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Issues:	*Rate of Return and Capital Structure*
Witness:	*David Murray*
Sponsoring Party:	*MoPSC Staff*
Type of Exhibit:	*Surrebuttal Testimony*
Case No.:	*GR-2018-0013*
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MISSOURI PUBLIC SERVICE COMMISSION

COMMISSION STAFF DIVISION

FINANCIAL ANALYSIS UNIT

SURREBUTTAL TESTIMONY

OF

DAVID MURRAY

LIBERTY UTILITIES (MIDSTATES NATURAL GAS) CORP., d/b/a LIBERTY UTILITIES

CASE NO. GR-2018-0013

Jefferson City, Missouri
May 2018

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

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OF THE SURREBUTTAL TESTIMONY OF

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Q. Please state your name.

A. My name is David Murray.

Q. Are you the same David Murray who prepared the Rate-of-Return Section of Staff's Cost of Service Report ("Staff Report") and rebuttal testimony in this case?

A. Yes, I am. I filed rate-of-return ("ROR") testimony on March 2, 2018, and rebuttal testimony on April 13, 2018.

Q. What is the purpose of your Surrebuttal Testimony?

A. I will address Liberty Utilities (Midstates Natural Gas) Corp.'s ("Liberty Midstates") ROR witness, Keith Magee's rebuttal testimony.

EXECUTIVE SUMMARY

Q. What are the main areas you will address?

A. Mr. Magee claims it is inappropriate to use Liberty Utilities Company's ("LUCo") adjusted actual capital structure because it doesn't represent the capital invested in the Liberty Midstates' system. He claims that Liberty Midstates has an identifiable capital structure that represents the mix of capital invested in Liberty Midstates' assets. The capital Mr. Magee is referring to appears to be the capital LUCo raised to purchase the system from Atmos Energy Corporation ("Atmos") in 2012. In Liberty Midstates' 2014 rate case,

Case No. GR-2014-0052, the Commission addressed the fact that this capital structure is not a market-tested capital structure (i.e. Liberty Midstates does not issue capital to third-party investors). In fact, Liberty Midstates only provides financial reporting for internal record keeping and regulatory financial statements filed with utility regulatory authorities. If Liberty Midstates' capital structure were considered appropriate because it was "identifiable," then its current equity ratio would be 100% based on its 2016 FERC Form-2 financial statements.

If the Commission adopts my capital structure recommendation, Mr. Magee indicates the ROE should be 155 basis points higher than what is appropriate for a company, such as Spire Missouri, with a 54.2% common equity ratio. If this 155 basis point adjustment is applied to the Commission's recent allowed ROE of 9.8%, this would result in an ROE of 11.35%. Mr. Magee's recommended adjustment is based on a combination of two approaches that rely on theory and assumptions that don't comport with reality. I will demonstrate why the Commission should continue to rely on my 20 basis point upward adjustment to consider the additional financial risk in my capital structure recommendation.

Q. Have any of Mr. Magee's criticisms caused you to change your recommended allowed ROR?

A. No. I still consider LUCo's capital structure to be the most representative of the debt capacity provided by Liberty Midstates' assets. Because ratepayers provide the cash flows that support this debt capacity, the lower cost of capital that arises from this debt capacity should be shared with ratepayers. I still consider my 20 basis point adjustment to Spire Missouri's allowed ROE to be reasonable for purposes of setting Liberty Midstates' allowed ROE.

TRUE-UP CAPITAL STRUCTURE AND COST OF DEBT

Q. Did you receive enough data through March 31, 2018, to allow you to update your ROR recommendation?

A. No. Liberty Midstates provided updated cost of debt information through March 31, 2018, but they had not provided LUCo's financial statements through the same date. However, Staff is not aware of any fundamental shifts in LUCo's capitalization strategy over the last three months. Therefore, Staff's updated ROR recommendation through December 31, 2017, should be reasonable for purposes of setting Liberty Midstates' allowed ROR.

RESPONSE TO MR. MAGEE'S REBUTTAL TESTIMONY

Capital Structure

Q. Mr. Magee implies that using LUCo's capital structure to set Liberty Midstates' ROR would take the capital structure out of the Commission's hands.[1] Does this make sense?

A. No. Mr. Magee's argument implies that if the Commission uses LUCo's actual capitalization ratios to set Liberty Midstates' ROR, it will somehow box itself in. In Staff's opinion, the opposite is the case. If this Commission sets the authorized ROR based on LUCo's actual capitalization, then LUCo, and the companies between it and APUC, will be incentivized to reduce the amount of debt held at this level. Reducing the amount of debt LUCo is responsible for would reduce LUCo's financial risk and improve its financial flexibility. If the Commission were to authorize Liberty Midstates' a higher equity ratio than LUCo's actual equity ratio, then LUCo would have no incentive to lower the amount of

[1] *Id,* p. 10, ll. 10-14.

leverage (i.e. debt) in its capital structure. In fact, setting the allowed ROR based on this phantom equity may incentivize LUCo to be even more aggressive with its use of debt because they would not face the risk of a loss in revenue requirement due to their financial engineering.

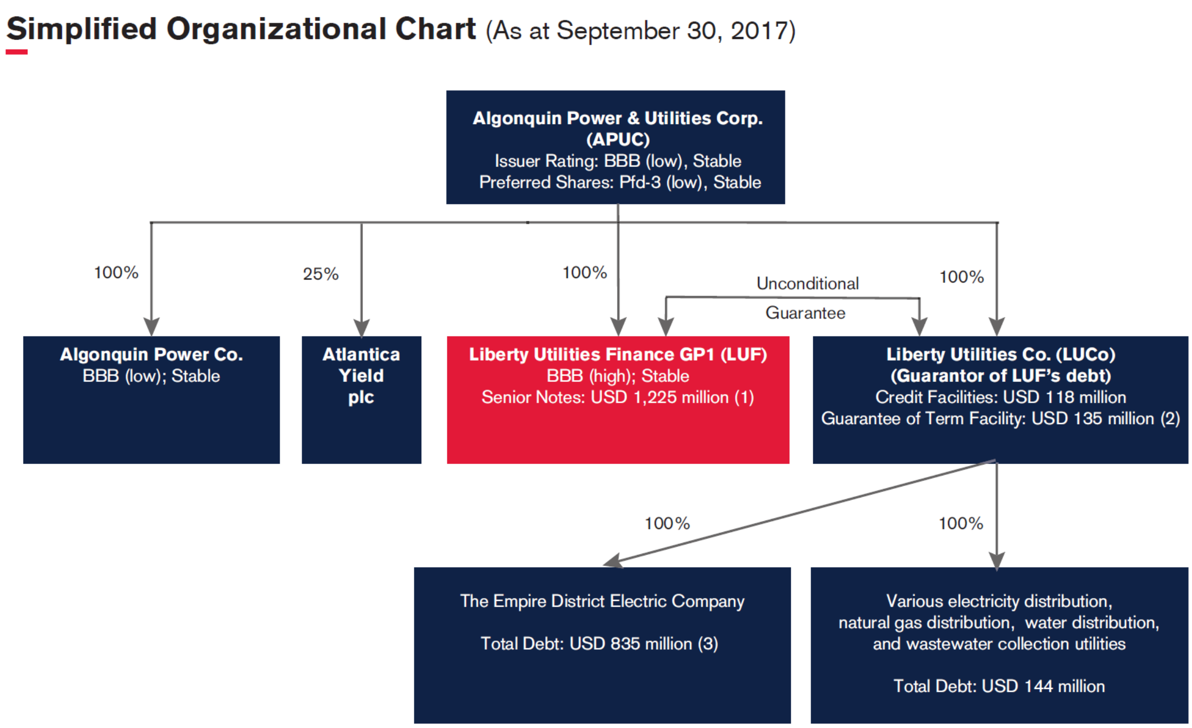
Q. Mr. Magee indicates that he has concerns about your imputation of additional debt to LUCo's reported book capital structure because it is the use of funds, not the source of funds, which determines the cost of capital.[2] Does this argument support Mr. Magee's position?

A. No. The debt issued by the intermediate companies between APUC and LUCo is guaranteed by LUCo. The cost of LUCo's funds is based on the risk profile of its regulated utility subsidiaries, which includes Liberty Midstates. Therefore, the cost of these debt funds is based on investors' assessment of the risk inherent in LUCo's regulated utility assets. Additionally, the debt loaned to the intermediate companies affects the cost of other debt loaned directly to LUCo. LUCo's DBRS credit rating is directly impacted by LUCo's guarantees of this intermediate parent company debt, which is then used to purchase LUCo's equity. But for their ownership interest in LUCo, these intermediate subsidiaries have no economic value. LUCo's regulated utility assets allow this debt capacity. The cash flows from these regulated utility assets are provided by the customers of these systems. The debt investors rely on these low-risk cash flows in deciding how much debt they want to purchase and the required return on this debt. The lower cost associated with this debt capacity should be reflected in both the authorized capital structure and the cost of debt applied to this capital structure.

[2] *Id.* p. 10, l.15 through p. 11, l. 4.

Q. Can you provide a chart that helps illustrate how LUCo interacts with its financing subsidiary, Liberty Utilities Finance GP1 ("LUF")?

A. Yes. This chart was provided in DBRS' January 29, 2018, Rating Report on LUF:



Source: DBRS' January 29, 2018 Rating Report on LUF

As indicated in the above chart, all debt issued by LUF is guaranteed by LUCo, which also guarantees the $135 million credit facility issued by Liberty Utilities (America) Holdco Inc. $965 million of the $1.225 million of LUF senior notes (shown in the red box above) were loaned through affiliate transactions to LUCo, with the remaining amount ($260 million) loaned as affiliate transactions to intermediate holding companies between APUC and LUCo.[3] Although the $135 million credit facility and $260 million LUF loans do not show up as debt on LUCo's balance sheet, these obligations are unconditionally

[3] See page 2 of Staff's Schedule 14 provided in Appendix 2 of Staff' Cost of Service Report.

guaranteed by LUCo. DBRS properly recognizes this "off-balance-sheet" debt as LUCo's debt obligations, which affects LUCo's credit quality, and therefore, its credit rating.

Q. You indicated that APUC is issuing intermediate holding company debt to give the appearance that LUCo has a higher equity ratio. What proof do you have of this?

A. The connection of these transactions can be determined by researching and analyzing LUCo's Notes to Financial Statements and LUCo's Statement of Cash Flows. Note 9(b) to LUCo's December 31, 2015 Audited Consolidated Financial Statements indicates the following:

> ** ____
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> ____
> ____
> ____
> ____
> ____
> ____
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> ____
> ____
> ____
> ______________________________[4] ** (emphasis added)

LUCo's Statement of Cash Flows for the three months ended June 30, 2015, and September 30, 2015, show cash inflows from the issuance of common equity of ** ____ ________________________ ** respectively, which very closely matches the amounts of debt loaned to the intermediate parent companies, but still guaranteed by LUCo.

Note 9(b) to LUCo's December 31, 2015 Audited Consolidated Financial Statements indicates the following:

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[4] Consolidated Financial Statement of Liberty Utilities Co. for the years ended December 31, 2015 and 2014, Notes to the Audited Consolidated Financial Statements, Note 9.(b).

> ** [5] **
>
> LUCo's Statement of Cash Flows for the three months ended March 31, 2016, show cash inflows from the issuance of common equity of the exact same amount.

Q. Did you discover anything troubling about how APUC is assigning the debt issued by LUF?

A. Yes. LUF issued $750 million of Series E bonds on March 24, 2017. LUF issued this debt in 6 different tranches with differing maturities, and therefore interest rates. LUF loaned the lowest cost tranche, 2.78%, in the amount of $100 million, to the intermediate holding company. In the same offering, LUF issued $229 million of 4.89% debt which was loaned to LUCo. If the Commission allows the 2.78% debt to be treated as equity, then LUCo earns an additional 200 basis points of margin on this debt as compared to if the 4.89% debt had been loaned to the intermediate holding company.

Q. What does LUCo claim as its cost of debt for purposes of this rate case?

A. 4.70%,[6] which does not include any of the debt transferred off of LUCo's balance sheet, even though it is still guaranteed by LUCo.

Q. What would LUCo's embedded cost of debt be if $100 million of 2.78% debt were swapped for $100 million of 4.89% debt?

[5] Consolidated Financial Statement of Liberty Utilities Co. for the years ended December 31, 2016 and 2015, Notes to the Audited Consolidated Financial Statements, Note 9.(b).

[6] Magee Rebuttal, p. 16, ll. 13-17.

A. Swapping the cheaper debt for the more expensive debt reduces LUCo's embedded cost of debt from 4.71% to 4.60%. Using Mr. Magee's recommended capital structure, this causes an approximate $43,000 increase in Liberty Midstates' annual revenue requirement.

Q. Assuming the same allowed ROE, what is the revenue requirement difference between your adjusted LUCo capital structure recommendation and LUCo's unadjusted capital structure?

A. Using financial statement data through December 31, 2017, the revenue requirement implied by LUCo's unadjusted capital structure is approximately $700,000 higher compared to LUCo's adjusted capital structure.

Q. Mr. Magee indicates the LUCo situation is similar to the circumstances the Commission evaluated in the Spire Missouri rate cases. Do you agree?

A. No. While Staff recommended the Commission include Spire Inc.'s holding company debt in setting Spire Missouri's allowed capital structure, a key difference in this case is that LUCo guarantees the intermediate holding company debt, whereas Spire Missouri does not. The Commission, in supporting its decision not to adopt Staff's recommendation to use Spire Inc.'s consolidated capital structure, indicated the following in its Report and Order:

> 7. Spire Missouri has an independently determined capital structure in that its debt is secured by its own assets and not the assets of Spire Inc. or any of Spire Inc.'s other subsidiaries. Additionally, Spire Missouri's assets do not guarantee the long-term debt of its parent or of any of Spire Inc.'s other public utilities or of Spire Marketing or Spire STL Pipeline. Further, the Commission must approve any long-term debt issuances made by Spire Missouri.

> 8. Spire Missouri's stand-alone capital structure supports its own bond rating.[7]

First, considering the Commission's above findings, it is timely to reiterate that Liberty Midstates does not issue its own debt and its capital structure does not support its own credit rating. The Commission cited these facts in deciding to adopt LUCo's capital structure in the 2014 rate case.[8]

Second, LUCo guarantees the debt issued by the intermediate parent companies. This is a key difference between the Spire Missouri rate cases and this case. LUCo's Canadian rating agency, DBRS, specifically recognizes the fact that LUCo guarantees this debt when assessing LUCo's financial risk and assigning it a credit rating of 'BBB (high)'. Staff discussed this extensively in its Detailed Direct Testimony.[9] LUCo's guarantee of this intermediate parent company debt causes increased financial risk and therefore higher costs on subsequently issued debt assigned directly to LUCo. Staff is not aware of a commercially justified reason to issue this debt at the intermediate holding company levels other than to attempt to support higher equity ratios for purposes of ratemaking. If there is another commercially justified reason for doing so, the Company should explain it to the Commission.

Q. Mr. Magee indicates that your capital structure approach is misplaced if you are "attempt[ing] to identify a consolidated capital structure that reflects the funds being used to finance Liberty Midstates' assets and operations…"[10] Was this your attempt?

A. No.

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[7] Footnotes omitted.
[8] Report and Order in Case No. GR-2014-0152, pp. 15-16.
[9] Appendix 2 to Staff's Cost of Service Report, p. 24, l. 19 through p. 26, l. 6.
[10] Magee Rebuttal, p. 11, ll. 5-7.

Q. What did you intend by recommending the use of LUCo's adjusted capital structure for purposes of setting Liberty Midstates' allowed ROR?

A. My intent was to recommend the capital structure that most closely reflects the amount of debt capacity consistent with the risk profile of LUCo's regulated utility assets, which includes that of Liberty Midstates. This debt capacity is made possible by the cash flows provided by the ratepayers of LUCo's regulated utility assets. Therefore, it is just and reasonable for ratepayers to receive credit for the lower-cost capital structure that is made possible by the revenue they provide to LUCo. LUCo's adjusted capital structure is that which third-party debt investors evaluate when deciding on the coupon (i.e. interest rate) they require to purchase LUF debt, which is guaranteed by LUCo. LUCo also guarantees the variable-rate term credit facility Mr. Magee discusses in his testimony.[11] This capital structure is also consistent with LUCo's targeted capital structure that it considers appropriate for its low-risk United States' regulated utility assets.[12]

Q. Mr. Magee indicates that Liberty Midstates has an "identified capital structure."[13] Do you agree with Mr. Magee that Liberty Midstates has an "identified capital structure?"

A. No. While Liberty Midstates' has balance sheet accounts,[14] Liberty Midstates does not develop and report separate financial statements for third-party investors. In fact, although it was Staff's understanding that Liberty Midstates did have affiliate loan agreements with LUCo, which is supposed to be evidence for the $55 million of debt Mr. Magee references in his testimony, Liberty Midstates' FERC Form 2 Balance Sheet as of

[11] *Id.*, p. 11, ll. 17-19.
[12] Liberty Utilities Fixed Income Presentation, September 2017, p. 12.
[13] *Id.*, p. 11, l.8.
[14] See Liberty Midstates responses to Staff Data Request 117.1

December 31, 2016, filed with the Missouri Public Service Commission did not identify these affiliate notes. According to Liberty Midstates' FERC Form 2 Balance Sheet as of December 31, 2016, Liberty Midstates' capital structure is supported by 100% equity.

Q. Is there additional evidence that the Commission can review in order to evaluate the legitimacy of Liberty Midstates' capital structure?

A. Yes. Liberty Midstates filed an Application for financing authority in Case No. GF-2018-0091. In that October 3, 2017, Application, Liberty Midstates asked for Commission Authority to refinance an internal loan that had already matured on July 31, 2017. Being that this was an affiliate note, there was no consequence to Liberty Midstates' default on this promissory note. As far as Staff can determine, this was simply a matter of internal recordkeeping. As Staff noted, although Liberty Midstates viewed these transactions as affiliate notes payable, these affiliate notes have not consistently been reported as "debt" on Liberty Midstates' FERC Form 2 Balance Sheets.

Q. Did the Commission consider similar issues in Liberty Midstates' last rate case in 2014 when it decided it should set Liberty Midstates' allowed ROR based on LUCo's capital structure?

A. Yes. While there is additional evidence in this case to further illustrate the illegitimacy of Liberty Midstates' capital structure, the financial relationship between LUCo and Liberty Midstates has not changed since 2014. The Commission should reaffirm its decision in 2014 and use LUCo's capital structure (as adjusted by Staff and recognized by DBRS) to set Liberty Midstates' allowed ROR because it is this capital structure that reflects the amount of debt capacity made possible by LUCo's regulated utility assets and its customers.

Q. Mr. Magee discusses actual and authorized equity ratios for the operating utility companies within your proxy group as well as authorized equity ratios for the natural gas distribution industry for 2017.[15] How do you respond?

A. Mr. Magee should have provided some context and discussion on the authorized equity ratios for the various companies. For example, Atmos Energy Corporation's ("Atmos") authorized equity ratios have been consistent with its *actual* equity capitalization levels. Although Atmos' corporate structure is different than LUCo's, the end-result is the same in which the debt financing for all of the utility assets is aggregated at the corporate level. Atmos does not hold its regulated gas distribution systems in subsidiary corporations as LUCo does. Atmos' gas distribution systems are divisions of Atmos. Because Atmos' is capitalized with more equity than LUCo and it also owns low-risk regulated utility assets, S&P assigns it an 'A' credit rating and Moody's assigns it an 'A2' credit rating. Therefore, while it is true that Atmos' ratepayers are paying a ROR based on a more equity-rich capital structure, Atmos actually maintains this higher common equity ratio in its corporate capital structure, which supports its strong credit rating. Mr. Magee is suggesting Liberty Midstates' ratepayers should pay for an 'A' rated capital structure without receiving the benefit of the financial stability/flexibility that would be afforded if this capital structure were actually maintained. This is not a fair and reasonable request from ratepayers. If LUCo managed its capital structure consistent with the amount of leverage appropriate for an 'A' rated regulated utility, then Staff would recommend the use of such a capital structure for ratemaking purposes.

[15] *Id.* p. 12, l. 8 through p. 13, l. 5.

Additionally, Staff discovered that other jurisdictions, such as Georgia, included short-term debt in their authorized capital structure for Atmos because of its significant and consistent use. The Georgia Public Service Commission specifically indicated the following in its Order in Docket No. 30422:

> As will be discussed in more detail below, Atmos' proposed capital structure is rejected because it is inconsistent with the Company's historic use of short-term debt, with the Company's representations before this Commission in recent financing applications, with the Company's actual use of short-term debt thus far in the projected test year, and with the Company's own testimony as to its plans to use short-term debt during the forecast test year.[16]

The Kentucky Public Service Commission indicated the following when it decided to include a short-term debt ratio of 5.16% in Atmos' capital structure for ratemaking purposes:

> <u>To</u> the extent there is a connection between long-lived assets and long-term forms of capital, the Commission has recognized that a utility's rate base includes items other than long-lived plant assets that may be financed with short-term debt. Furthermore, while it is the intent of utilities, from a planning perspective, to finance long-lived assets with long-term forms of capital, from a practical perspective the Commission has long held the position that capital cannot be assigned directly to a particular state, jurisdiction or specific asset.[17]

While Staff is not recommending inclusion of short-term debt in Liberty Midstates' authorized capital structure, if the Commission considers adopting a hypothetical capital structure approach, as Mr. Magee recommends, then Staff recommends the Commission include some short-term debt to recognize the fact that it is consistently used to support local natural gas distribution assets, as recognized by other jurisdictions when setting a gas utility's allowed ROR.

[16] Georgia Public Service Commission Order in Docket No. 30442, March 29, 2010, p. 13.
[17] Russell Ernst, Regulatory Focus, Final Report, *Regulatory Research Associates*, May 8, 2014, p. 3.

Q. How are the other companies in your proxy group structured and capitalized?

A. Northwest Natural Gas Company ("Northwest") directly owns its Oregon and Washington gas utility systems as divisions rather than subsidiaries. Therefore, these systems don't issue their own debt. The Oregon and Washington Commissions set the allowed common equity ratio at approximately 50%, which approximates Northwest's actual common equity ratio when short-term debt is included in the capital structure. Washington included approximately 5% of short-term debt in its authorized capital structure. Over the last five years, Northwest's actual capital structure has been supported by 49% equity and 51% debt, with 8.25% of the debt classified as short-term debt.

ONE Gas Inc. ("ONE Gas") performs all of its debt financing at the holding company level. Similar to LUCo, ONE Gas holds its three regulated utility systems in separate subsidiaries, one for each state in which it owns systems – Kansas, Oklahoma and Texas. However, these subsidiaries do not issue their own debt. It appears each of these states have authorized equity ratios very similar to ONE Gas' consolidated equity ratio, which had been close to 60%. However, Kansas limited the ratemaking equity ratio to no higher than 55% and Oklahoma indicated it will gradually reduce the equity ratio it allows for purposes of ratemaking. Although ratepayers are paying a ROR based on an equity-rich capital structure, ONE Gas' management's business and financial strategies do not dilute the credit supportiveness provided by ratepayers, as illustrated by ONE Gas' strong credit ratings of 'A' and 'A2' from S&P and Moody's, respectively.

In early 2017, Southwest Gas Corporation ("Southwest Gas") was part of a restructuring in which it became a subsidiary of Southwest Gas Holdings ("Holdings"). Southwest Gas directly owns gas distribution assets in Arizona, California and Nevada.

Before the restructuring, Southwest Gas was the publicly-traded entity and the gas distribution assets were directly owned at this level. Being that Southwest Gas has consistently had an actual common equity ratio of around 50% or above over the last several years and the authorized common equity ratios have approximated this level,[18] it is clear that Southwest Gas ratepayers are paying an authorized ROR based on an actual amount of common equity which supports Southwest Gas' S&P credit rating of 'BBB+' and Moody's credit rating of 'A3.' Although Holdings and its non-regulated subsidiary, Centuri Construction Group Inc. ("Centuri"), do not issue significant amounts of leverage, which could weaken Southwest Gas' credit rating, Centuri's higher business risk does weaken S&P's assigned credit rating to Southwest Gas.

Q. What does the context of the allowed equity ratios for the operating utility companies in your proxy group demonstrate?

A. That the allowed equity ratios are consistent with the more conservative financial strategies actually employed by the corporations that own these operating utility companies. While it is true that ratepayers are paying for more equity-rich capital structures for these companies, at least the corporate parent companies of these utility operating companies are capitalizing their assets consistent with the authorized equity ratios. This provides these companies with sufficient financial flexibility if uncertain events, such as the financial crisis of 2008 and 2009, should occur.

Q. Mr. Magee also cites mean and median authorized equity ratios for gas distribution cases decided in 2017, as reported by RRA. Did you research all of these cases

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[18] Southwest Gas Corp. (Southern) Division in Nevada was authorized a 42.74% equity ratio, but Southwest Gas Corp. (Northern) Division in Nevada was authorized a 59.06% equity ratio. Nevada allocates tax-advantaged debt secured by assets of one of its divisions, which lowers the equity ratio, but the equity is assigned to the other division.

to determine if the authorized equity ratios for these gas companies were also based on actual equity ratios?

A. No. Based on Staff's research of the operating companies in its proxy group, it appears that most authorized equity ratios are consistent with the actual equity ratios employed by the parent company. Consequently, Staff did not believe it was necessary to review all of these cases.

Q. Did Staff research how other states have approached setting a capital structure for LUCo's utility companies?

A. Yes. Staff researched information available to it through the Commission's subscription to S&P Global Market Intelligence ("MI") as well as through discovery.

Q. What did Staff determine through discovery?

A. In response to Staff Data Request No. 186, Liberty Midstates provided documents from its recent rate cases in Iowa and Illinois. Although both cases resulted in settlements, it is clear from the testimony of the Iowa's Office of Consumer Advocate's ("Iowa") ROR witness and the Illinois Commerce Commission's ("Illinois") Staff's ROR witness that each witness considered LUCo's leverage when determining their recommended capital structure. The Illinois ROR witness recommended a 45.81% common equity ratio. The Iowa ROR witnesses' testimony regarding the specific common equity ratio recommended was redacted from the document provided by Liberty Midstates.

Q. Who sponsored testimony on behalf of Liberty Midstates in these rate cases?

A. Mr. Magee.

Q. What did you determine about LUCo's other companies from your research of information available through MI?

A. I could determine the implied capital structures from settlements for the other companies, with most equity ratios of approximately 50%, but information for other parties' ROR testimonies was not available through MI. Therefore, I could not determine whether there was a significant difference in initial positions regarding the recommended equity ratio and/or the methodology for determining the recommended equity ratio.

Q. What do you conclude from this research?

A. For the cases in which I had access to the details of the other parties' ROR witnesses, it is clear that these other parties considered LUCo's more aggressive corporate financial strategies when making their ratemaking capital structure recommendations.

Q. Mr. Magee claims you should have allowed for issuance expenses in your cost of debt recommendation.[19] Do you agree?

A. Yes.

Q. Why didn't you do so?

A. Because Liberty Midstates had not provided me with sufficient information to do so. Staff requested Mr. Magee's workpaper that supports the 10 basis point estimate for issuance expenses. In response to Staff Data Request No. 364, Liberty Midstates provided issuance cost information that supports Mr. Magee's 10 basis point estimate. Therefore, Staff is revising its cost of debt recommendation to 4.67% from 4.57%.

<u>RETURN ON EQUITY ADJUSTMENT FOR CAPITAL STRUCTURE</u>

Q. What part of Mr. Magee's rebuttal testimony is most consequential to your recommended allowed ROE in this case?

[19] *Id.* p. 16, ll. 8-12.

A. Mr. Magee's rebuttal testimony addressing my recommended 20 basis point adjustment to the Commission's recent allowed ROE of 9.8% for Spire Missouri.[20]

Q. Do you agree with Mr. Magee's rebuttal on pages 21 through 39?

A. No, but being that this rebuttal is not directly consequential to my recommended allowed ROE, I am not going to address this testimony in any detail.

Q. Mr. Magee maintains that while credit rating differentials are informative about the direction of an adjustment in the cost of equity, he does not agree that average cost of debt differences based on ratings are a reliable proxy for cost of equity adjustments.[21] What are Mr. Magee's concerns about using bond yield differentials?

A. Mr. Magee indicates that "debt and equity are different securities with different risk/return characteristics, different lives, and different investors." Mr. Magee indicates that there are fundamental differences between debt and equity investors because debt investors have contractually defined returns, whereas equity investors do not. He indicates that because of these fundamental differences in risk/return profiles, the changes in risk cannot be assumed to affect the required rate of return equally.

Q. Do you agree with the general premise of Mr. Magee's discussion of risk/return differences between equity and debt investors?

A. Yes.

Q. Do you agree that utility equity investors are fundamentally different from debt investors?

A. No. This is where we disagree. The investment community commonly refers to utility stocks as "bond surrogates," "bond substitutes," "pseudo bonds," "bond proxies,"

[20] *Id.* p. 17, l. 1 through p. 21, l. 1.
[21] *Id*, p. 18, ll. 7-21.

etc. Consequently, I do not agree with Mr. Magee that utility equity investors and debt investors are "different investors."

Q. Mr. Magee indicates that my recommended LUCo equity ratio, which is 13.26% lower than the 54.2% authorized for Spire Missouri, implies a larger credit rating difference than two notches ('A' as compared to 'BBB+').[22] Did you estimate the credit rating differential between LUCo and Spire Missouri?

A. No.

Q. How did you determine the notching differential between Spire Missouri's credit profile and LUCo's credit profile?

A. I compared S&P's assigned "stand-alone-credit-profile" ("SACP") for Spire Missouri, which is an 'A,'[23] to DBRS' assigned credit rating to LUCo's financing subsidiary, LUF, which is 'BBB (high).'[24] DBRS's 'BBB (high)' credit rating is equivalent to S&P's 'BBB+' credit rating.

Q. Why didn't you compare S&P's ratings on both companies?

A. Because S&P does not provide a SACP for LUCo/LUF. S&P assigns LUCo/LUF a rating based on APUC's consolidated credit profile, which includes non-regulated power generation assets as well as other international operations.

Q. Does DBRS's credit rating consider LUCo's more leveraged capital structure?

A. Yes. In fact, DBRS recognizes the debt issued at the intermediate parent companies when assessing LUCo's financial risk. DBRS specifically notes that it adjusts

[22] *Id.* p. 19, ll. 1-12.
[23] "Summary: Laclede Gas Company," S&P RatingsDirect, July 19, 2017.
[24] Eric Eng and Adam Provencher, "Ratings Report – Liberty Utilities Finance GP1," DBRS, January 29, 2018. (Attached as Confidential Schedule ?)

LUCo's capital structure for this debt because LUCo guarantees this debt.[25] DBRS specifically indicated the following about LUCo's credit profile even with its more leveraged capital structure:

> The debt-to-capital ratio, excluding goodwill, increased significantly from the 2016 level, but remained in the BBB rating category.[26]

Q. Considering DBRS' assessment, is there any reason for Mr. Magee to estimate the credit rating implications of LUCo's more leveraged capital structure?

A. No. DBRS' confirmation of LUCo's 'BBB (high)' credit rating specifically considers LUCo's current leveraged capital structure. Mr. Magee's assumption of what Moody's credit rating might be given the leverage difference is speculation given the fact that Moody's doesn't rate LUCo or the debt issued by LUCo's financing subsidiary, LUF.

Q. Could LUCo seek a credit rating from Moody's?

A. Yes. Although LUCo would have to pay for Moody's ratings services, there is nothing preventing LUCo from requesting Moody's to rate its debt.

Q. Mr. Magee suggests that if the Commission adopts your capital structure recommendation, the Commission should add 155 basis points (1.55%) to the 9.8% it allowed Spire Missouri in its recent rate cases.[27] What would the allowed ROE be if the Commission adopted Mr. Magee's suggestion?

A. 11.35%.

Q. Is that a reasonable allowed ROE for this company?

A. No.

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[25] *Id.*, p. 3.
[26] *Id.* p. 1.
[27] *Id.* p. 20, l. 19 through p. 21, l. 1.

Q. How does Mr. Magee quantify his estimated adjustment?

A. He uses two approaches. For both approaches, he presumes the Commission's allowed ROE of 9.8% is equivalent to the current cost of equity for Spire Missouri. Because utility investors require a lower return than investments in the broader markets, Mr. Magee's assumption causes a market risk premium estimate of 10.26%. As Staff explained in its Detailed Direct Testimony, a market risk premium this high is well beyond reputable investor expectations. Because Mr. Magee presumes allowed ROEs are synonymous with market required returns, this causes his estimates to be upwardly-biased.

Mr. Magee's first approach relies on a theory used to remove the estimated impact of financial risk on a company's cost of equity. This theory relies on the Capital Asset Pricing Model ("CAPM") to estimate such adjustments. The adjustment relies on a formula used to remove the impact of the use of debt on the beta coefficient used to adjust the market risk premium.[28] The approach proposed by Mr. Magee is commonly used in valuation assignments when the subject company plans on targeting a different amount of leverage than that used by the proxy group. Again, although this approach is used by valuation analysts for purposes of estimating the impact of leverage on the cost of equity, the estimated market risk premiums used for such assignments are much lower than those assumed by Mr. Magee. Staff recalculated this adjustment using the risk premiums Staff provided in its Detailed Direct testimony, which were 4.5% and 6.0%. Performing the levered/unlevered beta approach with more reasonable market risk premiums implies a risk premium adjustment in the range of 58 to 78 basis points.

[28] See Staff's Detailed Direct Testimony, pp. 43-46 for a more detailed discussion of the CAPM and beta.

Q. Do you have any concerns with certain assumptions required in the levered/unlevered beta approach?

A. Yes. For purposes of unlevering the beta the corporate tax rate is an underlying assumption due to the tax deductibility of debt capital. Historical betas are a function of past higher tax rates. The relevering of betas with a lower assumed tax rate causes higher betas than actual current betas. This contradicts the recent downward trend in utility betas.

Q. Does the empirical beta information related to your proxy groups contradict the aforementioned theory that companies with more leverage will have higher betas, causing a higher cost of equity?

A. Yes. The two companies with the most leverage in my proxy group, Spire Inc. and Northwest Gas Company, have lower betas than the other three companies in the proxy group.

Q. What was Mr. Magee's second approach?

A. Mr. Magee's second approach calculates the ratio of the Commission's 9.8% allowed ROE to a recent 3-month average A-rated utility bond yield (9.8/3.83=2.55). Mr. Magee then multiplies this ratio by the 33 basis point spread between A-rated bonds and BBB-rated bonds and concludes that this 84 basis point (2.55 x 0.33 = 0.84) difference is more appropriate for deriving the amount of consideration to allow equity investors for a full letter grade difference in credit ratings. Because he concludes that Moody's methodology warrants a 4-notch differential, he multiplies the 84 basis point difference by 4/3 to arrive at a 112 basis point adjustment. If Mr. Magee had applied the actual two-notch differential to his 84 basis point determination, his quantified adjustment would have been 56 basis points.

Q. How do LUCo's debt costs compare to Spire Missouri's debt costs?

A. LUCo issued 30-year unsecured debt in April 2017 at a coupon of 4.89%. Spire Missouri issued 30-year secured debt in September 2017 at 4.23%. Considering the fact that average utility bond yields declined by approximately 25 basis points between the spring and fall of 2017 as well as the fact that Spire Missouri issued first mortgage bond debt as compared to LUCo's unsecured debt, the spread between Spire Missouri's cost of debt and LUCo's cost of debt is reasonably estimated to be approximately 25 basis points.

Q. After considering Mr. Magee's proposed theoretical adjustments compared to empirical data, are you still confident in the reasonableness of your recommended 20 basis point adjustment to the 9.8% allowed ROE if the Commission adopts your more leveraged capital structure recommendation?

A. Yes.

SUMMARY AND CONCLUSIONS

Q. What are the main points the Commission should consider in evaluating the credibility of Staff's recommendation?

A. Staff's capital structure recommendation is consistent with the approach it took in Liberty Midstates 2014 rate case, Case No. GR-2014-0152. In that case, the Commission determined that LUCo's capital structure was the proper capital structure to use to set Liberty Midstates' allowed ROR. Nothing has changed in how Liberty Midstates' financing needs are met since the 2014 rate case. The only thing that has changed is that APUC is moving some of LUCo's debt off the balance sheet even though LUCo is still responsible for this debt. The Commission should set Liberty Midstates' allowed ROR based on Staff's adjusted capital structure because this capital structure captures the amount of leverage supported by LUCo's low-risk regulated utility assets.

The Commission should accept Staff's recommended 20 basis point adjustment to the Commission's recent allowed ROE of 9.8% for Spire Missouri. Utility stocks have many bond-like characteristics. This explains why utility stock valuation levels traded at all-time highs when bond yields were at historic lows. Therefore, an adjustment to the ROE based on bond yield differentials is logical and consistent with investors' views in comparing return potential for utility stocks versus bonds.

Q. Does this conclude your Surrebuttal Testimony?

A. Yes, it does.

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of Liberty Utilities	)	
(Midstates Natural Gas) Corp. d/b/a	)	Case No. GR-2018-0013
Liberty Utilities' Tariff Revisions	)	
Designed to Implement a General Rate	)	
Increase for Natural Gas Service in the	)	
Missouri Service Areas of the Company	)	

AFFIDAVIT OF DAVID MURRAY

STATE OF MISSOURI	)	
	)	ss.
COUNTY OF COLE	)	

COMES NOW DAVID MURRAY, and on his oath declares that he is of sound mind and lawful age; that he contributed to the foregoing Surrebuttal Testimony, and that the same is true and correct according to his best knowledge and belief.

Further the Affiant sayeth not.

David Murray

DAVID MURRAY

JURAT

Subscribed and sworn before me, a duly constituted and authorized Notary Public, in and for the County of Cole, State of Missouri, at my office in Jefferson City, on this 9th day of May, 2018.

Dianna L. Vaught

Notary Public

DIANNA L. VAUGHT
Notary Public - Notary Seal
State of Missouri
Commissioned for Cole County
My Commission Expires: June 28, 2019
Commission Number: 15207377