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November 1, 1999

Mr. Dale H. Roberts
Secretary/Chief Regulatory Law Judge
Public Service Commission
P. O. Box 360
Jefferson City, MO 65102

FILED³

NOV 01 1999

RE: Laclede Gas Company
Case No. GR-99-315

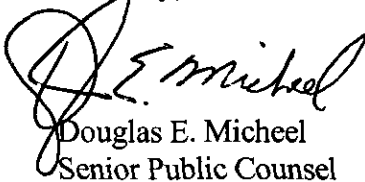
Missouri Public
Service Commission

Dear Mr. Roberts:

Enclosed for filing please find the original and fourteen copies of **Reply Brief of the Office of the Public Counsel**. I have on this date mailed or hand-delivered copies to all counsel of record. Please "file" stamp the extra-enclosed copy and return it to this office.

Thank you for your attention to this matter.

Sincerely,


Douglas E. Micheel
Senior Public Counsel

DEM/mm

Enclosures

cc: Counsel of Record

**BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI**

FILED

NOV - 1 1999

Missouri Public
Service Commission

In the Matter of Laclede Gas Company's)
Tariff Sheets to Revise Natural Gas Rates)
Schedules.)

Case No. GR-99-315

REPLY BRIEF OF THE OFFICE OF THE PUBLIC COUNSEL

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I. INTRODUCTION

The Office of the Public Counsel ("Public Counsel") files this Reply Brief in response to the Initial Brief of Laclede Gas Company ("Laclede"). Public Counsel believes that, for the most part, it has anticipated the majority of arguments made by Laclede. However, failure to reply to each specific argument does not indicate Public Counsel's agreement with that argument, merely that no response is necessary.

After reviewing the Initial Brief of Laclede, Public Counsel does not believe that Laclede has carried its burden to demonstrate that the Company should receive a 12.75% return on common equity. Laclede should receive a 9.7% return on common equity with a level of short-term debt in the regulatory capitol structure of \$79 million. Laclede has also failed to demonstrate that the Commission should discard its long-standing regulatory treatment of Laclede's advertising expenses or that the Commission should alter the sunset period for requiring Laclede to file a general rate case proceeding to recover its safety replacement program deferrals. Finally, the evidence supports Public Counsel's proposal to set the level of revenue imputation for Laclede's off-system sales at \$2.4 million.

II. CONTESTED ISSUES

A. Return on Equity

Laclede at pages 16 through 36 of its Initial brief attacks the return on equity recommendations of both the Staff and Public Counsel. Laclede asserts that its return on equity of 12.75% is the only ROE recommendation that comports with the legal standards for a reasonable ROE and satisfies the reasonableness test based upon other returns granted by this Commission and other utility commissions. Public Counsel disagrees. Public Counsel's

recommendation of a return on equity for Laclede comports fully with the legal requirements of the Hope and Bluefield cases and is reasonable given the current market conditions.

Beginning at page 19 of its brief Laclede alleges that Public Counsel's return on equity recommendation does not account for changes in economic conditions and capital markets. To demonstrate this alleged problem Laclede points to the fact that there has been significant changes in the capital markets over the past ten years with respect to unregulated companies, such as those included in the S&P 500. So what. The fact that unregulated companies have experienced growth in earnings and stock values does not equate to a requirement that this Commission ratchet up Laclede's return on equity to 12.75% as suggested by Laclede. It is meaningless to compare one company's or one industry's profitability or returns to another without taking into account risk differences between the companies or the industries. (Ex. 45 p. 2, l. 26-30).

Public Counsel's recommendation does indeed take into account changes in economic conditions and changes in the capital markets. In arriving at Public Counsel's recommendation for the appropriate return on equity to authorize for Laclede, Public Counsel witness Burdette primarily utilized the discounted cash flow ("DCF") method. Of course what Laclede fails to recognize is the fact that the DCF is a market-based methodology – it incorporates current stock price and therefore current market conditions as reflected through stock price. Thus, Public Counsel's recommendation does indeed take into account both economic and capital market conditions consistent with Hope and Bluefield.

In an attempt to substantiate its assertion that Public Counsel's recommendation does not consider economic conditions Laclede claims that because its "market to book" ratio is above 1.0 that traditional application of the DCF method is not appropriate. However, a comparison of

market to book ratios for unregulated firms and market to book ratios for regulated firms is meaningless under traditional book value ratemaking.

Unregulated firms do not have their earnings tied to book value, regulated firms earn on book value. Therefore any increase in market to book rates over 1.0 for a regulated firm, such as Laclede, is an indication that investors are more than meeting their expected return requirements. This fact is borne out by the evidence presented in this case.

If Laclede were correct in its assertion with respect to Laclede's market to book ratio one would expect to see evidence that Laclede is having difficulty attracting capital investment. The record evidence demonstrates the exact opposite fact. The record in this proceeding demonstrates that Laclede has been and is able to attract investors. Laclede recently issued \$25 million of common stock and \$25 million of debt. As admitted by witness Olson, Laclede was able to attract investors to both its equity and debt offerings. (Tr. p. 176, l. 4-16; p. 177, l. 19-25).

Recently, the Maryland Public Service Commission rejected the same type of specious market to book adjustment recommended by Laclede in this proceeding. In Re Baltimore Gas and Electric Company, 176 PUR4th 316, 341 (Maryland 1997) the Maryland Commission rejected a market to book adjustment stating:

Turning to the evidence at hand, we are not persuaded by the Joint Applicants' position that DCF analyses understate investors' required returns on equity when market to book ratios significantly exceed 1.0. The Commission set the currently authorized returns for BGE and PEPCO with the primary assistance of DCF methodologies. Even though market to book ratios exceeded 1.0 at the time of and since those decisions, investors have found shares of BGE and PEPCO to be attractive investments at current levels of earnings, dividend yields, and general prospects for the future. In fact, OPC demonstrates that BGE's and PEPCO's capital bases have grown significantly over the past decade, even though the Commission has consistently

utilized the DCF methodology in rate proceedings for the two companies. We wonder why, if Mr. Benore's theory is correct, the Joint Applicants did not present substantial evidence of difficulties in attracting capital investment.

Furthermore, we note that investors have paid increasingly higher prices for the common stock of BGE and PEPCO, even though the equity returns embedded in their rates are those set by the Commission using the DCF methodology. As Mr. Hill testified, if those returns provided investors with an inadequate yield on their investments, they would not pay the going prices for the stocks.

Accordingly, based on the above, we reject the Joint Applicants' criticism of the DCF methodology. We will rely on it in this proceeding as a method of determining investors' return expectations.

The facts in this proceeding are strikingly similar to the facts in the Baltimore Gas case. This Commission has set Laclede's return on equity with the primary assistance of the DCF. See: Re Laclede Gas Company GR-96-193, 172 PUR4th 83, 88 (1996) ("The Commission finds that evidence of Staff and MIEC, including DCF and CAPM analysis and evaluation of comparable companies, supports an ROE of 11 percent.") Despite the fact that Laclede's market to book ratio exceeded 1.0 Laclede has been able to attract investors to its debt and equity.

The Commission should reject Laclede's market to book analysis and disregard the upward adjustment to Laclede witness McShane's DCF analysis reflecting the market to book adjustment. Without this market to book adjustment, that artificially inflates investor expectations, witness McShane's DCF analysis produces a return on equity recommendation of 10.5%. (Ex. 2 p. 3, l. 7). This recommendation is only 80 basis points higher than Public Counsel's recommendation of 9.7%. Obviously, Public Counsel's recommendation is within the zone of reasonableness given its proximity to Laclede's DCF analysis.

Beginning on page 26 of its Initial Brief Laclede alleges that Public Counsel's method to derive Laclede's recommended return "does not comport with the fundamental requirement that

Laclede's return be based on, and reflective of, the returns being earned by other companies with comparable risks." (Laclede brief p. 24). The thrust of this claim is that it was inappropriate for Public Counsel to use a Laclede company specific DCF analysis as the primary method in arriving at its return on equity recommendation. Laclede goes so far as to assert that a company-specific DCF analysis is legally invalid when standing alone. Laclede cites absolutely no legal authority for this claim and Public Counsel is not aware of any legal authority that supports the proposition that a company-specific DCF analysis is legally invalid.

In fact, the legal requirements set forth in Hope and Bluefield do not dictate any specific method this Commission can or cannot utilize in deterring Laclede's return on equity. The Supreme Court in Hope stated:

[T]he Commission [is] not bound to the use of any single formula or combination of formulae in determining rates

Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 602-03, 64 S.Ct. 281, 287-88, 886 L.Ed. 333 (1944). The return authorized for Laclede should be in line with returns of other companies having similar overall risk profiles.

In determining the appropriate return on equity for Laclede, Public Counsel witness Burdette compared both his DCF analysis and his CAPM analysis with his comparable group of local distribution companies. This comparison showed that for his DCF analysis the midpoint ROE for the comparable group was 9.26% and for Laclede it was 9.48%. (Ex. 44 MB-10). This analysis demonstrates that witness Burdette's recommendation is wholly consistent with the legal requirement that the return in equity be reflective of returns being earned by other companies with comparable risks.

Finally, beginning at page 32 of its Initial brief Laclede alleges that Public Counsel's recommendation fails to consider the impact of its return on equity recommendation on

Laclede's financial integrity. The majority of Laclede's claims focus on mathematical mistakes made by Staff witness Broadwater, with respect to his calculation of pre-tax interest coverage ratios. Of course, Public Counsel witness Burdette made no such errors. Second, Laclede claims because Public Counsel's recommendation might result in a downgrade of Laclede's credit rating from AA- to A or BBB Laclede's financial integrity may be in jeopardy. The Commission should not reject Public Counsel's recommendation based upon Laclede's conjecture about its bond ratings.

Laclede has failed to present any credible evidence that Public Counsel's return on equity recommendation will not allow Laclede to maintain and support its credit. In fact, the record evidence demonstrates that there are many factors – not just interest coverage ratios – that go into credit ratings. During cross-examine Laclede witness McShane admitted this fact. (Tr. p. 101, l. 5-23). There is not any evidence in this record that indicates as a result of Public Counsel return on equity recommendation that Laclede's credit rating will be downgraded – let alone downgraded below the investment grade level credit rating of BBB. Simply put, the Commission should reject Laclede's speculation about bond rating downgrades. The purpose of regulation is not to preserve a particular credit rating for Laclede. Finally, no evidence has been presented by Laclede that, assuming arguendo, Laclede receives a downgrade that it would be unable to get credit or attract capital.

The Commission should reject Laclede's inflated return on equity request. Public Counsel believes the appropriate authorized return on equity for Laclede should be 9.70%.

B. Capital Structure

Public Counsel continues to believe it is appropriate to include a 12 month average of short-term debt in Laclede's capital structure. Laclede argues in its Initial brief that Staff and

Public Counsel have utilized a 12 month average of short-term debt simply to reduce the Company's revenue requirement. Such an allegation is not true.

Public Counsel has used a 12 month average to reflect the normal levels of short-term debt Laclede has historically had in its capital structure. Use of a 12 month average of short-term debt in Laclede's capital structure is not a new phenomenon. Indeed, as noted by the Commission in its Report and Order in GR-96-193:

The stipulated revenue increase should result in a return on common equity (ROE) of 11 percent based on a capital structure which includes a 12-month average balance of short term debt, adjusted for test year financings and construction work in progress.

Re Laclede Gas Company, 172 PUR4th 83,87 (1996) (emphasis added). Laclede's attempt to claim the use of a 12 month short-term debt average for determining Laclede's ratemaking capital structure is somehow new or unprecedented does not square with the facts.

Moreover, the record evidence already indicates that Laclede's short-term debt levels are far above the \$29 million level recommended by Laclede. Laclede's short-term debt level has already risen to \$43 for month end July 1999, the last month of the true-up period in this case. (Ex. 128 Schedule 3). This level is a full \$14 million higher than Laclede is recommending. Laclede's unreasonably low \$29 million short-term debt level should be rejected by the Commission.

Use of a 12 month average of short-term debt is the most reasonable way to deal with the changing levels of short-term debt experienced by Laclede. The average recognizes the fluctuations that have historically occurred and sets a more realistic level of short-term debt for Laclede. The Commission should determine that \$79 million of short-term debt is the appropriate level for Laclede's ratemaking capital structure as recommended by Public Counsel and Staff.

C. Advertising

Laclede is seeking nothing less than a complete overhaul of how this Commission determines what advertising expenses should be included in the cost of service for regulated utilities. Laclede opines that "both the Company and its customers would benefit if the Commission were to review and modify the existing standard." Public Counsel believes Laclede has gotten it half right. The Company would certainly benefit from the ability to pass on to its captive customers the costs of its "promotional" advertising in rates. However, Laclede has failed to demonstrate any benefit the captive customers would receive from being required to pay the cost of Laclede's "promotional" advertising.

Laclede proffers three reasons in its Initial brief that allegedly support the abandonment of the current standard for classifying advertisements. First, Laclede claims the current standard requires a line-by-line analysis of each advertisement to determine the "primary message" for each such advertisement. Second, Laclede asserts that determining the "primary message" requires the advertisements be force-fit into a category. Finally, Laclede complains it is very difficult, if not virtually impossible, for any company to meet the standard for including costs for promotional advertisements in rates. None of these "reasons" supports the Commission abandoning its standard for including the cost of advertisements in rates.

The fact that advertisements must be audited and specifically reviewed by Public Counsel and Staff auditors is not a reason to abandon the standard. Indeed, such auditing is a basic function when conducting a determination of what expenses should be included or excluded from the cost of service. Nor is the fact that an auditor must determine the "primary message" of the advertisement and the fact that occasionally people disagree on how to classify a particular advertisement a reason to abandon the standard. This Commission, based upon the evidence

presented, can determine the proper classification of the advertisement. That is the purpose for the Commission conducting hearings – to resolve disputed issues. Finally, the fact that no utility has demonstrated that the benefits of promotional advertising outweigh the costs is not a reason to abandon the standard.

The Commission should reaffirm the KCPL standard used by Public Counsel witness Bolin and disallow \$475,082 of expense related to Laclede's advertisements during the test year.

D. Accounting Authority Order Sunset

The vast majority of Laclede's arguments with respect to this issue were addressed in Public Counsel's Initial brief. However, Laclede's Initial brief demonstrates that its proposal lacks the specificity to be adopted and to become a workable proposal. Instead of simplifying the process, Laclede's proposal would only serve to add more complication and contention between the Staff, Public Counsel and the Company. Laclede's proposal would create a whole new type of proceeding. The current system, a two year sunset is easy in application and straight forward.

Laclede's claims that its proposal would allow the Company to avoid seeking rate relief thus benefiting customers. However, Laclede ignores the fact AAO deferrals are extraordinary and the Company should not defer costs indefinitely. As noted by the Commission In the Matter of Missouri Public Service, 1 MPSC 200, 207 (1991):

Rate stability is a benefit to consumers but deferring costs which could result in additional rate increases in the future to accomplish stability in the short term only will cause greater instability in the longer term. Rates that reflect the current cost of doing business are reasonable and provide more stability than sharp increases caused by improper deferrals of costs to a later period. Requiring a company to operate within the revenue requirement authorized encourages efficiency and prudent decisions.

As noted by the Commission, continued deferral only causes greater rate instability in the future. Simply put, if Laclede needs rate relief it should seek that relief. The Commission should not allow the Company to continue deferring costs on the short-term just to avoid a rate case filing. The Commission should reject Laclede's proposal.

E. Off-System Sales Revenue

Laclede requests that the Commission impute \$900,000 of off-system sales revenues in recognition of an alleged trend of decreasing revenues. Laclede claims that its \$900,000 recommendation is based upon "the most recent year's off-system sales revenues." However, Laclede's claim is based upon the Company's estimates for the 1998-1999 time frame. See: Ex. 125 citing GSIP case Ex. 45. For the last year with actual data Laclede had \$1.6 million worth of off-system sales revenue.

Public Counsel believes rather than focusing on one year, it is more appropriate for the Commission to utilize the 1995-1996 \$3.6 million; 1996-1997 \$2.3 million and 1997-1998 \$1.6 million actual numbers. Using this time frame the average off-system sales revenue experienced by Laclede was \$2.5 million. However, Public Counsel has reduced that average by \$100,000 to recognize any possible changes in the market. (Ex. 125 citing Tr. p. 779, l. 13-16 GO-99-303).

Public Counsel believes the Commission should impute \$2.4 million of revenues into Laclede's cost of service to represent an average of Laclede's historical off-system sales revenue.

III. CONCLUSION

For the above reasons, Public Counsel requests that Laclede be authorized 9.70% return on common equity based upon a capital structure that includes \$79 million in short-term debt. That the Commission disallow \$475, 085 in advertising expense from the cost of service and reaffirm the use of the KCPL standards for determining whether or not certain advertising

expenses are appropriate for recovery from ratepayers. That the Commission set a two-year "sunset" period for Laclede's proposal to extend the sunset period. Finally, Public Counsel requests the Commission determine that the appropriate amount of revenues to represent Laclede's level of off-systems sales is \$2.4 million.

Respectfully submitted,
OFFICE OF THE PUBLIC COUNSEL

A handwritten signature in black ink, appearing to read "D E Micheel". The signature is fluid and cursive, with the first letters of the first and last names being capitalized and prominent.

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CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the foregoing has been mailed or hand-delivered to the following on this 1st day of November, 1999:

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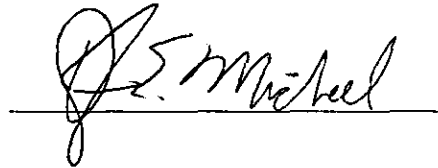
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A handwritten signature in cursive script, appearing to read "J. S. Michael", is written over a horizontal line.