejects the results of her DCF analysis on the basis of claimed rise in market prices, the use of accounting measures as proxies for capital appreciation, and the dramatic rise in interest rates and capital costs. As Mr. Gorman points out at pages 24-25 of his rebuttal testimony, Ms. Ahern's rationale for rejecting her DCF analysis results is misplaced. Ultimately, Gorman concludes that "the application of a DCF analysis produces reasonable and accurate estimates of the current market cost of equity for the utility companies of similar investment risk." (Gorman Rebuttal, page 25). Similarly, Ms. Ahern's risk premium and CAPM results are not an appropriate proxy for a Laclede / MGE return on equity. As Mr. Gorman shows, by utilizing more reasonable inputs, Ms. Ahern's risk premium estimate is reduced from 10.57% to 8.80%. (Gorman Rebuttal, page 29). Similarly, Ms. Ahern's CAPM result is reduced from 9.11% to 8.80%. (Gorman Rebuttal, page 32).

Ms. Ahern's business risk and flotation cost inflationary adjustments are similarly misplaced. Specifically, Ms. Ahern claims that because of the alleged size of Laclede / MGE, there are alleged investment risks that must be reflected in an increase to the authorized return on equity. As Gorman correctly points out, however, Laclede / MGE is not a stand-alone company, but is part of the larger, publicly traded Spire, Inc. As part of Spire, Laclede / MGE has entered into a service agreement with Spire "to receive services from its parent company structure." (Gorman Rebuttal, page 20). These services include "management expertise, access to capital, and technical expertise such as legal, engineering, financial and IT." (*Id.*). Given the fact that Laclede / MGE are part of a much larger corporate entity, any stand-alone investment risk is mitigated. In fact, recognizing that Spire owns natural gas subsidiaries in numerous regions in

the nation, this geographic diversity in operations "can mitigate small company risk." (*Id.*).

Finally, Ms. Ahern's attempts to inflate a return on equity by implementing a flotation cost adjustment should be similarly rejected. Ms. Ahern incorrectly estimates that there would have been three issuances of common equity over the period of May 2013 through May 2016 that would have resulted in flotation costs of approximately $59 million. As Gorman correctly points out, however, common equity for Laclede / MGE is not derived from stock issuances, but is largely the result of retained earnings. Recognizing that there are no flotation costs associated with retained earnings, there is no need for a flotation cost adjustment. (Gorman Rebuttal, page 23).

In the final analysis, a return on equity of 9.2% (range of 8.9% to 9.4%) is consistent with the dictates of the Supreme Court *Hope* and *Bluefield* standards and adequately compensates shareholders for the cost of equity.

ii. Capital Structure – What capital structure should be used to determine the rate of return?

Position: In its true-up testimony, Laclede / MGE proposes a capital structure that consists of 54.2% common equity and 45.8% long-term debt. (Buck True-Up Direct, page 2). As Mr. Gorman points out, however, the proposed capital structure is equity rich. As with any other expense item, the Commission must consider whether the utility's capital structure is managed in a manner consistent with providing just and reasonable rates. To the extent that a utility unnecessarily includes an excessive amount of equity instead of debt in its capital structure, that capital structure does not lead to just and reasonable rates, and is therefore unreasonable. Instead, Mr. Gorman recommends a capital structure that consists of 47.2% equity and 52.8% long-term debt.

The fundamental reason that the Laclede / MGE proposed capital structure is equity rich is founded on the fact that Laclede / MGE seeks to include goodwill as equity in the capital structure. As Gorman explains, goodwill is a paper asset that is recorded at the time of acquisitions. In essence, it represents the premium over book value that Spire paid for the acquisition of other utilities. As such, it is not a tangible asset that is used for the provision of service to ratepayers. (Gorman Rebuttal, page 7). Mr. Gorman then explains that, since it is not a tangible asset used to produce a cash flow, it cannot be assumed to be funded by debt. As such, goodwill must be funded entirely by equity.

> From a credit rating perspective, a goodwill asset has no economic value. A goodwill asset, unlike infrastructure investments that are included in a utility's rate base, produces no cash flow. Therefore, the existence of a goodwill asset cannot be funded by debt because it cannot produce cash flows adequate to meet the debt service obligations on a debt security. Therefore, these premium payments that represent transactions between shareholders, can only prudently and reasonably be financed by utility common equity. It would be imprudent to finance a goodwill asset with debt, because the goodwill asset would default on the obligations to meet the debt service obligation of a debt, and would cause significant distress on the utility's credit standing, and ability to operate as a

financially sough going concern. (Gorman Rebuttal, pages 7-8).

When one eliminates goodwill as a component of equity in the capital structure, a capital structure that is consistent with the Spire consolidated capital structure appears. (Gorman Rebuttal, Schedule MPG-R-3 (page 2)).

The unreasonable nature of the Laclede / MGE capital structure is also reflected in the fact that the capital structure is not reflective of ongoing operations. Instead, the capital structure appears to be manipulated for purposes of establishing higher rates in this case. As reflected in Mr. Gorman's rebuttal testimony, the Laclede / MGE capital structure has historically consisted of 50% common equity. (Gorman Rebuttal, page 5).

In conclusion, the Laclede / MGE proposed capital structure contains too much equity. This equity-rich capital structure is a result of the decision to classify goodwill as equity in the proposed capital structure. In addition, the unreasonable nature of the Laclede / MGE proposed capital structure is reflected in the capital structure by the Companies over the past several years as well as that used by other state utility commissions in establishing gas rates.

iii. Cost of Debt – What cost of long-term debt should be used to determine the rate of return?

Position: MIEC / MECG agree that the appropriate cost of long-term debt is 4.159%. (Gorman Direct, page 19).

iv. Should short-term debt be included in the capital structure? If so, at what cost?

Position: In his testimony, Mr. Gorman developed a reasonable capital structure consisting of 47.2% equity and 52.8% long-term debt. The proposed capital structure does not include any short-term debt.

Issue III(j). Trackers

Should LAC and MGE be permitted to implement an environmental tracker?

Position: MIEC/MECG oppose the implementation of an environmental cost tracker.

Issue IV. Rate Design/Class Cost of Service

a. Rate Design

i. Should a Revenue Stabilization Mechanism or other rate adjustment mechanism be implemented for the Residential and SGS classes for MGE and LAC? If so, how should it be designed and should an adjustment cap be applied to such a mechanism?

Position: MIEC/MECG oppose the implementation of a revenue stabilization mechanism.

ii. Reflective of the answer to part i, what should the Residential customer charge be for LAC and MGE, and what should the transition rates be set at until October 1, 2018?

iii. Reflective of the answer to part i, should LAC's weather mitigated Residential Rate Design be modified to collect a customer charge and variable charge for all units of gas sold, or should it be continued in its current form?

iv. What are the appropriate respective LAC and MGE Class Revenue Allocations?

Position: MIEC/MECG propose that those classes of customers who would receive a rate decrease under the Companies respective class cost of service studies be moved 25% towards their actual cost of service, which is below the revenue currently collected in rates.

v. What are the appropriate respective LAC Transportation and MGE Large Volume Rate Designs?

Position: MIEC/MECG support the respective rate designs as proposed by the Companies and accepted in the testimony of Brian Collins.

b. Class Cost of Service

i. Should the general service classes of each rate division be consolidated or modified? If so, how? What inter-class revenue requirement shifts, if any, should be made in implementing rates resulting from this case?

Position: MIEC/MECG support the general service classes as proposed by the Company and accepted in the testimony of Brian Collins.

ii. What is the appropriate cost allocation to the customer classes of LAC's Underground Storage Costs?

Position: MIEC/MECG assert that LAC Transportation customers do not use, nor does LAC use on their behalf without specific compensation, the underground storage facilities of LAC. Thus, transportation customers should be allocated no costs of those facilities. MIEC/MECG support the Company's position, which allocates no cost of LAC's underground storage to transportation customers, as proposed by the Company and accepted in the testimony of Brian Collins.

iii. What is the appropriate cost allocation to the customer classes of LAC's Gas Inventory and Propane Inventory Costs?

Position: MIEC/MECG support the Company's position, which allocates no cost of LAC's Gas Inventory and Propane Inventory to LAC transportation customers as proposed by the Company and accepted in the testimony of Brian Collins.

iv. What is the appropriate cost allocation to classes of LAC's and MGE's Measuring and Regulating Station Costs?

Position: MIEC/MECG support the Companies position, which allocates these costs based on Design Day Demand and accepted in the testimony of Brian Collins.

Issue XI: Performance Metrics

b. Should a proceeding be implemented to evaluate and potentially implement a performance metrics mechanism? If yes, how should this be designed?

Position: MIEC/MECG Oppose implementing a proceeding to investigate performance mechanisms.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I do hereby certify that a true and correct copy of the foregoing document has been emailed this 30th day of November, 2017, to all parties on the Commission's service list in this case.

/s/ Edward F. Downey