LACLEDE GAS COMPANY
720 OLIVE STREET
ST. LOUIS, MISSOURI 63101

AREA CODE 314
342-0532

MICHAEL C. PENDERGAST
ASSOCIATE GENERAL COUNSEL

October 15, 1999

HAND DELIVERED

FILED[3]

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Missouri Public
Service Commission

Mr. Dale Hardy Roberts
Secretary/Chief Regulatory Law Judge
Missouri Public Service Commission
Harry S Truman Building
301 W. High Street
Jefferson City, MO 65101

RE: Case No. GR-99-315

Dear Mr. Roberts:

Enclosed for filing, please find the original and fourteen copies of the Initial Brief of Laclede Gas Company in the above-referenced case. Please see that this filing is brought to the attention of the appropriate Commission personnel.

Copies of this Initial Brief have been hand delivered or mailed to all parties of record on this date. Thank you for your consideration in this matter.

Sincerely,

Michael C. Pendergast

Michael C. Pendergast

MCP:jaa

cc: All parties of record

Enclosure

FILED[3]

OCT 15 1999

Missouri Public
Service Commission

MISSOURI PUBLIC SERVICE COMMISSION

Case No. GR-99-315

INITIAL BRIEF OF LACLEDE GAS COMPANY

Gerald T. McNeive, Jr.
Senior Vice President – Finance
and General Counsel
Laclede Gas Company
720 Olive Street
St. Louis, MO 63101
(314) 342-0508
MBE #19649

Thomas M. Byrne
Associate Counsel
Laclede Gas Company
720 Olive Street
St. Louis, MO 63101
(314) 342-0536
MBE #33340

Michael C. Pendergast
Associate General Counsel
Laclede Gas Company
720 Olive Street
St. Louis, MO 63101
(314) 342-0532
MBE #31763

Ellen L. Theroff
Assistant General Counsel
Laclede Gas Company
720 Olive Street
St. Louis, MO 63101
(314) 342-0530
MBE #40956

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BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Laclede Gas Company's Tariffs	)	
to Revise Natural Gas Rate Schedules	)	Case No. GR-99-315

INITIAL BRIEF OF LACLEDE GAS COMPANY

Pursuant to the briefing schedule established by the Missouri Public Service Commission ("Commission") in this proceeding, Laclede Gas Company ("Laclede" or "Company") hereby submits this Initial Brief for the Commission's consideration.

I.
BACKGROUND

This case was initiated on January 26, 1999, when Laclede submitted to the Commission revised tariff sheets reflecting increased rates for gas service provided to customers in its Missouri service area. The proposed tariff sheets contained a requested effective date of February 26, 1999 and were designed to produce an annual increase of approximately 6.1 percent ($30.5 Million) in charges for gas service.

By Order dated February 9, 1999, the Commission suspended the proposed tariff sheets and established a procedural schedule for interventions, the prefiling of direct testimony and exhibits by Laclede and evidentiary hearings. On April 29, 1999, the Commission issued its Order granting the Applications to Intervene that had been filed by Union Electric Company d/b/a AmerenUE; the Missouri Industrial Energy Consumers (Adam's Mark Hotels, Alcoa Foil Products, Anheuser-Busch Companies, Inc., The Boeing Company, Ford Motor Company, General Motors Corporation, Hussmann Refrigeration, MEMC Electronic Materials, Inc., Monsanto Company, Paulo Products

Company, and Proctor & Gamble Manufacturing Company), Oil, Chemical & Atomic Workers, Local 5-6; and the Missouri Energy Group (Barnes-Jewish Hospital, DaimlerChrysler Corporation, Emerson Electric Company, and SSM Healthcare).

By Order dated May 11, 1999, the Commission scheduled local public hearings in the City of St. Louis and St. Louis County, Missouri. Local hearings were subsequently held in this proceeding on August 11, 1999. Pursuant to the procedural schedule established by the Commission, a prehearing conference was convened on July 9, 1999. As a result of the prehearing conference and further discussions, the active parties to this case reached agreement on a number of issues, which were eventually reflected in the First Amended Partial Stipulation and Agreement filed in this case on September 3, 1999 ("Stipulation and Agreement").[1]

Among other things, the Stipulation and Agreement submitted by the parties recommends: (1) an overall dollar settlement of a number of the revenue requirement issues in this case (*See* ¶¶ 1 and 2); (2) a resolution of the rate design and class cost of service issues raised in this proceeding, as well as a settlement of certain miscellaneous tariff matters relating to the "period of excess receipts" applicable to the Company's transportation customers and the Company's reconnection charges (¶12; Attachment 2); (3) the elimination of four out of the five accounting authority orders ("AAO's") previously granted Laclede and a continuation of the AAO relating to the Company's gas safety program (¶ ¶ 4,5 and 6); and (4) the undertaking of a joint project aimed at

[1] The First Amended Partial Stipulation and Agreement filed on September 3, 1999 was signed by most but not all of the parties to this case. Since no other party to this case requested a hearing in connection with this Agreement within five days, however, it should be considered to be a Unanimous Stipulation and Agreement under the Commission's Rules. *See* 4 CSR 240-2.115.

developing the appropriate data, methodology, period and other criteria necessary to establish weather normalized rates in Missouri (¶ 10).

As a result of the recommendations set forth in the Stipulation and Agreement, as well as the positions taken by the parties at the October 7, 1999 true-up proceeding in this case, the parties have reached agreement on a minimum overall revenue requirement of $5,139,000, based on Staff's proposed midpoint return on equity of 9.5% and before resolution of the remaining issues that were litigated during the evidentiary and true-up hearings in this case.[2] As discussed below, these remaining issues include:

- the return on equity that should be authorized for Laclede in this case;
- the level of short term debt that should be included in the Company's capital structure;
- the revenue collection lag that should be used for purposes of deriving an appropriate cash working capital amount;
- the standards and appropriate regulatory treatment that should be applied to the Company's advertising expenditures;
- the terms that should govern the duration of the AAO which the parties have recommended be granted Laclede in connection with its gas safety costs;
- the method that should be used to establish Laclede's depreciation rates;
- the level of off-system sales revenues that should be reflected in rates;

[2] The minimum revenue requirement amount agreed upon by the parties at the true-up proceeding is substantially less than the approximately $6.3 million initially recommended in the First Amended Partial Stipulation and Agreement., As discussed in that section of Laclede's Brief addressing the short-term debt issue, this reduction is principally due to Staff's removal of revenue requirement that it had initially included in its direct case to reflect a subtraction of the Company's recent long-term debt issuance from the Company's short term debt level.

- the degree to which Laclede should be required to identify in its tariffs the areas in which the Company operates; and
- the proper level of annualized customers.

Each of the above-referenced issues are addressed in turn in the Argument Section of this Initial Brief.

II.
ARGUMENT

A. Introduction

As Laclede noted at the opening of the evidentiary hearing in this case, it has been more than twenty years since the Company last litigated a general rate case proceeding before this Commission. (Transcript, p. 19).[3] Over that period of time, there have been tremendous changes in the way the natural gas industry is structured, the way the Company is regulated, and the way it conducts its business. There were the nationwide natural gas shortages of the mid to late '70s, during which the very ability of local distribution companies ("LDCs") to meet the expanding demands of their customers for essential natural gas services was threatened. This era of shortage was eventually followed by federal efforts, beginning in 1978 and culminating in 1993, to deregulate natural gas prices at the wellhead and to provide LDCs, like Laclede, with the ability, and then the obligation, to buy their own gas supplies and procure the myriad of

[3] Throughout the remainder of this Initial Brief and in Laclede's Reply Brief, citations to the official transcript will use the abbreviation "Tr." followed by the page number of the cited portions of the transcript. References to the exhibits received into evidence in this proceeding will use the abbreviation "Exh." followed by the page number (s) of the cited portions of the exhibit.

transportation and storage services necessary to move those gas supplies to the LDCs' city gates. [4]

Throughout this entire period, the Commission has played a central role in reshaping and improving the process by which Missouri consumers receive natural gas service. In response to the natural gas shortages of the mid to late '70's, it authorized Laclede to seek additional sources of gas supplies through exploration and drilling ventures in the production fields. With the advent of open access transportation at the federal level, it approved guidelines under which Missouri LDCs could provide transportation services to those customers large enough to purchase their own gas supplies on an economically favorable basis. To ensure that smaller customers also benefit from the cost savings and other competitive opportunities afforded by the largely deregulated wholesale market for natural gas, the Commission has been equally aggressive in approving innovative programs that have given Laclede and other Missouri LDCs the financial incentives required to maximize those savings as well as the financial tools required to protect customers from dramatic price spikes and other risks inherent in that market.[5]

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[4] The effort to decontrol wellhead prices began with the passage of the Natural Gas Policy Act of 1978, See Pub. L. No. 95-621, 92 Stat 3351 (codified as amended at 5 U.S.C. §§3301-3432 (1994)), and was completed with the passage of the 1989 Natural Gas Decontrol Act, which removed all remaining price controls applicable to gas sold to interstate pipelines, effective January 1, 1993. Pub. L. No. 101-60, 103 Stat 157 (1989). As the Commission knows, these Congressional initiatives were followed by the Federal Energy Regulatory Commission's ("FERC") issuance of Order No. 436 in 1985 and Order No. 636 in 1992, in which the FERC permitted and then required that the customers of interstate pipelines, including LDCs, purchase their gas from third parties other than the pipelines and simply use the pipelines as common carriers to transport the gas from the wellhead to the city-gate. See Order No. 436, FERC Stat. and Reg., CCH ¶ 30,665 (October 18, 1985); Order No. 636, FERC Stat. and Reg. CCH ¶ 30,936 (1992).

[5] *See Re: Laclede Gas Company*, Case No. GT-99-303, Report and Order (September 9, 1999); Case No. G0-98-484.

In each of these endeavors, the Commission has been mindful of its fundamental responsibility to ensure that the natural gas services required by Missouri consumers to heat their homes and to run their businesses are reasonably priced, consistent with the most important goal of all – namely, making sure that such critical services continue to be available on a reliable basis. Judging by the exceptionally low number of customers who have found it necessary to voice any concerns regarding either the cost or quality of the Company's services, Laclede believes that both the Commission and the Company have been successful in meeting these goals.[6]

The achievement of these twin goals in the setting of a general rate case proceeding is no less important. At a minimum, it requires that the Commission establish rates at a level that will protect customers from any unnecessary or imprudently incurred costs, while still affording the Company the financial resources needed to meet its public service obligations. For more than twenty years, Laclede, the Commission Staff and the Office of the Public Counsel have been able to reach agreement on the level of rate relief that should be approved by the Commission to accomplish these objectives. The end result has been a series of periodic, but relatively modest, rate increases that have recognized the financial and operational dynamics driving the Company's need for rate relief.

[6]The most telling evidence in this regard lies in the remarkably small number of customers who have felt the need to testify unfavorably about the Company's rates or services at the local public hearings held by the Commission to receive public comments. In its last four rate case proceedings, the Company has never had more than a handful of customers testify at a local public hearing and has generally averaged one or two at most – an exceptional record for a Company with approximately 620,000 customers. (Exh. 1, p. 20; Exh. 127, p. 4). The degree to which the Company's customers are generally satisfied with the quality and cost of the Company's services is also illustrated by the fact that less than one-tenth of one percent of its customers have found any need over the past eight years to contact the Customer Services Department regarding Laclede's services, a number that was maintained even during the run-up in gas prices in the early months of the 1996-97 winter season. (Exh. 1, p. 20).

As the record in this case demonstrates, those dynamics have not changed. Nor are they difficult to understand. Simply put, Laclede's extremely limited opportunities for *real* revenue growth have not been sufficient to offset even the moderate increases in costs that the Company continues to incur to provide service. On the revenue side of the equation, Laclede's opportunities for growth have been limited by several factors. First, as the Staff's own evidence shows, Laclede operates in a very mature market in which it has already captured more than 90% of the single-family home heating market. (Exh. 59, p. 18).[7] As a result, it is expected that Laclede's opportunities for future sales growth will continue to be limited over the next several years to no more than 1% to 1.5% on an annual basis.[8]

Moreover, much of the growth that Laclede has experienced has been the kind that brings added costs but no new revenues. This is due to the fact that the Company operates in a service territory that continues to undergo what can only be described as an extraordinary migration of customers from the inner city to outlying suburban areas. From 1960 to 1990, for example, the City of St. Louis lost nearly half of its population, with more than 350,000 residents leaving the City for surrounding counties or other areas. (Exh. 1, p. 9). Unfortunately, this trend has continued in more recent years, as evidenced by the fact that since 1990 alone another 55,000 residents have moved out of

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[7] According to the Standard & Poor's Corporation's Utilities Ratings Report, which Staff witness David Broadwater cited at page 18 of his direct testimony (Exh. 59), Laclede "... has a St. Louis service area that is very stable and mature with a heating saturation level of about 94%, which lessens growth opportunities. Expected annual sales of about 1% - 1.5% during the next few years are attributable to modest customer growth, flat consumption patterns, few main extensions, and a limited conversion potential."

[8] Laclede's actual growth in customers has not even kept pace with these very modest projections, as evidenced by the fact that for the annual period ending July 31, 1999, Laclede had only added 5,677 customers, or less than 1% of its overall customer base of approximately 620,000 customers. (Exh. 127, p. 4).

the City. (*Id.*).[9] This extreme incidence of "urban sprawl" has had a two-fold effect. First, Laclede has had to make substantial investments in facilities to serve "new" customers who are not actually generating any new revenues. Instead, they are simply relocating those revenues from one part of the Company's service territory to another. (*Id.*). As a consequence, the Company's overall costs increase (since it must now bear the fixed costs of the older facilities in its traditional market, as well as the new facilities required to serve its migrating customers), while its revenues do not increase. Second, this large migration of customers tends to accelerate the "conservation" effect that occurs when customers abandon older, less energy efficient housing stock in favor of newer housing, with more energy efficient features and appliances.[10] Once again, the primary impact of this phenomenon is an actual reduction in usage and a corresponding reduction in revenues.

The end result of all of these factors is a limited rate of revenue growth that does not begin to compensate for the increases in costs incurred by the Company to expand, maintain and operate its system. Since Laclede last received a rate increase in September of 1996, these cost increases have included, among others, depreciation, carrying costs and property taxes on ten of millions of dollars in additional capital investments, three years worth of increases relating to wages, salaries, medical costs and other related

[9] The mobility of Laclede's customers is further illustrated by the fact that the Company had 177,908 turn-ons and cut-offs in one recent 12 month period alone. (Exh. 12, p.7).

[10] This conservation effect was illustrated by the two exhibits filed by the Company in response to several questions asked by Vice Chair Drainer. Exhibit 113 contains a portion of usage data for residential heating customers that was originally included in the Company's annual report. That data showed a decline in residential customer usage from 1032 therms per customer in 1990 to 969 therms per customer in 1998. Both Exhibit 113 and the marketing study in Exhibit 114 indicate that at least a portion of this reduction in residential usage is attributable to customers relocating in new areas of the Company's service territory where, because of the forgoing efficiency factors, per customer usage is significantly lower than in the older areas of the Company's service territory.

expenses, and three years of increases in the cost of materials, equipment and supplies, all of which have been affected by a rate of inflation nearly twice as great as the rate of growth experienced by the Company over the same period of time.[11] Indeed, to get a sense of the degree to which these cost increases have exceeded (and continue to exceed) the incremental revenues being received by the Company, all one has to do is review the true-up recommendations that have been made in this case for cost and revenue changes occurring between March 31st of this year and the August 1, 1999 true-up date. According to Staff's own analysis, in only the four month period between the end of March and August, the Company's revenue requirement has increased by at least $6.8 million. (Exh. 129, p. 3).

Despite all of this evidence of substantial cost increases, the Staff has become extremely reluctant to recommend any meaningful rate relief. In its 1998 rate case, the Company responded to a Staff filing recommending a rate decrease by agreeing to a settlement that, with a number of accounting changes, permitted the Company to temporarily defer a rate increase. Notwithstanding this deferral, however, and the length of time that has elapsed since the Company's last rate increase, the Staff now comes before this Commission with a recommendation that the Company receive an overall increase of only $5.1 million, down from its initial recommendation of $6.3 million. In doing so, the Staff would have the Commission reach the amazing conclusion that after three years of rising costs, the Company should receive an overall increase in rates that is actually less (by approximately $1.7 million) than the net cost increases that Staff says

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[11] According to Schedule 7 of Staff witness Broadwater's direct testimony, the Consumer Price Index rose by 2.3% during the annual period ending April 30, 1999 (See Exh. 60) which rate is more than double the Company's historic rate of growth.

have been incurred by the Company in just the past four months alone. Needless to say, it is simply not possible to reconcile such a recommendation with the financial and operational dynamics discussed above -- particularly where such dynamics have been so starkly and convincingly illustrated, at least in microcosm, by Staff's own true-up recommendation.

In fact, it is abundantly clear from the record in this case that Staff has only been able to arrive at this overall revenue requirement recommendation by taking away with one hand what it has given with the other. On the giving side, the Staff has indeed added up and included in its revenue requirement recommendation many of those ordinary and routine cost increases (ranging from rate base additions to payroll increases) that, for all intents and purposes, *must* be reflected in rates because there is absolutely no question regarding their amount, propriety or reasonableness. It has done so, however, only to take them away again (with an assist from Public Counsel) through a series of unsupported and arbitrary reductions to other components of the Company's revenue requirement – reductions that, in contrast to the foregoing increases, rely far more on "judgment" than they do on any objective accounting of costs. Indeed, in staking out its position on these issues, Staff has followed a pattern of clinging hard to past practices or abandoning them in favor of new ones based on one, and only one, common criteria -- namely, which approach will serve to reduce the Company's revenue requirement. While each of these reductions will be addressed in detail in the following sections of this Initial Brief, it is possible to gain a sense of how unreasonable -- and even punitive -- they are from just a brief review of the positions that Staff and Public Counsel have taken on the remaining issues in this case. Consider the following:

- For their return on equity ("ROE") recommendations, Staff and Public Counsel have recommended a return that is literally hundreds of basis points lower than those authorized by this Commission for other Missouri energy utilities and thousands of basis points lower than the effective returns being earned by unregulated firms. Moreover, they have developed their recommendations through the use of a circular "company-specific" Discounted Cash Flow ("DCF") analysis that even the Staff did not feel comfortable relying on less than a year ago -- an analysis that also shares the distinction of being flatly inconsistent with the legal standards that all of the ROE witnesses in this case have asserted must govern the determination of a fair return. Even worse, Staff's ROE witness has plainly admitted that Staff has failed to include in its proposed revenue requirement the dollars actually required to give Laclede's investors an opportunity to earn Staff's recommended return and, when asked where those dollars would come from, could only respond "I don't know. (Exh. 116, p. 59-60). The end result is an ROE recommendation that is so inadequate that, by Staff's own calculations, it even jeopardizes Laclede's very ability to retain the "AA-" or better credit rating that the Company has maintained to the financial benefit of its customers for more than three decades. (*Id*. at 38-39).

- With regard to the Company's capital structure, Staff and Public Counsel have proposed a capital structure that not only includes short-term debt, but does so at a level that completely fails to recognize the annualized effect on that short-term debt of the $25 million bond and $24 million equity issuances placed by the Company in the spring and early summer of this year. Staff's and Public Counsel's refusal to recognize the impact of these issuances on Laclede's short term debt is simply inexplicable given the record in this case. As discussed more fully below, the fact that such issuances were to be used to repay and hence reduce the Company's short term debt was specifically and repeatedly stated in all of the Securities and Exchange Commission ("SEC") disclosure documents filed by the Company before the issuances were even made. Moreover, the record shows that since those issuances were completed, the actual monthly balances of short term debt carried by the Company have, in fact, declined by some $43 million on average. (*See* Exh. 128, Schedule 3). Even more disturbing, however, is the fact that Staff's current position on this issue directly conflicts with what it recommended less than four months ago when, consistent with the position it had taken in past Laclede cases, it actually deducted the proceeds of the bond issuance from the Company's short term debt level for purposes of performing its true-up estimate in this case. (*See* Exh. 128, p. 3). Because of their failure to reduce short term debt to the levels that will actually be experienced by the Company, Staff and Public Counsel are now recommending a total capital structure that is some $42 million greater than the entire rate base amount that they have recommended for inclusion in rates and that the capital structure is designed to finance -- a result that by itself demonstrates the unreasonableness of their position.

- When it comes to determining an appropriate revenue collection lag for cash working capital purposes, Staff recommends a lag that has been developed based on a small and plainly unrepresentative sample of the Company's customers. Staff does so even though it admits it has absolutely no idea whether the sample it relies on is large, or representative, enough to produce statistically valid results, and despite the fact that the Company has used a method to determine its proposed lag that completely eliminates the need for sampling by reflecting the revenue collection lag experienced by the Company for the universe of *all* of its customers.

- As to the Company's advertising expenditures, both Staff and Public Counsel recommend a complete exclusion of all advertising expenses incurred by the Company to promote the use of natural gas. They do so even though the Company has demonstrated both the effectiveness of such advertising and the compelling need for promotional programs that can help the Company improve growth, or at least prevent any further erosion in the limited growth opportunities described above.

- As evidenced by their position on what type of sunset provision, if any, should be adopted to govern the termination of the Company gas safety AAO, it appears that Staff and Public Counsel are uninterested in doing anything that might actually permit the Company to avoid seeking rate relief for a more extended period of time. In steadfastly insisting that the gas safety AAO become null and void (and all amounts deferred thereby written off) unless the Company files for rate relief in two years, Staff and Public Counsel have simply added another barrier to the Company's efforts to break its historical cycle of seeking rate relief at least every two years. Moreover, they have done so even though it is clear from the record in this case that Laclede's ratepayers would unquestionably benefit from any successful effort by the Company to defer seeking additional rate relief (and despite the fact that the Commission would retain full discretion to require a general rate case filing in the event it ever concluded such a filing was necessary).

- Staff's position on how the Company's depreciation rates should be set is also premised on the Company making regular rate filings. In fact, Staff uses the prospect that the Company will be making regular rate case filings as a pretext for proposing an unconventional methodology for setting depreciation rates that is: (a) flatly inconsistent with the traditional goal of depreciation – namely that the cost of an asset should be recovered over its useful life; (b) at odds with virtually every authoritative text on how depreciation rates should be set; and (c) incompatible with the depreciation methodologies followed by this Commission and the overwhelming majority of commissions that routinely address this issue. Indeed, the only thing that is at all conventional about Staff's depreciation proposal is its consistency with Staff's overall penchant for taking whatever position it can to reduce the Company's revenue requirement.

- The positions taken by Staff and/or Public Counsel on the two remaining revenue requirement issues in this case are equally extreme. With regard to the off-system sales issue, both Staff and Public Counsel have proposed that the Commission impute a level of off-systems sales revenues in this case that is nearly three times greater than what the Company actually achieved in connection with these sales for the year ending September 30, 1999. Moreover, they have done so despite the undisputed evidence in this case that shows that such revenues are trending downward and are likely to decline even further given the current pipeline capacity expansions and other market conditions in the areas where the Company has traditionally made such sales. (*See* Exh. 125).

Similarly, during the true-up phase of this case, the Staff proposed that the Commission recognize for ratemaking purposes an "annualized" number of customers that is substantially greater than the total customer increases actually experienced by the

Company in the most recent annual period ending July 1999. (Exh. 127, p. 4). In addition, Staff's annualization adjustment inexplicably assumes customer increases in those areas of the Company's service territory that have traditionally seen little or no growth, and declines in the number of customers in an area where growth has traditionally been strongest. (*Id.* at 5). Once again, the common theme uniting both of these proposals is their use of arbitrary assumptions and unsupported methods to inflate the Company's revenues and, in the process, decrease its revenue requirement.

Standing alone, each of the positions and recommendations discussed above would fail the test of reasonableness, and fail it badly. When woven together, they reflect a pervasive and, in the Company's view, irresponsible unwillingness on the part of their proponents to provide the Company with the financial resources it requires to fulfill its public service obligations. Faced with such circumstances, the Company concluded that it had no choice but to litigate its first rate case in more than twenty years if it was to have the wherewithal to continue doing what it has always done – provide natural gas service to its customers with the reliability they have come to expect and deserve to receive in the future.[12] As it has in past proceedings, Laclede trusts that the Commission, in the interests of both the Company's customers and its shareholders, will give this guiding principle, which Staff and Public Counsel have ignored, the due and careful consideration that it deserves and establish a revenue requirement consistent with the Company's recommendations herein.

B. Return on Equity

In this case, Laclede has recommended that the Commission authorize the Company a return on equity of 12.75% -- a recommendation that equates to an effective market return of approximately 10% based on the market value of Laclede's stock over the past several years. (Exh. 2, p. 3; Exh. 4, p. 3). Staff and Public Counsel, on the other hand, have proposed that the Commission grant the Company returns of 9.5% and 9.7%, respectively, -- amounts that yield an effective market return of approximately 6.3%.

As discussed below, the Company strongly believes that it has presented the only ROE recommendation in this case that actually comports with the legal standards that all of the ROE witnesses in this proceeding have asserted must govern the determination of a fair return. Indeed, it is the only recommendation that will provide the Company's investors with a real opportunity to earn the returns that Staff and Public Counsel have said investors require in this proceeding. Moreover, it is the only recommendation that satisfies the test of reasonableness based on a common sense comparison of the returns authorized by this Commission for other Missouri utilities, the returns authorized by other commissions for LDCs throughout the country, and the returns currently being earned by unregulated firms. Finally, it is the only return that will not jeopardize the "AA-" or better credit rating that Laclede has maintained for the better part of three decades, often at Staff's urging -- a credit rating that has for many years enabled the Company to attract capital on favorable terms to the substantial benefit of its customers.

[12] It is also worth noting that the Commission itself has expressed concerns in the past over the fact that no Laclede rate case has been litigated since 1978. See Case No. GR-94-220, Report and Order, pp. 6-7; Case No. GR-96-193, Suspension Order and Notice; Concurring Opinion of Commissioner Kenneth McClure.

For all of these reasons, the Company's ROE recommendation should be adopted by the Commission.

1. **<u>The Standards for Determining a Fair and Reasonable Return</u>.**

There can be no argument that a utility such as Laclede, as well as its shareholders, have a constitutional right to a fair and reasonable return on their investment. *State ex rel. Missouri Public Service Company v. Fraas*, 627 S.W.2d 882, 886 (Mo. App. 1981). In fact, all of the witnesses presenting ROE testimony in this proceeding have cited the same United States Supreme Court decisions for the principles and standards that must be followed to determine a fair return that will pass constitutional muster. Indeed, Staff witness Broadwater provides an excellent summation of these standards and principles at page 5 of his direct testimony in this case. As Mr. Broadwater notes:

> In the case of *Bluefield Water Works and Improvement Company v. Public Service Commission of the State of West Virginia*, 262 U.S. 679 (1923), the Supreme Court ruled that a fair return would be:
>
> 1. A return "generally being made at the same time" in that "general part of the country";
> 2. A return achieved by other companies with "corresponding risks and uncertainties";
> 3. a return "sufficient to assure confidence in the financial soundness of the utility"; and
> 4. A fair return can change with economic conditions and capital markets.
>
> The Court specifically stated:

> 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; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties. A rate of return may be reasonable at one time and become too high or too low by changes affecting opportunities for investment, the money market and business conditions generally. *Id.* at 692-3.
>
> (Exh. 59, p. 5).

The same principles and standards cited in Mr. Broadwater's testimony have, in turn, been followed by the Missouri appellate courts in their review of past ratemaking determinations by this Commission. Specifically, with reference to how such principles apply to the determination of a fair return, the Missouri Supreme Court, quoting from *Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U.S. 575, 586; 62 S.Ct. 736, 743; 86 L.Ed. 1037; has stated:

> ... the return to the equity owner should be commensurate with returns on investment in other enterprises having corresponding risks. That return, moreover, should be sufficient to ensure confidence in the financial integrity of the enterprise so as to maintain its credit and to attract capital.

State ex rel. Missouri Water Co. v. Public Service Commission, 308 S.W.2d 704, 715 (Mo. 1957).

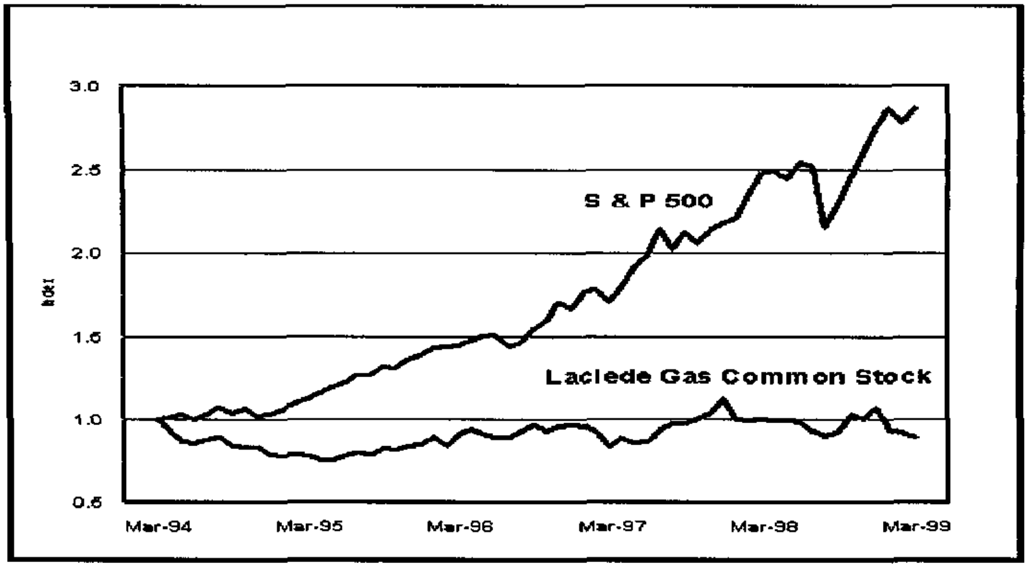
Among all of the varied issues considered by this Commission, those involving a determination of a fair return on equity are unique in the degree to which the legal framework governing a proper resolution of the issue are routinely set out in the testimony of the parties. Like other matters that are frequently repeated, however, it is sometimes easy to lose sight of the original meaning and significance of the words being spoken. Laclede would respectfully suggest that this is precisely what Staff and Public Counsel have done in making their ROE recommendations. Although they have correctly cited in their testimony the standards and principles that should govern the establishment of a fair return, they have effectively ignored them in developing their recommended returns on equity. Indeed, as discussed below, a proper application of each of those standards and principles to the record in this proceeding clearly demonstrates that the Company has presented the only ROE recommendation that can actually be reconciled with the legal standards that all of the ROE witnesses in this case have agreed must be followed in determining a fair and reasonable return.

2. **<u>"A Fair Return Can Change with Economic Conditions and the Capital Markets."</u>**

The most obvious and significant example of how dramatically Staff and Public Counsel have departed from the requirements for establishing a fair return relates to their wholesale failure to recognize and account for the fourth principle cited by Mr. Broadwater in the above-quoted testimony -- namely, that "a fair return can change with economic conditions and capital markets." As the Court in *Bluefield, supra*, observed: "A rate of return may be reasonable at one time and become too high or too low by changes affecting opportunities for investment, the money market and business conditions generally." *Bluefield, supra,* at 693.

The Court's language in *Bluefield* clearly indicates that in determining what constitutes a fair return at a particular point in time, the Commission must take into account any changes in the capital markets or the economy generally that may affect the appropriate level at which that return should be set. Without question, one of the most significant changes in the capital markets over the past ten years has been the tremendous growth in the earnings and stock values of American companies. As described by Company witness John Olson, an experienced analyst of natural gas stocks, unregulated companies, such as those included in the S&P 500, have for a number of years now been averaging earned returns on equity in the 18% to 20% range and above. (*See* Exh. 5, p. 3; Schedule 1). Compound market returns for these companies have been even greater, averaging 26.4% during the 1990s. (Exh. 3, p. 2). As the Commission knows from its own experience, the end result of this tremendous and persistent growth in corporate earnings has been an unprecedented increase in stock values, as reflected in the now decade-long boom in the stock market.

For purposes of assessing what constitutes an adequate ROE for LDCs such as Laclede, this radical change in the capital markets has had a two-fold effect. First, it has substantially widened the gap that has historically existed between the total returns being earned by unregulated companies and the returns being generated under traditional cost of equity analyses for regulated companies like Laclede. The following graph, which was originally included in the direct testimony filed in this case by Laclede witness Douglas Yaeger (See Exh. 1, p. 4), shows how significant this large and growing gap in returns has become over the past several years.



(Exh. 1, pp. 4-5). This growing disparity has, in turn, decreased the attractiveness of Laclede's stock as investors consider other opportunities for their investment dollars that promise far more growth and earnings than that achievable by Laclede under the traditional formulas used to set its return. (Exh. 5, p. 3).

At the same time, these market changes have had a secondary and even more significant impact on the return requirements for Laclede and other LDCs. With the overall increase in the market value of stocks generally, there has also been a corresponding, albeit much more modest, increase in the market value of Laclede's stock. In other words, just as a rising tide lifts all boats, so too does a rising market tend to lift the value of most, if not all, stocks. As a result of these increases in market value, stock prices for companies in the S&P 500 are now some six to eight times higher, on average, than the book value of those stocks, while the market value of Laclede's stock and those of other LDCs have climbed to a level some 1.5 to 1.8 times above their book value. (Exh. 2, p. 3; Exh. 3, p. 2).

This increase in the "market to book" ratio for Laclede's stock makes it virtually impossible, without appropriate adjustments, to obtain a reasonable ROE result through the use of the traditional method whereby a market-based ROE is derived and then applied to the book value of the utility's stock. For purposes of illustrating this problem, consider the following example. First, assume that a stock has a market to book ratio of 1.5 times, i.e., the market price of the stock is $15, and its book value is $10. Further assume that the Commission has determined that investors in the stock require a 10% return. Under the traditional method, the 10% return will be applied for ratemaking purposes only to the book value of the utility's equity. As a result, only a dollar in revenue (10% x $10) will be generated to provide the return required by the investor on that stock. If the market price of the stock was also $10, such an amount would be adequate to generate a 10% return. Because the market price is actually $15, however, the one dollar in revenue will only generate an effective market return for the investor of 6.7% ($1.00/$15.00). As a result, the investor who required a 10% return on his investment will end up receiving an effective return of only 6.7% based on the market value he paid for the stock. Unfortunately, there is nothing at all theoretical about this problem. During his deposition, Staff witness Broadwater went through an exercise similar to the one described above. In this case, however, Mr. Broadwater used real stock price information from his own analyses of Laclede to calculate the actual return that Laclede's investors would be given an opportunity to earn, assuming his recommended returns were adopted. (Exh. 116, pp. 48 - 57). As shown in the following table, Mr. Broadwater's own calculations demonstrated that Staff's recommended ROE of 9.5% would only generate enough revenues under Staff's book value approach to provide

Laclede's investors with a <u>6.3%</u> return on the market value of their stock as of March 31, 1999.

Laclede Gas Company
Analysis of Effect of Staff Return on Equity Recommendations

		Low	Mid	High
1.	Staff Recommended Return	9.00%	9.50%	10.00%
2.	Common Equity (Broadwater Schedule 19)	274,770,773	274,770,773	274,770,773
3.	Earnings Allowed (Broadwater Sch 19) (1x2)	24,729,370	26,103,223	27,477,077
4.	Common Shares Outstanding @ 3/31/99	17,627,987	17,627,987	17,627,987
5.	Earnings Per Share (3/4)	1.403	1.481	1.559
6.	Avg. High/Low Stock Price*	23.55	23.55	23.55
7.	**Market Return (5/6)**	**6.0%**	**6.3%**	**6.6%**
8.	**Shortfall from Recommended Return (7-1)**	**-3.0%**	**-3.2%**	**-3.4%**

* Average of stock prices from Mr. Broadwater's Schedule 16:

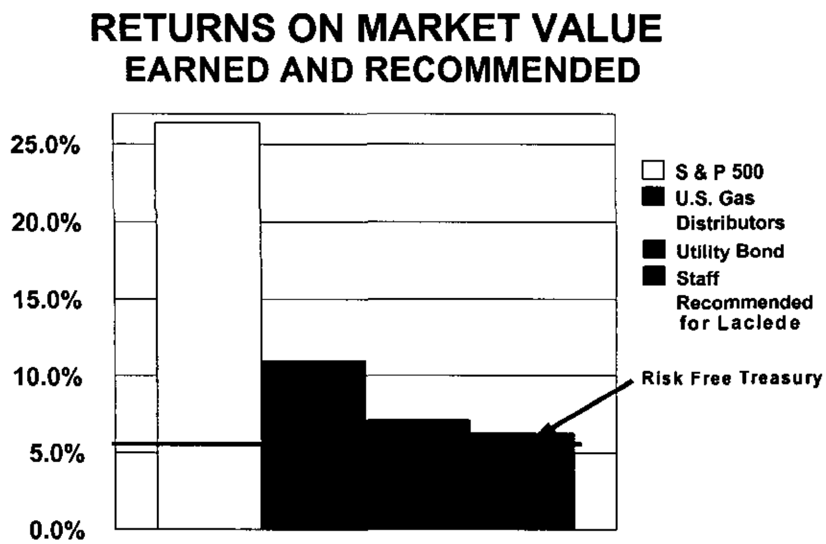
(*See* Exh. 8, Schedule 1; Exhibit 116, pp. 48-57).

Notably, Mr. Broadwater was completely unable to explain where Laclede was supposed to obtain the money to make up for the 320 basis point shortfall between the 9.5% ROE he says the Company's investors actually require and the much lower 6.3% market return that is actually generated by Staff's approach in this case, much less the higher returns that investors would expect given the other investment opportunities available. In fact, when he was asked that direct question during his deposition, all he could do was respond with a simple "I don't know." (Exh. 116, pp. 59-60).

It is beyond imagining how anyone can assert that they have provided a utility's investors the opportunity to earn a fair return when, as a matter of simple mathematics, they have admitted that their proposed approach will not provide the funds -- indeed, will not come close to providing the funds -- required under current market conditions to achieve the very return they themselves have recommended. When the United States Supreme Court stated in *Bluefield, supra,* that the reasonableness of a utility's return may change over time as a result of changes in market conditions, it clearly intended for state utility commissions to take those market changes into account when establishing a fair return. Unfortunately, in developing their recommendations, both Staff and Public Counsel have failed to take into account, or in any way reflect in their recommendations, the very real impact of what has perhaps been the most significant and enduring change in the financial markets since the early part of this century.[13]

When such an obvious failure to comply with guiding principles occurs, it is not unusual to see absurd and unrealistic results follow. And those are the very type of results produced by Staff's and Public Counsel's analyses. While there is little need to further substantiate the unreasonableness of analyses that result in an effective market return of 6.3%, it is nevertheless instructive to consider how such a return compares to those being earned on other investments, as illustrated below. Needless to say, it is simply not possible to justify a result which, as shown below, suggests that Laclede's equity investors should receive an effective market return that is some 2000 basis points lower than those being earned by unregulated firms, 400 basis points below those being earned by other utilities, and barely sandwiched between the returns being collected on *utility bonds* and *risk free treasury instruments.*

[13] Staff's and Public Counsel's failure to take this change into account also violates the requirement under Missouri law that all relevant factors must be considered in establishing rates for a public utility. Missouri



In contrast to Staff and Public Counsel, the Company has presented an ROE recommendation in this case that actually takes these significant market changes into account. As explained by Laclede witness McShane, her 12.75% ROE recommendation contains an explicit market-to-book adjustment that corrects for this problem. (Exh. 2, p. 17-21). Indeed, her market to book adjustment accounts for most of the difference between her recommended return and the returns recommended by Staff and Public Counsel. Moreover, it should be noted again that the end result of the 12.75% ROE recommended by Ms. McShane is an effective market return of approximately 10.00%. Since this result both falls within the range of what Staff and Public Counsel have said Laclede's investors require *and* accords with the legal standards for determining a fair return, it should be adopted by the Commission.

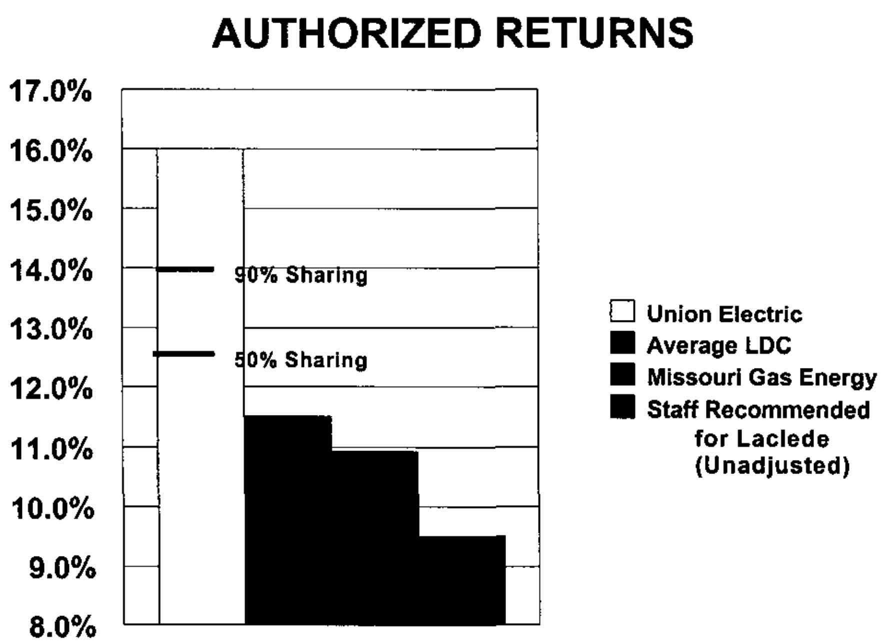
Water Company, supra, at 718.719.

3. A Fair Return is One that is "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."

As noted above, one of the most fundamental principles established by the courts is that the return granted a utility's investors "must be commensurate with returns on investments in *other* enterprises having corresponding risks." *Missouri Water Co.*, supra, at 715. (*emphasis supplied*). The Company would concede that some latitude can reasonably be exercised under the above-referenced standard in determining what type of *other* companies have the kind of corresponding risks that make them suitable for determining a utility's fair return. What is not permissible, however, is to do what Staff and Public Counsel have done -- namely ignore the requirement by using a "company-specific" DCF analysis that, for all intents and purposes, focuses on Laclede and Laclede only as the basis for deriving their recommended returns. To the contrary, if the Supreme Court of the United States or the Supreme Court of Missouri had intended that a fair return be derived based on such a company-specific analysis, they would not have established the requirement for examining the returns of *other* companies with corresponding risks that is so prominently mentioned in Mr. Broadwater's own testimony.

Before addressing in detail the many ways in which the method employed by Staff and Public Counsel conflicts with these well-established legal standards, it is helpful to gain a sense of how the results produced by that method compare to returns that have previously been authorized or allowed for energy companies in Missouri and elsewhere. As set out on page 5 of Company witness Fallert's rebuttal testimony (Exh.

8), the results produced by the company-specific DCF analysis employed by Staff and Public Counsel to determine Laclede's required ROE are absurdly low when compared to these other returns, averaging some 300 basis points below the *minimum* 12.61% return allowed the Company's primary electric competitor, some 200 basis points below the average 11.51% return granted gas distributors in 1998, and almost 150 basis points below the 10.93% return granted Missouri Gas Energy, the state's second largest LDC in Case No.GR-98-140. Just look at the disparity in these authorized returns:



Once again, these are the type of patently unfair and unreasonable results that can occur when fundamental principles governing how a fair return should be determined are ignored. And ignored they have been. Indeed, the basic inconsistency between the type of company-specific analysis relied upon by Staff and Public Counsel and the legal requirement to examine the returns being earned by companies with comparable risks was fully illustrated in the following exchange with Mr. Broadwater during his deposition in this case:

> Q. Okay. We had talked earlier about this concept of a fair return being one that's reflective of the returns of other firms with corresponding risks, is that correct?
>
> A. Yes.
>
> Q. And the importance of that to the standards that you annunciated (sic) in your testimony, is that correct?
>
> ...
>
> A. Yes.
>
> Q. And does that suggest to you that it's therefore, important to do a comparative analysis evaluating how the company that's being analyzed compares to other companies with similar risks?
>
> A. Yes.
>
> Q. Okay. Now, when you did your DCF analysis for Laclede, and I'm not talking about your alternative analyses, but I'm talking about your main analysis, was that done on a company specific basis?
>
> A. Yes.
>
> Q. Okay. And in that company specific analysis, how many other companies did you look at with similar risks to come up with your recommendation?
>
> A. I don't think I understand what you're saying.
>
> Q. Well, you told me that in determining a fair return, it's important to look at other companies with similar risks, and I'm asking you under your DCF analysis, your primary DCF analysis, how many other companies did you look at with similar risks in developing your recommended rates of return?
>
> ...
>
> A. I just looked at Laclede.
>
> Q. When you did your main analysis, you looked at no other companies, you just focused on Laclede?
>
> A. Correct.

. . .

Q. Okay. And so just to clarify, the main tool you used gives no consideration to companies, to looking at other companies with corresponding risks, is that a fair statement?

A. Yes.

(Exh. 116, pp. 76-79).

It is clear from the above exchange that the primary analysis relied upon by Staff and Public Counsel to derive their recommended returns does not begin to 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. Under such circumstances, it is simply not possible to conclude that their return recommendations are in any sense valid or sufficient under the legal standards by which this Commission must determine a fair return.

In an apparent effort to paper over the implications of this fundamental flaw, Mr. Broadwater went on to suggest in his deposition that his approach to determining a fair return was really appropriate after all because he also performed alternative analyses that did, in fact, look at the returns of comparable companies. (Exh. 116, p. 79-80). There are two basic problems, however, with this obvious attempt to explain away Staff's and Public Counsel's failure to follow the law.

First, the assertion that a company-specific DCF analysis can be used as long as alternative analyses involving comparable companies are also performed simply begs the question. If the company-specific DCF analysis is legally invalid when standing alone -- which it clearly is -- it cannot suddenly be transformed into a valid one by simply conducting other analyses that may pass legal scrutiny. This is particularly true in a case, such as this one, where the proponents of the legally invalid analysis have failed to offer any independent explanation as to why it is appropriate or necessary to use such an analysis notwithstanding its legal infirmities.[14]

Second, it is abundantly clear from the return recommendations actually made by Staff and Public Counsel that neither of those recommendations have been materially influenced by their supposed consideration of these alternative comparable company analyses. To the contrary, the ROE range of 9.00% to 10.00% that has been proposed by Staff in this proceeding is *identical* to the range produced by Staff's Laclede-specific DCF analysis. (*See* Exh. 59, p. 28). It is also substantially *below* the ROE range that Staff's alternative comparable company analyses would support. As Mr. Broadwater indicated in his direct testimony, as well as during his deposition and cross examination, the various analyses he employed utilizing comparable companies resulted in an overall

[14] There is simply nothing in the testimony presented by either Mr. Broadwater or Public Counsel witness Burdette that would provide an independent justification for using a company-specific DCF analysis. To the contrary, their approach in conducting their alternative analyses of comparable companies would suggest just the opposite. For in conducting those analyses, Mr. Broadwater and Mr. Burdette both found it appropriate to exclude from their evaluations any company with Missouri operations on the grounds that the inclusion of such companies could lead to "circular results." (Exh 116, pp. 72-76; Tr. 266-268). As explained by Mr. Broadwater and Burdette, this concern over circularity relates to the potential impropriety of a regulatory body using the returns earned by other companies subject to its jurisdiction to determine the fair return for another company that is also regulates. (*Id.*). Under such circumstances, the returns being earned or recommended for a particular utility may be unduly influenced by the regulatory practices followed in a single jurisdiction, rather than the returns actually being required by companies with comparable risks. (*Id.*) Indeed, this concern over circularity is apparently so significant in the minds of Staff and Public Counsel, that Public Counsel witness Burdette actually criticized Laclede witness McShane on the grounds that she had used a company with only marginal Missouri operations (Atmos Energy) in her analysis of comparable companies. (Exh. 45, p. 7). Given these circularity concerns, it is exceedingly difficult to understand how Staff and Public Counsel could possibly deem it appropriate to use a company-specific analysis as their primary tool for determining a fair return for Laclede because such an approach takes circularity to its ultimate extreme by focusing exclusively on only one company that is regulated by only one Commission.

range of 9.11% to 11.45%.[15] Indeed, even at the *midpoint* of these alternative ranges, Mr. Broadwater's analysis would support an upper range of at least 10.80%. (Tr. 365).[16]

Despite the availability of these alternative (and more legally sound) analyses of comparable companies, all of which indicated a higher ROE range than the one initially proposed by Staff, neither Staff nor Public Counsel have adjusted their ROE recommendations by even a single basis point to take these results into account. Nor was Mr. Broadwater able to provide any guidance, when asked during his deposition, as to when or under what circumstances Staff would finally feel compelled to vary from the results of a company-specific analysis based on the results of a comparable company analysis. (Exh. 116 , p. 16).[17] All we know is that, for some unexplained reason, Mr. Broadwater concluded that an alternative analyses that suggested his proposed ROE range may be too low by as much as *145 basis points* wasn't sufficient.

In view of these considerations, it could not be more obvious that Staff has given only the barest of lip service to its alternative analyses of comparable companies. Rather than cure the fundamental legal deficiencies of their company-specific DCF analysis, it is clear that Staff and Public Counsel have simply substituted that analysis for the type of

[15] *See* Exh. 59, pp. 32-35; Exh. 60, Schedules 24 through 28; Exh. 116, pp. 92-94; Tr. 365.

[16] The alternative comparable company analyses performed by Public Counsel witness Burdette also resulted in a range of results that, on the upper end of the range, substantially exceeded both his 9.70% ROE recommendation as well as Staff's 9.50% midpoint ROE recommendation. Specifically, the two analyses performed by Mr. Burdette indicated a range of 7.01% to 11.51% and 9.79% to 10.65%. (Exh. 44, pp. 18-19).

[17] When asked whether a 50, 100 or even 150 basis point difference between the results of his company-specific DCF analysis and the results of his alternative comparable company analyses would warrant a reassessment of the former, Mr. Broadwater simply replied that "... there isn't a number" he could point to say when he would start questioning the results of his DCF approach. (Tr. 16). If Staff is truly serious about using these alternative analyses to verify the reasonableness of its company-specific analyses and the result produced thereby, one would think it would have developed some objective criteria by now to determine when a difference was significant enough to justify a reassessment.

comparative company evaluation that they themselves have acknowledged is a legally required and indispensable component of any valid ROE determination.

Fortunately, the Commission can effectuate its own cure for this glaring deficiency by adopting the result of the analyses performed by Company witness McShane. (*See* Exh. 2). In stark contrast to the analyses conducted by Staff and Public Counsel, Ms. McShane actually derived her recommended return of 12.75% based on a careful and thorough analysis of the returns being earned or required by *other* companies that, as the law requires, were specifically selected and even adjusted to ensure compliance with the corresponding risk criteria discussed above. (Exh. 2, pp. 9-20). In determining a fair return in this case, the Commission should also recognize that Staff's alternative comparable company range of 9.11% to 11.45%, while still wholly inadequate, is the only arguably lawful range that has been offered by Staff in this proceeding. Given Mr. Broadwater's statements during his deposition that he has "done a good job with [his] comparable company analysis," and that there is "no theoretical reason" why the Commission could not rely on those analyses to the extent it had concerns with his company-specific approach (Tr. 90-91), Laclede believes that the Commission should not hesitate to view the high end of Staff's alternative ROE range as the minimum point of departure upon which to build a fair and reasonable return in this case. To do less would be to sanction an approach to determining ROE that, at least as implemented in this case, is flatly inconsistent with what all of the parties have agreed are the controlling legal standards for making that determination.

4. <u>A Fair Return is One that is "Reasonably Sufficient to Assure Confidence in the Financial Soundness of the Utility and Should Be Adequate, Under Efficient and Economical Management, to Maintain</u>

<u>And Support its Credit and Enable it to Raise the Money Necessary for the Proper Discharge of its Public Duties."</u>

Another fundamental flaw in the return recommendations presented by Staff and Public Counsel in this proceeding is their complete failure to consider the impact of those recommendations on Laclede's financial integrity. As previously noted, the applicable legal standards require that any return established by the Commission "... be sufficient to assure confidence in the financial soundness of the utility and ... adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties." *Bluefield, supra,* at 692-93; *Missouri Water Co., supra,* at 715. It is clear from the record in this case, however, that this standard has also been largely ignored by Staff and Public Counsel in developing their recommendations.

At least in the case of Staff, it appears that the failure to consider the impact of these recommendations on Laclede's ability to maintain its financial standing may have been due to a mathematical error that Staff made in its initial analysis of such impacts. At the time he filed his direct testimony in this case, Mr. Broadwater performed a number of analyses to determine what effect his recommended ROE might have on Laclede's financial position and to generally verify the reasonableness of his proposed return. (Exh. 162, 14-20; Exh. 59, p. 31) One of these analyses focused on the impact of his return recommendation on the Company's pre-tax interest coverages -- an indicator long used by the Staff, rating agency analysts and others to determine whether a utility will have earnings sufficient to pay its debt and maintain it credit rating. (*Id.*).

The calculations presented in Mr. Broadwater's testimony purported to show that his return recommendation would produce earnings that were sufficient to permit Laclede to maintain its interest coverages at a level that were consistent with Laclede's current "AA-" credit rating. (Exh. 59, p. 31).[18] The maintenance of a favorable credit rating is a matter of great importance to both Laclede and its customers. As Mr. Broadwater observed during his deposition, the higher the credit rating, the easier it is for the Company to issue debt and attract capital at a lower cost. (Exh. 116, p. 20). Conversely, the lower the credit rating, the more costly it will be to borrow money. (*Id.*).

For this reason, the Company has diligently worked over the years to maintain its credit ratings and has been successful in preserving an "AA-" or better rating since 1966 -- a span of more than three decades. (Exh. 9, p. 6). These same considerations have also prompted the Staff in its review of prior Laclede financing applications to seek assurances regarding the Company's ability to maintain an appropriate credit rating. (Tr. 399-401).

It was therefore with some alarm that Laclede discovered that Staff had made a mathematical error in its interest coverage calculation -- an error which, when corrected by Mr. Broadwater himself, showed that Staff's return recommendation would actually produce interest coverages consistent with a "BBB" credit rating, a downgrade of *two* full ratings levels from Laclede's current rating. (Exh. 116, pp. 38-39). After being made aware of this significant error, Mr. Broadwater indicated that he would "go back and look at" the reasonableness of his recommendation. (Tr. 40). He also indicated that had he known of the error beforehand he would have considered it important enough to advise

[18] Under the Standard and Poor's credit rating system used by Mr. Broadwater in his direct testimony, the highest credit rate is an AAA, followed by an AA, a single A and then a BBB. (Tr. 19). Any security with

the Commission of the actual impact of his recommendation on Laclede's credit rating. (Tr. 41).

Based on subsequent events, however, it appears that Staff is simply indifferent to whether adoption of its recommendation would cause Laclede to lose a credit rating it has held for more than three decades and the impact such a loss would have on the Company and its customers. Although Mr. Broadwater eventually filed as part of his rebuttal testimony a revised schedule that corrected for the error in his interest coverage calculation that had been pointed out to him during his deposition (See Exh. 61, Revised Schedule 19), he did not bother to correct (until reminded to do so at the evidentiary hearing) the text of his testimony, which still claimed, erroneously, that such calculation was consistent with an "A" or "AA" credit rating. (Tr. 322-323). Nor did Mr. Broadwater bother to correct his interest coverage calculation for other errors in that analysis that were identified by Laclede and never disputed by him -- errors that, when corrected, indicated a further erosion in Laclede's ability to maintain its credit ratings as a result of his return recommendation. (*See* Exh. 9, p. 4; Tr. 401-402). In fact, Mr. Broadwater made absolutely no effort in his subsequent testimony filings to even acknowledge, let alone address, *any* of the credit rating concerns or associated financial impacts raised by his low return recommendation.

Even in the face of a full and carefully considered explanation as to why such a result was appropriate, it would be extremely difficult to justify a return recommendation that compromised a utility's long-standing credit rating to the degree that those presented by Staff and Public Counsel do. Making such recommendations with the type of casual indifference that Staff and Public Counsel have demonstrated in this case, however,

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a credit rating below BBB is not even considered investment grade.

shows an utter and complete disregard for their legal obligation to consider how a utility's financial integrity will be affected when determining a fair return. Consistent with that standard, the Commission should do what Staff and Public Counsel have not -- adopt a return, such as the one proposed by the Company in this case, that is sufficient to preserve the good credit that has served Laclede and its customers so well for so many years. Indeed, as Mr. Broadwater conceded during his deposition, the 12.75% return recommended by Ms. McShane is the *only* ROE recommendation made in this proceeding that is consistent with the Company maintaining its current credit rating. (Exh. 116, pp 45-48). It should accordingly be adopted by the Commission.

C. <u>Capital Structure</u>

The only matter still at issue in this proceeding relating to the Company's capital structure concerns the proper level of short-term debt that should be included in that structure. Although the Commission has previously recognized that short term-debt is used as only a bridge to permanent capital and has therefore sanctioned its complete exclusion from a utility's capital structure, *See Re: Missouri Public Service*, 30 Mo. P.S.C. (N.S.) 320, 353-54 (1990); the Company nevertheless proposed to include a reasonable level of short term debt in its capital structure from the outset of this case. Specifically, the Company included a twelve month average level of short-term debt, with a downward adjustment to reflect the annualized effect of two permanent financings issued by the Company for the express purpose of reducing its short term debt. (Exh. 11, p. 10; Exh. 127, p. 8). These included a $24 million dollar equity issuance and a $25 million bond issuance. (*Id.*)

Operating on the theory that no good deed should go unpunished, Staff and Public Counsel have proposed a capital structure that not only includes short-term debt, but does so at a level that completely fails to recognize the annualized effect on that short-term debt of the $24 million equity and $25 million bond issuances that were actually placed by the Company in May and June of this year, respectively. (Exh. 127, p. 8). Staff's and Public Counsel's refusal to recognize the impact of these issuances on Laclede's short-term debt is simply inexplicable given the record in this case.

First, as shown by Schedule 1 to the rebuttal testimony filed by Laclede witness Buck in this proceeding, all of the disclosure documents filed by the Company with the SEC *before* these issuances were even made explicitly stated that proceeds of such issuances would be used to repay the Company's short-term debt. (Exh. 12; Schedule 1-1, 1-2). Specifically, the prospectus supplement that was filed with the SEC and distributed to the Company's investors in connection with the Company's equity issuance stated that: "The net proceeds from the sale of the shares, excluding the over-allotment option, will be approximately $21 million. *We will use the net proceeds to repay short term debt."* (Exh. 12, Schedule 1-1, *emphasis supplied.*). Similarly, the supplemental prospectus filed in connection with the bond issuance stated: "*We will use the net proceeds from the sale of the bonds to repay short term debt.*" (Exh. 12, Schedule 1-2).

In light of these explicit representations regarding the intended use of the proceeds from these issuances, it is exceedingly difficult to understand what possible basis Staff and Public Counsel could have for assuming, as they have, that such proceeds will not in fact be used to repay, and hence, reduce the Company's short term debt level. This is particularly true when one considers: (a) the financial reasons underlying the

Company's decision to make these issuances in the first place; and (b) what has happened since those issuances were completed.

As to the first point, it is clear that the Company placed these issuances for the same reasons it is opposing the ROE recommendations made by Staff and Public Counsel in this case, namely, to maintain the integrity of its current credit rating. (Exh. 12, pp. 10-12). As Public Counsel witness Burdette recognized in his testimony, Standard and Poor's, a major credit rating agency, considers it a cause for concern, whenever the amount of short term debt in a company's capital structure exceeds 10%. (Exh. 44, p.5). It was for this very reason, among others, that the Company sought to reduce its short-term through the issuances of equity and bonds that would give the Company the financial wherewithal to do so. Despite this consideration, however, the Staff and Public Counsel have inexplicably assumed that the Company will nevertheless continue to maintain short term debt at a level that would be exceed 13.8% of its capital structure. (*See* Exh. 128). Moreover, they make this assumption even though the record in this proceeding clearly shows that the average monthly balances of short term debt carried by the Company have, in fact, declined, on average, to $35.222 million in the two months (June and July 1999) which occurred between the time issuances were completed and the true-up period in this case ended. (*See* Exh. 128, Schedule 3). This amount is some $44 million below the short-term debt levels recommended by Staff and Public Counsel.

Staff's position on this issue is also flatly inconsistent with its own testimony regarding why the Company carries short-term debt in the first place. According to Staff witness Broadwater's direct testimony, short-term debt is used to support the Company's natural gas and propane inventories and cash working capital. (Exh. 59, p. 22). As

Laclede witness Buck noted, however, while it did not agree with Staff's premise that short-term debt necessarily supports all these items, the fact remains that the total amount included by Staff in its case for these rate base items was only $48.111million or some $30 million dollars less than the short term debt levels recommended by Staff and Public Counsel. (Exh. 13, p. 6). Indeed, due in large part to their inflated estimate of the Company's short-term debt level, Staff and Public Counsel are now recommending a total capital structure that is some $42.5 million greater in value than the entire rate base amount that they have recommended for inclusion in rates and that the capital structure is designed to finance. (Exh. 127, p. 9). How can such a difference exist for a Company that has no material investments in other lines of business and no operations in other jurisdictions?

In light of these considerations, it is clear that the short term-debt levels proposed by Staff and Public Counsel are simply designed to reduce the Company's revenue requirement rather than establish a reasonable level of such debt on a going-forward basis. Indeed, there could not be a better illustration of this purpose than the disturbing fact that Staff's current position on this issue directly conflicts with what it recommended in its direct filing less than four months ago when, consistent with the position it had taken in past Laclede cases, it actually deducted the proceeds of the bond issuance from the Company's short term-debt level for purposes of performing its true-up estimate in this case. (Exh. 127, p. 8).[19] Largely as a result of this change in position, Staff's true-up allowance in this case for capital structure changes went from a positive increase in

[19] Although Mr. Broadwater attempted to portray his initial subtraction of the Company's bond issuance in Staff's direct case as a matter of convenience rather than principle, he conceded that he had made the same type of adjustment in the Company's 1996 rate case. (Tr. 1090). In doing so, he specifically recognized in

revenue requirement of $1,456,000 (an amount which was also reflected in the First Amended Partial Stipulation and Agreement), to a negative decrease of $350,000 in its ultimate true-up recommendation. (Exh. 127, pp. 8-9). It is simply inconceivable that a utility can issue nearly $50 million of stocks and bonds and have the additional investment result in a decrease in revenue requirement.

For all of these reasons, the Commission should adopt the Company's position on this issue and increase the Company's revenue requirement by $2,325,000 consistent with the recommendations set forth in the true-up testimony of Company witness Fallert. (Exh. 127, pp. 7, 10).

D. <u>Cash Working Capital/ Revenue Collection Lag</u>

Cash working capital is the average amount of capital that must be provided by a utility's shareholders to finance the payment of bills, payrolls and other expense items before the time that corresponding revenues are received from its customers. (Exh. 11, p. 3). Utilities are permitted to include cash working capital in their rate base so that their shareholders are afforded a return on this investment requirement. The Commission has historically calculated the amount of each utility's cash working capital requirement through the use of a lead-lag study. A lead-lag study measures the time between when items of revenue or expense are realized or incurred by the utility and the date service related thereto is provided. In this context, a "lead" is the measure of time used when an item of revenue or expense is realized or incurred prior to the utility's provision of service, and a "lag" is a measure of time used when an item of revenue or expense is

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that case that such an adjustment was appropriate "to account for Laclede's $25 million long-term debt issuance in November 15th, 1995, to pay down short-term debt." (*Id.*).

incurred after service is provided. (Exh. 11, p. 4). Since Laclede's customers pay their bills after service is rendered, Laclede always has a net revenue lag. Similarly, since the vast majority of Laclede's expenses are paid after service is rendered, Laclede has a net expense lag, the duration of which is shorter than the net revenue lag. The difference between Laclede's net revenue lag and net expense lag determines the amount of cash working capital that must be included in Laclede's rate base. (*Id.*).

In this case, the Staff and Laclede, the only parties that addressed the cash working capital issue, agree on many of the elements of the cash working capital calculation. The Staff and Laclede both agree that a lead-lag study is the appropriate method to use for calculating the cash working capital requirement. (*See* Exh. 84, p. 5 and Exh. 11, p. 3). In addition, the Staff and Laclede both agree on the amount of the net expense lag that should be utilized. The difference between the parties is in the calculation of Laclede's net revenue lag.

The net revenue lag is comprised of several components: The "usage lag" is the midpoint of the average time elapsed from the beginning of the first day of a service period through the last day of the service period; the "billing lag" is the period of time between the last day of the service period and the day the bill is placed in the mail by the Company; and the "collection lag" is the period of time between the day the bill is placed in the mail by the Company and the day the Company receives payment from the ratepayer. (Exh. 84, pp. 8-9). In this case, the Staff and Laclede have reached agreement on the appropriate usage lag and billing lag to be used in the net revenue lag calculation. The only issue remaining in dispute is the amount of the collection lag to be used in the calculation.

The Company calculated the revenue collection lag using an accounts receivable turnover analysis of all of the Company's utility receivables for the test year in this case, ending December, 1998. These receivables were compared to average billing items for the twelve months ended November, 1998 and December, 1998 to derive a revenue collection lag of 34.8 days. (Exh. 11, pp. 6-7). This is the type of analysis the Commission has utilized to calculate collection lags in previous cases. *Southwestern Bell Telephone Company*, 2 Mo.P.S.C. 3d 497, 502-504 (1993). In contrast, the Staff calculated a revenue collection lag of 25.4 days based on a small sample of Laclede's accounts from twelve month period ending February 1998 used in Case No. GR-98-374, Laclede's last rate case. (Tr. 659-661). As explained more fully below, Laclede believes that it is inappropriate to use Staff's sample to calculate the revenue collection lag in this case, because: a) the Staff has provided no evidence that its small sample has any statistical validity, and indeed the Staff's witness admitted he has no idea whether it is statistically valid or not; b) the Staff's sample is clearly not representative of Laclede's customer base demographics, and in many cases departs from those demographics by several orders of magnitude; and c) the Staff's sample was designed to exclude customers with less than twelve months of billing history, who typically have significantly worse-than-average payment practices.

1. There is No Evidence That The Staff's Sample is Statistically Valid.

Perhaps the most important consideration in determining whether to use a sample in calculating Laclede's revenue collection lag (as opposed to an analysis of all of the accounts as Laclede has done) is whether the sample has been designed to produce statistically valid results. In this case, there is no evidence that the Staff has made any effort whatsoever to assure that its sample meets this basic standard. The sample, consisting of 275 accounts, constitutes only 4/100ths of 1% of Laclede's customer base, which averaged more than 620,000 customers during the period in question. (Exh. 12, p. 4). It seems inconceivable that such a tiny fraction of Laclede's customers could provide any statistically meaningful information about the paying habits of the customer base as a whole. In response to a data request submitted by Laclede, the Staff acknowledged that it had not performed any tests to determine whether the sample it selected was large enough to produce statistically valid results. (Exh. 12, p. 4). Moreover, at the hearing, long after this issue had been raised by Laclede's data request, Staff witness Griggs acknowledged that the Staff had still not conducted any analyses to determine if its sample was valid from a statistical standpoint:

> Q. Okay. And you asked the Company to pull 300 accounts?
>
> A. Yes.
>
> Q. Why did you pick that number of accounts for the Company to pull?
>
> A. It was thought that, in the time that was allowed, that would give the—that would allow for analysis of each of those accounts.
>
> Q. Well, do you know if that is a statistically valid number of accounts to pull for a sample?
>
> A. No. Staff has not performed an analysis to determine that.
>
> Q. And you're not a statistician, are you, Mr. Griggs?
>
> A. No, I'm not.
>
> Q. So for all you know, from a statistical standpoint it may be perfectly valid or it may be perfectly invalid?
>
> A. Yes, that's correct.

(Tr. 661-662).

The Staff's admission that it has no idea whether its sample is statistically valid is a fatal flaw in its argument. Even if the sample had no other deficiencies, it should be rejected for this reason alone in favor of Laclede's analysis of <u>all</u> of the accounts. Indeed, the simple fact remains that there is no need whatsoever to use any kind of statistical sample <u>at all</u> – when the entire universe of data is available and has been used

2. <u>Staff's Sample Should Be Rejected Because It is Wildly Inconsistent With the Demographics of Laclede's Customer Base.</u>

The demographics of the customers whose accounts are contained in Staff's sample are inconsistent with the demographics of Laclede's customer base as a whole in many respects. For example, commercial and industrial customers are over-represented in the Staff's sample by a magnitude of 100%. (Exh. 12, p. 5). Budget billing customers are over-represented in the sample by a magnitude of approximately 25%, and merchandise only customers are over-represented in the sample by nearly 10,000%. (Exh. 12, pp. 4-5). These demographic inconsistencies clearly compromise the usefulness of the sample as a reflection of the revenue collection lag actually experienced by Laclede. For example, the over-representation of commercial and industrial customers, which are required to pay their bills in 15 days (as opposed to 21 days for residential customers), obviously would have the effect of improperly shortening the overall revenue collection lag, as Mr. Griggs himself admitted. (Tr. 673). Moreover, the multiple inconsistencies between the Staff's sample and Laclede's demographic base as a whole show that the sample is simply not a reasonable representation of Laclede's customers. Consequently, based on these inconsistencies, the Staff's sample should not be used to calculate Laclede's revenue collection lag.

3. Staff Improperly Excluded Customers With Less Than 12 Months of Billing Data From Its Sample.

Perhaps the most serious deficiency with Staff's sample is that Staff intentionally excluded all customers with less than twelve months of billing data. As Laclede witness Buck testified, this eliminates from consideration well over 20% of Laclede's customers. In other words, this requirement eliminates well over 100,000 customers from consideration in the Staff's sample. (Exh. 13, p. 4). More importantly, this exclusion eliminated new customers, inactive customers, final-billed customers and charge-off customers—categories of customers that are likely to have longer-than-average revenue collection lags. (Exh. 13, p. 4). In Case No. GR-98-374, Laclede submitted a study to support a tariff change that would require new renters to place a deposit with Laclede. The study showed that almost 80% of Laclede's bad debts were from customers who were renters rather than home owners. (Exh. 120). This inherently more mobile customer base, which Staff admits have relatively poor payment characteristics, is substantially underrepresented by the Staff's exclusion of customers with less than 12 months of payment history. (Tr. 678). For this reason as well, Staff's sample should be rejected.

4. Conclusion.

In this case, Laclede has provided an accounts receivable turnover analysis of <u>all</u> of its accounts, using test year (calendar year 1998) data, to calculate its revenue collection lag. The evidence clearly establishes that this is far superior to Staff's calculation, which is based on a miniscule sample of stale customer data that: a) has not been shown to be statistically valid; b) clearly is inconsistent in many significant respects with the demographics of Laclede's customer base; and c) was designed to exclude accounts with less than 12 months of data, thereby excluding a substantial portion of

Laclede's accounts with poor payment histories. For all of these reasons, the Commission should adopt Laclede's calculation of its cash working capital revenue collection lag in this case.

E. **Advertising**

1. **Overview.**

The issue with regard to advertising is whether Staff and Public Counsel should continue to apply an outdated, inconsistent, subjective and virtually unobtainable standard to the advertisements placed by public utilities in order to determine which advertising costs should be recovered for ratemaking purposes. Staff and Public Counsel are clinging to the existing flawed approach apparently because they believe that they are benefiting ratepayers by making it very difficult, if not almost impossible, for a company to obtain cost recovery of its "promotional" advertising expenses in rates, regardless of the benefits that such advertising may garner for ratepayers. In light of the manner in which Staff and Public Counsel are interpreting and applying the current standard, and the fact that the current classification standard has not been reconsidered by the Commission in more than a decade, Laclede believes that both the Company and its customers would benefit if the Commission were to review and modify the existing standard.

2. **The Current Standard as it is Applied by Staff and Public Counsel is Flawed and Should be Abandoned.**

The Commission should abandon the current standard for classifying advertisements, which was established by the Commission in *Re: Kansas City Power & Light Company*, 28 Mo.P.S.C. (N. S.) 228 (1986). For several reasons, Laclede believes this standard is inappropriate and unworkable in the current competitive environment facing public utilities. First, the current standard requires Staff and Public Counsel to undertake a line-by-line analysis of each advertisement in an effort to determine one "primary message" for each such advertisement. Such an approach can result in inconsistent treatment of advertising costs among various companies and even in the same company's advertisements from one rate case to the next. For example, Staff admitted at the evidentiary hearing that it had placed the same advertisement in a combination of three different classifications during Laclede's last several rate cases (Tr. 810-813). Meanwhile, Public Counsel in Laclede's 1996 rate case (GR-96-193) classified the same advertisement as a combination of Safety, General, Promotional and Institutional. (Exh. 22; Schedule 2). Interestingly, Staff and Public Counsel excluded from recovery different percentages of the advertisement's cost based on their respective classifications. In contrast, Staff and Public Counsel classified this same advertisement in the current case as General only. (Exh. 88, p. 3; Exh. 51, p. 7).

Secondly, the current standard requires Staff and Public Counsel to force-fit advertisements into one of five categories based on the "primary message" of an advertisement -- an arbitrary process that is not consistent with the way that consumers view, or companies budget, advertising. As Public Counsel admitted at the evidentiary hearing (Tr. 779-780), determining the "primary message" of an advertisement can often be complicated by the need to ferret out the overall theme of an advertisement that may include aspects of numerous classifications. As a result, Public Counsel and Staff inevitably end up arbitrarily forcing multi-faceted advertisements, which may include a wide range of information and multiple Safety, General, Promotional and Institutional messages, and which are viewed by the audience as a whole, into <u>one</u> narrow classification. For example, in the current case, even though Public Counsel admitted that Laclede's advertisements often contain multiple messages (Tr. 778-780), not a single advertisement was divided among classifications by Staff or Public Counsel. Instead, each advertisement was forced into one of five categories, and the rate recovery recommendation was based on this arbitrary, forced classification.

Finally, the manner in which the current standard is applied to advertisements that are classified as Promotional has made it very difficult, if not virtually impossible, for any company to meet the standard for including the costs for such Promotional advertisements in rates. In fact, no public utility in Missouri has ever met the current standard for recovery of Promotional advertising costs. (Tr. 781, 807). Even more telling, Staff is not aware of any company, other than Laclede, that has even tried to recover such costs (Tr. 807), leading one to suspect that most companies believe the standard is unachievable and that it is not worth the time and effort required to pursue recovery of these normal and prudent operating expenses in light of the virtual impossibility of succeeding.

One reason that the current standard is so difficult to achieve is that Staff and Public Counsel are not sure how the standard should be applied and what a company needs to show in order to meet the standard. At the hearing, Staff admitted that it has no opinion with regard to whether a company must show that it obtained certain revenues from a particular Promotional advertisement or campaign in order to demonstrate the cost-benefit relationship that is required to qualify for rate recovery under the current standard. (Tr. 808-809). On the other hand, Public Counsel witness Bolin testified that a sufficient cost-benefit analysis would be one that is based on empirical data, but that

Public Counsel was not sure of what the nature of this empirical data would be. (Tr. 780). In fact, Ms. Bolin admitted that she had not given "much thought" to what empirical data would be sufficient to meet the standard to which Public Counsel is holding Laclede. (Tr. 780-781). Moreover, Ms. Bolin stated at the hearing that part of the test for the inclusion of Promotional advertisements in rates is whether a particular Promotional advertisement is necessary for the provision of safe and reasonable gas service. (Tr. 786). This misunderstanding by Public Counsel of the applicable standard reinforces the point that it is both unfair and inappropriate to establish a standard for recovery of a normal and reasonable expense, such as advertising, that no one, not even the people who are determining whether the standard has been met, understands or knows how to interpret and apply.

3. Laclede has met the Existing Standard for Rate Recovery of Promotional Advertising Costs.

If the Commission determines that the existing classification standard, despite its substantial flaws, is the best method for determining the recoverability of advertising costs, Laclede is still entitled to recover all, or at the very least a portion, of the costs Laclede incurs for Promotional advertisements. As previously noted, the current standard was established by the Commission in 1986. It provides that the cost of Promotional advertising should be included in the cost of service if the company can demonstrate that the benefits of such advertisements exceed the costs of the Promotional advertisements themselves and that there is a causal relationship between the advertisements and the benefits achieved. *Kansas City Power & Light Company*, 28 Mo. P.S.C. (N.S.) at 269. It is noteworthy that the Commission has not, in *Kansas City Power & Light* or any other case, established a "revenues generated" test that requires a company to prove that individual advertisements or campaigns resulted in particular, identifiable revenues. Instead, the Commission's decisions require only that the benefits to ratepayers from advertising exceed the costs of the Promotional advertising itself.

Laclede's customers clearly benefit, both individually and collectively, from Laclede's Promotional advertising in at least two ways. First, customers receive valuable information regarding natural gas, its many uses, and its relative efficiency and cost savings versus alternative energy sources that they could not as readily obtain from other sources. (Exh. 20, p. 2). This information, which is presented in a format to which customers have grown accustomed, enables customers to make informed energy decisions. Second, customers as a whole benefit to the extent that Laclede is able to maintain and/or expand its customer base through Promotional advertising and thereby spread its fixed costs over a larger customer base. (*Id.*)

Moreover, to the extent that the Commission's current standard requires Laclede to demonstrate the existence of a causal relationship between Promotional advertising and the benefits received by the ratepayers, the 1990 survey of certain of Laclede's customers conducted by Marketeam Associates provides such a demonstration. Marketeam's Executive Summary of the results of this survey, a copy of which summary was attached to Laclede witness Hargraves' rebuttal testimony as Schedule 3, states that over one-half of the respondents recalled Laclede's advertising and said that it was important in their decision to choose natural gas. (Exh. 21: Schedule 3, p. 1). Additionally, when asked in an open-ended manner, over one-half of all respondents recalled seeing or hearing advertising about natural gas before choosing gas heat. (Exh. 21; Schedule 3, p. 2). It is significant that the survey respondents did not note any formal source of communication, other than Laclede's advertising, as having a significant effect on their decision to use natural gas. (Exh. 21; Schedule 3, p. 3). Although Laclede's Promotional advertising may not be the only reason that a particular customer chooses gas heat, clearly customers are seeing and/or hearing, and recalling, Laclede's Promotional advertisements, and these experiences are impacting customers' decisions in a positive manner.

Other evidence that Laclede's Promotional advertisements effectively distribute useful information and help Laclede to maintain and/or enlarge its customer base can be inferred from the increased visibility and success enjoyed by Laclede's residential service work program. Between the twelve-month period ending just prior to when Laclede began its current residential service work advertising campaign, and the end of the test year, Laclede's revenues from residential service work increased by more than seventy percent (70%). (Exh. 21, pp. 7-8). The only material change in the program is the advertising conducted by Laclede. There is no reason to believe that the advertising that Laclede engages to inform customers of its regulated utility business is any less effective at increasing awareness among, maintaining existing, and/or attracting new, customers than the residential service work advertising.

4. Reasonable Spending Level Review Provides a More Fair and Equitable Standard.

All of the time and effort expended by the various parties reviewing and classifying advertisements, and disputing the classification determinations made by Staff and Public Counsel, could be avoided if the Commission were to revise the standard for the recovery of advertising costs by implementing one that focuses on whether the public utility has spent a reasonable amount on advertising in light of the facts and circumstances. The determination of this reasonable amount could be based on any number of standard ratemaking criteria, including, for example, an average of the amount that such company has expended on advertising during the previous five or ten years, or a straight percentage (approximately .5% as suggested by Laclede at the hearing) of the utility's overall revenues during the test year or the previous five or ten years. A company would be entitled to recover only its actual advertising costs in an amount not to exceed such a reasonable level of expenditures. By basing such a standard on a reasonable level of expenditures, which would exclude recovery for Political advertisements (a form of advertising that Laclede has traditionally not undertaken), the Commission would provide a fair, reasonable and consistent method for determining the amount of advertising costs that a company would be entitled to recover, without the inconsistencies and vagaries present in the current classification system.

5. **Natural Gas is Virtually Pollution Free.**

Finally, Laclede would briefly respond to a criticism that was expressed by Mr. Ryan Kind, a witness for Public Counsel, regarding the content of some of the Company's advertisements. Mr. Kind, who holds no certifications or degrees in the environmental area, would have the Commission believe that natural gas is not virtually pollution free as stated in some of the Company's advertisements.[20] (Exh. 57, Pages 6-7). Admittedly, there are sources of energy, such as wind and sun, that produce absolutely no adverse effects on the environment. None of these alternative energy sources, however, can practically be used by the general public in a residential setting on a cost-effective basis. On the other hand, natural gas, which is readily available and convenient to use, is

[20] It should be noted that Judge Dippell ruled that Mr. Kind was not competent to answer a question regarding his opinion about whether natural gas is almost entirely pollution-free (Tr.771-773).

the cleanest burning, commonly used residential energy source, and burns without creating many of the by-products that are major sources of air pollution and acid rain. (Exh. 21, p. 9). In fact, Public Counsel admitted that approximately four times the amount of Carbon Dioxide emissions are associated with electric resistance space heating as compared to natural gas heat (Tr. 767). Additionally, Public Counsel acknowledged that the Environmental Protection Agency does not even consider Carbon Dioxide (a substance released with every human breath and the main by-product of natural gas) to be a pollutant. (Tr. 763-764). In light of these considerations, it is clear that Mr. Kind's criticisms are completely unfounded.

Based on all of the evidence in the record, and for the reasons stated above, the Commission should adopt Laclede's position on the issue of advertising.

F. <u>Sunset Provision for AAO</u>

Pursuant to the Stipulation and Agreement filed in this case, the parties have recommended that the Commission terminate, effective August 1, 1999, the four AAO's that were previously granted to the Company in connection with its OPEB, SERP, Y2K and MGP costs. (*See* Stipulation and Agreement, ¶ 4). The parties have also recommended that the Company be permitted to continue, with certain modifications, the AAO relating to safety-related costs incurred by the Company to replace, maintain, cathodically protect, and/or survey certain of its pipeline facilities. (Stipulation and Agreement, ¶ 5). The parties have not been able to reach agreement, however, on the issue of what terms should govern the duration of this AAO.

As set forth in Schedule 3 to the rebuttal testimony filed by Laclede witness Fallert, the Company has proposed a procedure under which it would provide periodic reports to both the Staff and the Office of the Public Counsel detailing the amounts being deferred pursuant to this AAO and financial information regarding the Company's earnings. (Exh. 8, Schedule 3). No less than six months prior to the third anniversary of the effective date of the AAO, the Company would submit a request to the Commission addressing whether such accounting authorization should be continued beyond the third year without the necessity of the Company making a general rate case filing. (*Id.*). After other parties had been given a reasonable opportunity to respond to the Company's request, the Commission would issue an Order resolving the issue. In the event the Commission determined that the Company should file a general rate case, the Company would be required to do so within six months from the date of the Commission's Order or face an immediate termination of the AAO at that time. (*Id.*).

In the Company's view, such an approach presents a practical and common sense solution for all of the concerns that have been raised regarding the appropriate duration of an AAO. On the one hand, it provides Staff and Public Counsel with the information necessary to determine whether the magnitude of the costs being deferred, or the level of earnings being achieved, by the Company are such that continuation of such an AAO beyond three years is inappropriate. It also preserves the Commission's full discretion to require a general rate case filing as a condition for continuing the AAO in the event the Commission concludes that any concerns regarding the above-mentioned items may in fact warrant such a filing. On the other hand, the approach suggested by the Company also affords it an opportunity to break its historical cycle of filing rate cases at least once every two years by removing the threat that the Company will have to automatically write off costs that have been legitimately deferred under the AAO unless such a filing is made.

Despite these considerations, however, Staff and Public Counsel have nevertheless taken the position that the Gas Safety AAO should become null and void unless the Company files a rate case within two years of its effective date. (Exh. 83, pp. 3-5; Exh. 49, pp. 5-9). In doing so, it appears that Staff and Public Counsel are completely disinterested in doing anything that might permit the Company to actually avoid seeking rate relief for a more extended period of time. To the contrary, by steadfastly insisting that the AAO should become null and void unless the Company files for rate relief in two years, Staff and Public Counsel have needlessly added another barrier to the successful pursuit of any such effort. Moreover, they have done so even though it is clear from the record in this case that: a) Laclede's ratepayers would unquestionably benefit from any successful effort by the Company to defer seeking rate relief; and b) the Commission would retain full discretion to require a general rate case filing in the event it ever concluded that such a filing was necessary and appropriate.

As to the first point, it should be noted that even Public Counsel's witness Robertson agreed that, while he personally liked to work on rate cases, it was generally a good thing for customers when a utility deferred efforts to increase their rates. (Tr. 612-13). Moreover, given the extraordinary low carrying charges applicable to costs deferred under the AAO, it is difficult to understand why Staff and Public Counsel would not prefer to have the Company delay their recovery for as long as possible. As Mr. Rackers acknowledged during the hearing, and as the Stipulation and Agreement in this case provides, the amount subject to the Gas Safety AAO are deferred at a rate equal to the Allowance for Funds Used During Construction ("AFUDC") rate minus 1%. (Tr. 628). He also acknowledged that under the method used to calculate the AFUDC rate, the cost of the Company's short-term debt is used first, until and unless that amount is exhausted. (Tr. 641-43). Since the cost of the Company's short-term debt over the past year, as calculated by Staff, has averaged 5.29% (Exh. 128, Schedule 1) it is entirely possible that all or a substantial amount of the costs subject to the AAO will be deferred at an extremely low rate of less than 5%. Moreover, under the approach currently being followed by the Commission, such a rate will be effectively discounted even further in the event the Company is only permitted to obtain a recovery of, rather than a recovery on, such costs over a ten year period. Given this simple economic, neither the Staff or Public Counsel are doing the ratepayer any favor by proposing that the Company be effectively forced to seek recover of such costs sooner rather than later.

As to the second point, Laclede fails to see how the Commission, or anyone else, is disadvantaged by a proposal that simply gives it the means and the latitude to determine whether the Company should be required to file a rate case in order to continue an AAO beyond a prescribed period of time. There is simply no valid reason to conclude beforehand, as Staff and Public Counsel apparently have, that such latitude will somehow work to the detriment of the Company's customers. For all of these reasons, the Company's proposal should be adopted.

G. Depreciation

1. Net Salvage Value.

In this case Paul Adam, the Staff's witness addressing depreciation issues, has recommended that the Commission radically deviate from the method normally used to calculate depreciation rates for Laclede's capital assets, by altering the way the net salvage associated with those assets is calculated. Laclede opposes this proposed change in depreciation methodology because: a) it defeats the primary goal of depreciation, which is allocation of the full cost of an asset over the useful life of the asset; b) it contradicts Generally Accepted Accounting Principles; and c) it is completely contrary to the treatment of net salvage that is consistently recommended by the authoritative texts on depreciation theory and the expert testimony presented by Laclede in this proceeding. Mr. Adam's method has never been adopted by this Commission, by federal regulatory commissions, or by public utility commissions in the overwhelming majority of the other states, and it should not be adopted in this proceeding.

In order to understand the positions of the parties on the net salvage issue, a basic understanding of the theory underlying the calculation of Laclede's depreciation rates is necessary. The National Association of Regulatory Utility Commissioners ("NARUC") defines depreciation accounting as:

> the mechanism through which the capital invested in depreciable plant is recovered. is the process used to allocate that capital investment to the accounting periods during which the depreciable plant is in service. A system of accounting which allocates the cost adjusted for salvage over the estimated useful life of a property unit or group of assets in a systematic and rational manner.
>
> (Exh. 23, p. 3).

In other words, depreciation charges the cost of utility property investments—including both the original cost and net salvage—to operating expenses over the service life of the underlying property. (*Id.*).

The Commission has historically used the straight line – average life – amortization system to calculate Laclede's depreciation rates. Under this methodology, a depreciation rate for each plant account is calculated according to the following formula:

$$\text{Depreciation Rate} = \frac{100\%\text{-}\%\ \text{Net Salvage}}{\text{Average Service Life (years)}}$$

(Exh. 23, p. 4).

The depreciation rate is then multiplied by the applicable plant account balance to determine the annual depreciation expense. In the depreciation rate formula, net salvage equals gross salvage minus the cost of removing the property from service. The net salvage percentage equals net salvage for a period, divided by the original cost of the property retired during that same period. (Exh. 23, pp. 4-5). Since the cost of removal of many natural gas assets, such as mains and service lines, typically exceeds the gross salvage, the net salvage percent is usually a negative number. The effect of this methodology is to allocate the cost of the asset, including estimated net salvage, over the estimated life of the asset. (Exh. 26, p. 4).

Mr. Adam proposes in this case to modify the net salvage component of the depreciation rate equation in an arbitrary manner that significantly reduces the annual depreciation expense applicable to Laclede's capital assets. Mr. Adam utilizes a net salvage percentage which, in effect, assumes that the average dollar amount of negative net salvage that Laclede has experienced in the past ten years will be the dollar amount of net salvage applicable to all future retirements. (*See* Exh. 92, Schedule 3-2). This change in the manner that depreciation rates are calculated has the effect of reducing Laclede's revenue requirement in this case by millions of dollars. Even more significantly, as the evidence in this case shows, such a change would contradict not only this Commission's long-standing practice with regard to the calculation of net salvage, but also the views of virtually every depreciation expert and public utility commission that has ever addressed this issue. The adoption of Mr. Adam's unconventional and illogical treatment of net salvage would result in inadequate depreciation rates for Laclede, and, more importantly, would establish an unreasonable precedent for the calculation of depreciation rates for all utilities in Missouri. For those reasons, Mr. Adam's proposal should be rejected.

(a) <u>Mr. Adam's Proposal Defeats the Primary Purpose of Depreciation Accounting.</u>

As was previously mentioned, the primary purpose of depreciation accounting is to allocate <u>all</u> of the costs of an asset over the useful life of the asset. The formula used to calculate depreciation expense for Laclede includes three factors. First is the balance in the plant account of the depreciable asset. This consists of the original cost of the assets in the account, adjusted for any additions and retirements. This amount, of course, is known when the depreciation rates are established, so it is generally not subject to dispute. And indeed this component of the formula is not subject to dispute in this case. The second factor that goes into the calculation of the depreciation expense is the average service life of the assets in the plant account, in years, which is the denominator in the depreciation rate formula. This obviously cannot be known with certainty at the time that the depreciation rate is established for an asset or group of assets that remain in service. Consequently, the average service lives of assets currently in service must be estimated to calculate the depreciation rate. Depreciation professionals have developed widely-adopted methods for estimating these average service lives through the use of actuarial techniques and Iowa-type survivor curves, as explained in detail in the direct testimony of Laclede witness Richard A. Kottemann. (Exh. 23, pp. 8-9). Again, there is no dispute about this aspect of the depreciation expense calculation in this case.

The third and final component of the depreciation expense calculation, and the component that is at issue in this proceeding, is the calculation of the average net salvage rate. Like the average service life component, the average net salvage rate must be estimated. Again, depreciation professionals have developed widely used techniques for estimating this component of the depreciation rate formula. The net salvage percent is calculated based on the historical relationship between the salvage cost of an asset, or group of assets, and the original cost of that same asset or group of assets. Then this net salvage percentage is subtracted from 100% in determining the numerator for the depreciation rate formula. Because the net salvage percentage is generally negative, the numerator of the depreciation rate formula is frequently larger than 100%, providing recovery of the original cost of the plant plus the net salvage cost. (Exh. 23, pp. 5-7).

In this case, Mr. Adam has completely ignored this established convention for calculating the net salvage rate applicable to Laclede's depreciable assets in favor of a method that recognizes only the average amount of net salvage costs experienced by Laclede in the last ten years. This will obviously not provide a reasonable estimate of the future net salvage costs Laclede can be expected to experience with respect to existing plant. For example, under Mr. Adam's methodology, regardless of any increases or decreases in the plant balances, Laclede would only be allowed to recover the average net salvage cost experienced over the last ten years. In addition, Mr. Adam's proposal also does not take into account the predictable escalation in the cost of removal that occurs over time. Consequently, his calculation is a very poor predictor of the actual net salvage costs Laclede is likely to experience with respect to future retirements of existing plant.

Laclede witness Dr. Ronald E. White illustrated the difference between Mr. Adam's approach and the conventional approach with a simple example:

> The practical difference between these two accrual formulas can be observed by considering a plant category in which no plant has been retired from service to date, but it is known with certainty that removal expense will be incurred when the plant is retired at some future date. The formula proposed by Mr. Adam would charge <u>no</u> removal expense to operations until retirements are posted and removal expense has been realized. This treatment will significantly understate the cost of providing utility service to current ratepayers. In contrast, the conventional accrual formula will allocate future removal expense to operations over the accounting periods in which the service capacity of the assets is consumed. Thus, both current and future ratepayers are charged a reasonable share of the cost of the service provided to them.
>
> (Exh. 26, p. 12; *See also* Tr. 862).

Mr. Adam openly admits that his approach only reflects recently experienced net salvage costs and is not designed to reflect future net salvage costs at all. He states that "the net salvage component of the Depreciation Rate equation should recover the current actual net salvage amounts over the total life of the current plant." (Exh. 92, p. 7). His solution is for Laclede to file a new rate case each time its actual experienced net salvage cost differs significantly from the amount incorporated into Laclede's depreciation rates. (Exh. 92, p. 8). This is an unreasonable proposal in that it would require numerous rate cases driven solely by changes in net salvage costs. But more significantly, it contradicts the fundamental goal of depreciation—to do the best job possible in allocating <u>all</u> of the costs of an asset over the <u>entire</u> useful life of the asset. Mr. Adam's method does not adequately account for the future net salvage costs Laclede will experience, and for that reason it should be rejected.

(b) <u>Mr. Adam's Method for Calculating the Allowance for Net Salvage Costs Violates GAAP And Contradicts the Clear Consensus of Depreciation Professionals.</u>

Laclede has presented uncontradicted evidence in this proceeding that Mr. Adam's approach to calculating net salvage violates Generally Accepted Accounting Principles (GAAP) in general, and widely-adopted depreciation accounting practices in particular. (Exh. 25, p. 4; Exh. 26, p. 13). Although the Commission is not obligated by law to adopt GAAP in all cases, the Commission has shown a consistent preference for following accounting practices consistent with GAAP in the absence of a compelling reason to depart from it. *See, for example, Re: Missouri Cities Water Company*, 2 Mo.P.S.C. 3d. 60, 90 (1993).

In this case, the evidence shows that there is absolutely no justification from the standpoint of depreciation accounting theory to depart from GAAP by adopting Mr. Adam's unconventional, illogical and punitive treatment of Laclede's net salvage costs. First, numerous depreciation authorities cited by Laclede unanimously agree upon the "classical"[21] method utilized by Laclede for calculating net salvage. Laclede's expert witness, Dr. White, (who unlike Mr. Adam[22]) who has decades of experience in teaching and applying depreciation theory and whose testimony on depreciation has been adopted in numerous jurisdictions, testified as follows:

> Q. IS THE TREATMENT OF NET SALVAGE ADVOCATED BY MR. ADAM IN THIS PROCEEDING CONSISTENT WITH THESE [DEPRECIATION] PRINCIPLES?
>
> A. No, it is not. Mr. Adam has modified a conventional and widely accepted formula for depreciation rates to produce a net salvage allowance that is inconsistent with the goals and objectives of depreciation accounting. Achievement of cost allocation over economic life in proportion to the consumption

[21] Mr. Adam himself refers to Laclede's method as the "classical" method.

[22] Mr. Adam testified that his background is generally in the oil and construction industries. He only began addressing depreciation issues on a regular basis approximately five years ago when he was first employed by the Commission. (Tr. 853-859).

> of service potential requires a recognition of both realized and future net salvage in the depreciation rate formula. The treatment advocated by Mr. Adam is equivalent to amortizing historical or realized net salvage over a time period equal to the band of years included in the observed data.
>
> To his credit, however, Mr. Adam does not claim that his formula has any theoretical foundation other than a desire to shift the timing of depreciation expense. While those of us concerned with advancements in cost allocation and accounting theory should always be receptive to innovative ideas and creative thinking, it would be a mistake, in my opinion, to institute a change in the principles of depreciation accounting based solely on a desire to reduce depreciation expense in a general rate proceeding.

(Exh. 26, p. 5).

Dr. White also testified that:

> The treatment of net salvage advocated by Staff reduces to a recommendation to the Commission to abandon accrual accounting for net salvage and to institute a policy of allowing no more than the annual average of the net salvage realized over a recent band of years as the currently recoverable revenue requirement for salvage and cost of removal. This, in my experience, is without precedence both in theory and in practice. The proposal violates generally accepted accounting principles and would shift the expense recognition and recovery of net salvage to accounting periods beyond which the service capacity of the related assets had been consumed. I firmly believe, however, that responsible regulation would not knowingly abandon a universally accepted accounting practice and sanction a new depreciation formula designed with no other objective than to shift current costs to future accounting periods.

(Exh. 26, p. 13).

In addition to Dr. White, Laclede's in-house witness on depreciation issues, Mr. Kottemann, testified that all of the texts with which he is familiar universally support the treatment of net salvage costs that Laclede is proposing in this case. Mr. Kottemann cites the NARUC publication entitled *Public Utility Depreciation Practice*, and *Depreciation*

Systems authored by Wolf and Fitch as examples of authoritative texts which support Laclede's approach to net salvage. Mr. Adam, on the other hand, was unable to cite a single authority which supports his unconventional approach to calculating net salvage costs. [23]

In Missouri, like the overwhelming majority of the other states,[24] Laclede's methodology for calculating net salvage has been consistently used. As this Commission has pointed out: "It is ...customary to recover through the depreciation rates the estimated cost of ultimately removing the asset offset by the projected amount to be realized from its salvage price." *Re: Missouri Public Service*, 30 Mo.P.S.C. (N.S.) 320, 344 (1990). (*emphasis supplied*). This is clearly a forward-looking standard which does not limit a utility's recovery to net salvage costs which have actually been experienced, as Mr. Adam's proposal would. Instead, this standard supports the use of the conventional method for calculating net salvage, as Laclede has proposed in this case.

It is also important to consider the casual process Mr. Adam employed in deciding to adopt his new position on this issue. According to Mr. Adam's testimony, in the course of preparing his work papers in Case No. GR-98-374, Laclede's last rate case, he suddenly realized that the net salvage rate incorporated into Laclede's depreciation rates under the conventional methodology produced an annual recovery of net salvage costs that exceeded the recent net salvage costs being experienced for some accounts. Consequently, Mr. Adam simply scratched out the salvage values he had calculated using

[23] During cross-examination, Mr. Adam cited only a single sentence in the Wolf and Fitch text: "Salvage is sometimes viewed as though it remains constant as a property agent as opposed to the more realistic view that salvage varies with age." (Tr. 866). But this sentence does not appear to have anything to do with Mr. Adam's calculation of net salvage.

[24] Dr. White, who has testified on depreciation matters in 27 states and the District of Columbia, and before the Federal Energy Commission and the Securities Exchange Commission, among other agencies, testified that Mr. Adam's proposal is unprecedented in his experience. (Exh. 26, pp. 2, 13).

the conventional methodology and substituted lower net salvage values calculated based on his new methodology. (Tr. 889-892; Exh. 124).

Mr. Adam's proposed change is a radical departure from the current method used by the Commission in establishing depreciation rates. It would have the effect of reducing Laclede's depreciation expense by millions of dollars, and would have a similar effect on all other Missouri utilities, assuming it were employed in calculating their depreciation rates. Given the substantial impact this proposal would have on all Missouri utilities, it seems inconceivable to Laclede that Mr. Adam made the decision to sponsor his proposal in such a casual manner. According to his testimony, he did not even discuss the proposal with upper level Staff personnel prior to filing testimony advocating the change, although Mr. Adam testified that he hopes that senior Staff members are aware of his proposal by now. (Tr. 893). For this reason as well, Mr. Adam's proposal should be rejected.

In summary, Mr. Adam's proposal to change Missouri's treatment of net salvage costs defeats the primary purpose of depreciation accounting, violates GAAP, and contravenes the overwhelming consensus of depreciation professionals and commissions that have considered this issue. It is a proposal contrived by Mr. Adam to artificially reduce depreciation rates, and it would have significant adverse and unwarranted consequences for all Missouri utilities if adopted. For all these reasons, the Commission should reject Mr. Adam's proposed change to the treatment of net salvage costs.

(c) <u>Adjustment of Laclede's Depreciation Rates To Reflect Proper Treatment Of Net Salvage Costs Should Be Phased In.</u>

Although Laclede believes that all of its depreciation rates should ultimately be adjusted where necessary to reflect the appropriate treatment of net salvage costs,[25] in this proceeding Laclede has proposed to increase the rates applicable to mains and services accounts by only one-third of the amount necessary to reflect the appropriate salvage cost. Laclede proposes that the balance of the adjustments to the depreciation rates applicable to the mains and service accounts, and any adjustments required for the depreciation rates applicable to other accounts, be implemented in subsequent rate proceedings. (Exh. 23, pp. 11-12). This phase-in of the change to depreciation rates will mitigate the impact on ratepayers of correcting Laclede's depreciation rates, while ensuring that all of Laclede's depreciation rates will ultimately reflect the appropriate net salvage cost.

2. <u>Natural Gas Holders</u>.

The second depreciation-related issue addressed in this proceeding concerns the depreciation rate applicable to Laclede's four natural gas holders. With regard to this issue, Mr. Adam has proposed to completely cease all depreciation accruals related to the holders. (Exh. 92, p. 14). Mr. Adam states that he is only willing to permit the resumption of the depreciation accrual if the Chief Executive Officer of Laclede makes an irreversible commitment to demolish the holders by a date certain. (Tr. 900-901).

As explained in the testimony of Laclede witness Kottemann, this issue has a long and tortured history. In Case No. GR-94-220, three Laclede rate cases ago, Mr. Adam supported continuation of the then-existing accrual for the holders, but testified that it

[25] As part of the settlement in Laclede's last rate case, the majority of Laclede's depreciation rates were lowered significantly below the level that would be derived from the conventional calculation consistently advocated by Laclede. Pursuant to the settlement, however, the parties did not agree on any ratemaking principle or methodology for determining depreciation rates in future cases.

was inappropriate to increase the accrual to reflect the estimated removal cost of the holders because of "the absence of verifiable data." (Exh. 24, p. 4).

Following the settlement of that case, Mr. Adam sent a letter to George M. Russell, then Laclede's depreciation witness, explaining exactly what he would require in order to include the removal cost applicable to the holders in Laclede's depreciation rates. In that letter, Mr. Adam stated that "it is better to recoup retirement and remediation cost from current customers rather than passing these costs on to future customers." He also stated "[t]he cost of dismantling and remediation must be a reliable figure based on what we know when a study is conducted." Finally, Mr. Adam stated:

> With the absence of an experienced environmental remediation organization within Laclede and the Missouri Public Service Commission the reasonable way to have a verifiable cost of removal and remediation based on known materials and measured quantities is to have an environmental remediation company complete a thorough study and bid on each of the four gas holders. From these bids a depreciation rate can be determined for Laclede's next rate case.

(Exh. 24, Schedule 2, p. 1).

In Laclede's next rate case, Case No. GR-96-193, Laclede attempted to address Mr. Adam's stated concerns by retaining Black & Veatch, an environmental engineering firm, to conduct additional studies of the gas holders and prepare an independent estimate of removal costs. Although Mr. Adam permitted the inclusion of some removal costs based on the Black & Veatch study, the study was still insufficient, in Mr. Adam's mind, to be used as a basis for estimating the cost of remediating sludge contained within the holders. (Tr. 903). Consequently, the depreciation rates adopted for the gas holders in Case No. GR-96-193 included some removal costs, but contained no recognition of the cost of remediating the sludge. However, the stipulation and agreement, signed by the parties and adopted by the Commission in that case, provided as follows:

> The parties expressly acknowledge that the depreciation rate recommended herein for Account 362 does not resolve the issue of what level of costs should be reflected in such rates to reflect the estimated future cost of removal associated with sludge materials contained in Laclede's four remaining holders. Laclede agrees to cooperate with the Staff in advance of its next general rate case filing to develop a mutually acceptable estimate of such costs for consideration in the establishment of a future depreciation rate or other appropriate recovery mechanism for this account.
> (Exh. 24, p. 5).

Following that case, in a further attempt to satisfy Mr. Adam's concerns regarding the sludge, Laclede arranged for Creamer Environmental Inc., an environmental contractor with extensive experience in holder remediation that was specifically recommended by Mr. Adam, to develop an estimate of the cost of remediating the holder sludge. (Tr. 834-835). The estimate Creamer provided is incorporated into the depreciation rate proposed by Laclede for the holders in this case.

Now, however, when after much effort Laclede has finally provided a detailed estimate of holder sludge remediation costs that not even Mr. Adam disputes, Mr. Adam has changed the rules of the game. In this case, for the first time, Mr. Adam has testified that the depreciation accrual should be completely discontinued unless and until Laclede's Chief Executive Officer makes an irreversible commitment to dismantle the holders by a date certain.

Mr. Adam's recommendation completely ignores the fact that he has been asking Laclede to conduct additional studies of the holders consistently since 1994. It ignores the fact that Laclede has expended substantial effort and money to hire outside consultants to satisfy Mr. Adam's desire for ever more precise estimates. And it ignores the fact that Mr. Adam has never before this case even suggested that an iron-clad commitment to retire the holders by a date certain is a prerequisite to recovering legitimate remediation costs. Under these circumstances, the Commission should reject Mr. Adam's change in position and permit Laclede to recover the appropriate depreciation expense associated with the holders, including the cost of remediating the holder sludge, as recommended by Mr. Kottemann.

H. Off-System Sales

On September 9, 1999, the Commission issued its *Report and Order* in Case No. GT-99-303 -- a proceeding that had been established to consider what type of regulation should govern the Company's management of its gas supply assets following the September 30, 1999 expiration of Laclede's then-current Gas Supply Incentive Plan ("GSIP"). As part of its *Report and Order*, the Commission adopted Public Counsel's recommendation in that case that the revenues achieved by the Company from its sale of natural gas to customers located "off" the Company's distribution system (hereinafter "off-system sales") be addressed as a rate case item in this proceeding rather than as a continuing part of the Company's GSIP. (*See Report and Order*, pp. 15-16).

Although Laclede believed, for a variety of reasons, that it was more appropriate to deal with off-system sales revenues as part of the incentive provisions contained in the Company's PGA clause, the Company did not seek rehearing of the Commission's decision to include off-system sales revenues as an element to be considered in this case. Nor did the Company join in the request for rehearing filed by another LDC that raised issues relating to the Commission's jurisdiction over such revenues. Whether through inclusion in the PGA process or imputation in a rate case, Laclede believes it is appropriate to share with its customers the benefits of its off-system sales activities, just as the Company is permitted to share in other savings and revenues it achieves in connection with its gas supply assets.

Laclede believes just as strongly, however, that the level of off-system sales revenues imputed in this case must be reasonably reflective of what the Company is likely to achieve based on recent experience and current market conditions. This is particularly true given the fact that the Company will be required, for the first time, to absorb 100% of any shortfall between the actual revenues it achieves and the amount of revenues imputed in this case.

Staff and Public Counsel have proposed to impute approximately $2.5 million and $2.4 million of off-system sales revenues, respectively. These recommendations are unreasonable because they are significantly in excess of off-system sales revenues the Company has earned in recent years under the GSIP, they ignore the clear downward trend in those revenues which has continued unabated for four years, and they ignore the fundamental changes in the market which have taken place and which make these levels of off-system sales revenues unachievable. In light of these considerations, the Company proposes that its most recent annual level of off-system sales revenues be used, an amount which equals $ .9 million.

The unmistakable and significant downward trend in off-system sales revenues is shown by Exhibit No. 45 in the GSIP proceeding, which has been incorporated by reference in this case as part of Exhibit No. 125. This exhibit, which was sponsored by

Public Counsel in the GSIP case, shows the following off-system sales revenues achieved by the Company in the last three years:

Year	Off-System Sales Revenues
1996-'97	$2.3 million
1997-'98	$1.6 million
1998-'99 (est.)	$ .9 million

(Exh. 125; GSIP case Exh. 45).

None of these amounts are as high as the amounts Staff and Public Counsel propose to impute in this case, and the off-system sales revenues for the two most recent years are significantly below the amounts Staff and Public Counsel would impute.

Even more important, these results evidence a clear trend of declining revenues, which Public Counsel acknowledged in response to cross-examination in the GSIP case:

Q. Let's turn to off-system sales real quick. Prior to the GSIP, would you agree with me that it was approximately 3.5 million?

A. Yes.

Q. First year of the GSIP, about 2.3 million?

A. Yes.

Q. And that's – that represents a loss of about 1.2 million; is that right?

A. I wouldn't say represents a loss. It represents decreased –

Q. Okay. Decrease.

A. -- capacity release revenues by 1.2 million, yes.

Q. And the second year of the GSIP, 1.6 million?

A. Yes.

Q. And that's a decrease of about, what, 700,000?

A. Yes.

Q. Once again, based on what Mr. Jaskowiak included in his testimony and what will hopefully finalize in the next couple of months, the company's projecting that it's going to have off-system sales revenues of about 900,00 this year?

A. I believe that is the number.

Q. Okay. And that represents a decrease of, what, another 700,000?

A. Yes.

Q. So once again we've gone from 3.5 to 2.3 to 1.6 to 900,000 over the last four years; is that correct?

A. That is correct.

Q. Once again, I've got to ask you, Mr. Shaw do you see a trend there?

A. There does appear to be a trend there.

(Exh. 125, GSIP Tr. 672-673).

In addition, Public Counsel witness Meisenheimer, an economist who provided testimony in the GSIP case, acknowledged that from an economist's standpoint it would be relevant to consider trends in establishing a baseline for off-system sales revenues. (Exh. 125, GSIP Tr. 548). Moreover, in recommending a baseline for capacity release revenues in the GSIP proceeding, Public Counsel actually did recognize a similar downward trend in revenues for capacity release transactions by selecting the lowest level of revenues. (Exh. 125; GSIP Tr. 778-779). Consequently, based on Public Counsel's own evidence and its approach toward capacity release revenues, there is absolutely no basis or rationale for the Commission ignoring the distinct downward trend in off-system sales in this case.

The evidence presented in the GSIP case also demonstrates there are identifiable and logical reasons for the steady decrease in off-system sales revenues. Changes in the market demand for pipeline capacity on Laclede's upstream pipelines, and particularly construction of additional capacity into the Chicago market, have significantly and adversely affected the market for Laclede's off-system sales as well as capacity release volumes. Specifically, Mr. Jaskowiak testified that a 700,000 MMBtu/day expansion of the Northern Border pipeline and the pending completion of a 1.3 Bcf/day Alliance Pipeline are depressing market values for off-system sales and capacity release. (Exh. 125, GSIP Tr. 322, 349). Staff also recognized changing market conditions in general and the capacity glut into the Chicago market in particular in its response to Laclede's request for Clarification and/or Reconsideration filed in the GSIP case. *(See Order Regarding Request for Clarification and/or Reconsideration*, Case No. GT-99-303, p, 3).

The effect of these market factors is reflected in the consistently declining margins and volumes for off-system sales depicted on Schedules 8 and 10 to Mr. Jaskowiak's rebuttal testimony in the GSIP proceeding.

Exhibit 8, which is reproduced below, shows the persistent decline in margins:

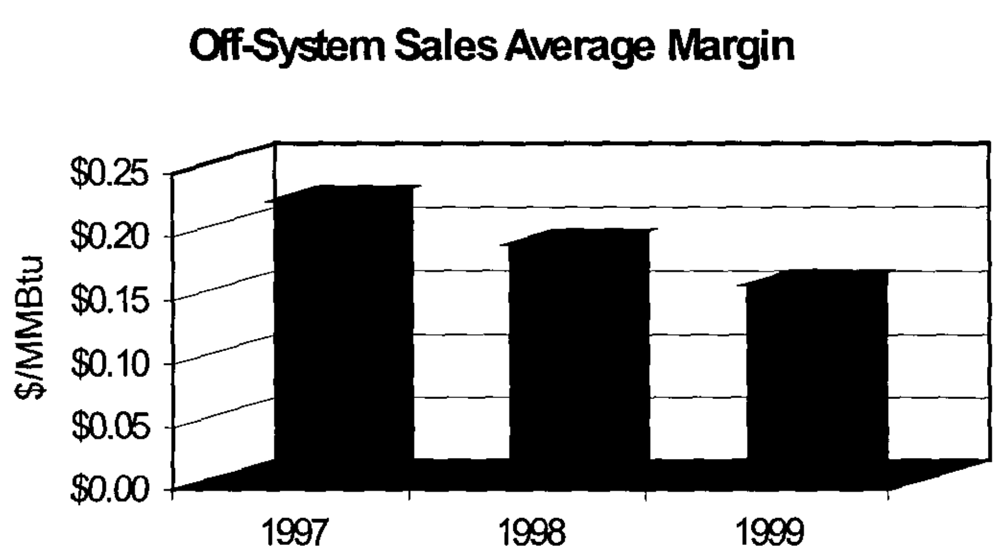

Exhibit 10 depicts a corresponding decline in volumes:

Year	Off-System Sales Volumes (MMBtu)
1997	8,334,916
1998	6,074,776
1999	5,510,023

(Exh. 125, GSIP Exh. 6, Exhs. 8 and 10).

These margin and volume statistics, like the declining off-system sales revenues, evidence a persistent erosion of Laclede's off-system sales.

In the past case the Commission has consistently taken into consideration trends which affect various elements in the ratemaking process. *See for example, Re: Southwestern Bell Telephone Company*, 29 Mo.P.S.C. (N.S.) 607, 614-616 (1989); *Re: GTE North*, 30 Mo. P.S.C. (N.S.) 88, 99 (1990); *Re: St. Louis County Water Company*, 5 Mo.P.S.C. 3d 341, 350 (1996). Particularly with regard to the imputation of revenues in a rate case, the Commission has recognized the importance of incorporating trends. The Commission has stated:

> Where the trends show that revenues are increasing over the twelve-month period or from year to year, using the final month times twelve is more appropriate than an average. Even though the evidence indicates monthly access and toll revenues fluctuate, a twelve-month average is not appropriate where there is a general trend showing an increase in revenues. Staff's method thus is more reflective of the level of revenues SWB will experience when the rates set in this case will go into effect.

Re: Southwestern Bell Telephone Company, 2 Mo.P.S.C. 3d 479, 488 (1993).

Although Laclede is not proposing to annualize off-system sales revenues based on the most recent month's revenues, Laclede does propose to impute the most recent year's off-system sales revenues, a result which is clearly more reflective of the declining trend than either Staff's or Public Counsel's recommendation. This level of off-system sales revenues was also proposed as a component of a benchmark supported by Laclede in the GSIP proceeding. (See Exh. 125, GSIP Exh. 6).

For all of the reasons addressed herein, it would be unreasonable for the Commission to impute the unreasonably high levels of off-system sales revenues that Staff and Public Counsel recommend in the face of the clear trend of declining off-system sales revenues. Instead, in recognition of this trend, the Commission should impute the most recent year's off-system sales revenues, $.9 million, pursuant to Laclede's recommendation.

I. Service Territory Descriptions

In this case, the Staff has proposed that Laclede significantly expand the service territory description contained in its tariff to include a list of each township, range and section in which it provides service. This is an unreasonable proposal, because it would provide absolutely no useful information to Laclede's customers or anyone else. Moreover, it would be counterproductive because it would clutter Laclede's tariff and cost a substantial amount of money to implement.

To understand how useless the tariff changes the Staff is proposing would be, one need only look at Exhibit No. 126, which contains portions of Missouri Gas Energy's ("MGE") tariff that the Staff presented as an exhibit in this proceeding. (Tr. 955). For the Commission's convenience, reprinted on the next page of this brief is just one of the seventeen pages of township, range and section references that currently clutter MGE's tariff. This information would obviously be of little or no use to anyone who is attempting to determine the area Laclede serves. Mr. Gray, the Staff witness who is sponsoring this recommendation, admitted that even he does not know which township, range and section he lives in. (Tr. 994). There is no reason to anticipate that anyone else will have this information and be able to make use of the territorial descriptions the Staff has proposed. Moreover, as Mr. Gray acknowledged, there is absolutely no legal requirement that such information be included in a gas company's tariff. (Tr. 1007).

The Staff's prefiled testimony lists five reasons why a more specific territorial description is needed in Laclede's tariff. It is apparent, however, that none of these reasons justify tariff provisions setting forth townships, ranges and sections. The first reason Staff has provided is:

> Safety related issues. If a person notices a gas leak in a neighborhood, that person might not know to which utility to report the gas leak; (Exh. 71, p. 4).

This problem, if it exists at all, obviously would not be mitigated by a tariff containing townships, ranges and sections. People who notice gas leaks do not consult tariff books—they call 911 or the gas company. In the rare instance where two gas companies are operating in the same vicinity, the responsible gas company would quickly be identified over the telephone—not through a search of tariff sheets in the Commission's records room in Jefferson City. In addition, even if the tariff sheets were consulted in such a situation, they would not be specific enough under Staff's proposal to establish exact boundaries between gas companies that occupy the same section. In

Missouri Gas Energy,
a Division of Southern Union Company

For: All Missouri Service Areas

INDEX OF CERTIFICATED AREAS

RECEIVED
FEB 21 1997
MISSOURI
Public Service Commission

TOWNSHIP	RANGE	SECTIONS
CLAY COUNTY		
T50n	R31w	2,3,7,10,11,18
T50n	R32w	1,2,3,4,5,6,7,8,9,10,11,12,13,14,15,17,18,23,24
T50n	R33w	1,2,3,10,11,12,13,14,21,22,23,24,26,27,28
T51n	R30w	5,6
T51n	R31w	1,2,3,4,5,6,7,8,9,10,11,12,13,14,15,16,17,18,19,20,21,22, 23,24,25,26,27,28,29,30,31,32,33,34,35,36
T51n	R32w	1,2,3,4,5,6,7,8,9,10,11,12,13,14,15,16,17,18,19,20,21,22, 23,24,25,26,27,28,29,30,31,32,33,34,35,36
T51n	R33w	1,2,3,10,11,12,13,14,15,22,23,24,25,26,27,34,35,36
T52n	R30w	1,2,3,4,5,6,7,8,9,10,11,12,13,14,15,16,17,18,19,20,21,22, 29,30,31,32
T52n	R31w	1,2,3,4,5,6,7,8,9,10,11,12,13,14,15,16,17,18,19,20,21,22, 23,24,25,26,27,28,29,30,31,32,33,34,35,36
T52n	R32w	1,2,3,4,5,6,7,8,9,10,11,12,13,14,15,16,17,18,19,20,21,22, 23,24,25,26,27,28,29,30,31,32,33,34,35,36
T52n	R33w	1,2,3,10,11,12,13,14,15,22,23,24,25,26,27,34,35,36
T53n	R30w	1,2,12,13,14,18,19,20,21,22,23,24,25,26,27,28,29,30,31,32, 33,34,35,36
T53n	R31w	1,2,11,12,13,14,15,16,21,22,23,24,25,26,27,28,29,30,31,32, 33,34,35,36
T53n	R32w	25,26,27,28,29,30,31,32,33,34,35,36
T53n	R33w	1,2,3,10,11,12,13,14,15,22,23,24,25,26,27,34,35,36
T54n	R30w	35,36
T54n	R31w	35,36
T54n	R33w	34,35,36

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ISSUED BY: Charles B. Hernandez, Director, Pricing & Regulatory Affairs
Missouri Gas Energy
Kansas City, MO. 64111

short, there is absolutely no safety consideration whatsoever that justifies making the tariff change that the Staff has proposed.

The second justification the Staff has provided is:

> Rate confusion. Neighbors might have different rates for natural gas. This can create confusion to customers regarding rate increases and decreases. That may in turn require additional involvement by the governmental entities involved;
> (*Id.*).

Again, it is ridiculous to assume that confused neighbors would consult a tariff book in such a situation. They could easily determine that they are being served by different gas companies that charge different rates by either a) talking to each other; b) calling either gas utility; or c) calling the Commission. The one way they would clearly not resolve their confusion is by consulting the township, range and section information contained on tariff sheets. Even Mr. Gray, the Staff witness sponsoring this proposal, had to acknowledge that customers in such a situation would "probably not" consult the tariffs of the utilities. (Tr. 1010). And in any event, even if the tariffs were consulted, they would again provide no useful information to neighbors who live in the same section. Consequently, customer confusion would not be in any way diminished through the adoption of Staff's proposal.

As a third justification for its proposal, Staff stated:

> Construction crews for the city and developers should be able to contact the proper utility for location of facilities (underground, etc.), which could reduce hazards related to construction.

(Exh. 71, p. 4).

Laclede agrees that it is vitally important to minimize the hazards associated with construction, but the Staff's proposal would do absolutely nothing to reduce those hazards. As the Commission is aware, Missouri has a statutory One-Call program, which allows anyone who is conducting any construction or excavation work to call a single number to obtain information about utility facilities in the vicinity of the construction and excavation work. Laclede has long been a member of this program, and it clearly provides the best mechanism for minimizing hazards associated with construction. Additional information in the tariff, particularly information which does not even address the location of Laclede's facilities, would only have the potential to confuse construction crews by suggesting that they might not need to call One-Call. Again, Mr. Gray himself acknowledged at the hearing that it would be more logical for excavators to use One-Call than to consult Laclede's tariff to determine the location of underground facilities. (Tr. 1011). Consequently, this concern provides no justification for modifying Laclede's tariff in the cumbersome manner that the Staff has proposed.

The fourth and fifth reasons Staff submitted to justify its proposed tariff change generally state that utilities will find this information to be useful in planning their facilities and avoiding boundary disputes. (Exh. 71, p. 4). However, as Mr. Gray recognized at the hearing, utilities are in a better position than the Staff to know what information would be useful to them in planning their growth. (Tr. 1001). And in this case, Laclede and Union Electric Company, the only two utilities that actively participated, are opposed to Staff's proposal.

The real problem with utility service territory boundaries is that in many instances the certificates issued by the Commission long ago which underlie them are vague or inconsistent. In the past, the Commission frequently issued certificates authorizing utilities to serve "in the vicinity of" cities or towns. This is obviously very vague language, particularly where the city or town expands its boundaries after the certificate is issued. Utility boundary delineation can become an even more thorny legal issue when a city's expansion incorporates an area where an incumbent certificated utility has already planned, or even actually constructed, facilities. Contrary to the Staff's assumption, such boundary disputes cannot be avoided or resolved merely by requiring more specific territory descriptions in each utility's tariff than are set forth in its underlying certificates. Many of these vague or overlapping certificates never create any problem, but where problems do arise they involve difficult legal issues which must be addressed on a case-specific basis, and provide absolutely no justification for the tariff change the Staff has suggested.

Union Electric Company ("UE"), which has had tariff provisions similar to those proposed by the Staff in this case encompassing 63 pages of its electric tariff for some time now, offers valuable insight into the utility of such provisions. Mr. Difani, UE's witness, testified that such provisions have proven to be "absolutely useless to the customers." (Tr. 981). Moreover, maintenance of the tariff has become a costly and time-consuming administrative burden for UE, wasting 60 to 100 hours each time UE is required to adjust the tariff to reflect even minor changes in the boundaries. (Tr. 983). Clearly, UE's experience suggests that the Commission should not expand this bad idea to include Laclede's tariff.

The bottom line is that the Staff has utterly failed to show that there would be any benefit from requiring Laclede's tariffs to include a multi-page litany of townships, ranges and sections. The only credible evidence in this case suggests that such a requirement would unnecessarily clutter Laclede's tariffs, and impose costly and time consuming administrative burdens on Laclede, with no corresponding benefits for ratepayers. It is the kind of counterproductive, bureaucratic requirement that defies common sense, and the Commission should avoid at all costs. Consequently, Laclede requests that the Commission reject the Staff's proposal to require Laclede to include in its tariff the township, range and section of each portion of its service territory.

J. Customer Annualization

The final remaining issue between the parties relates to the proper annualized level of customers that should be recognized in this case. Pursuant to the Stipulation and Agreement in this case, the Company and Staff agreed to "split the difference" between the results produced by their respective methodologies, as such results were updated through the true-up period (Exh. 127, p.3). As explained by Company witness Fallert, the difference between Laclede and Staff relates to the manner in which Staff applied its customer annualization methodology for true-up purposes. (Id.)

Simply put, instead of updating all of the elements of its methodology to the end of the true-up- period, the Staff chose to update only one component of that method to July 31, 1999 (Exh. 127, p. 4-5). Under its method, Staff adjusts the current month's customer level based on a ten year average of how that monthly customer level has compared to the annual average customer levels served by the Company. (Id.) Although Staff updated the current month customer level to July 31, 1999, it did not similarly update its ten year average. (Id.)

The end result of this highly selective approach to the true-up process is a substantial overstatement of the number of customers served by the Company -- an overstatement that does not begin to comport with Laclede's actual experience. As

Mr. Fallert explained, the Staff's customer annualization, as developed for true-up, implies an annual level of customer growth (7,935) that is more than 2,000 customers greater than the annual number of customers (5,677) actually added by the Company in the most recent annual period ending July 1999 (Exh. 127, p. 4). Moreover, Staff's adjustment assumes that the Company will experience its greatest customer growth in areas where actual growth has been small or even negative, and incredibly, that customers will decline in an area where the Company has experienced its greatest growth. (Exh. 127, p. 5).

Since the Staff used yet another method to develop its initial true-up estimate for customer annualizations in this case and had never done a true-up in a Laclede case using its current methodology (Tr. 1105, 1108), the Company could not have anticipated that Staff would apply its methodology for true-up purposes in such an arbitrary and selective manner. Given the unreasonable and nonsensical results that have been produced by Staff's approach, the Commission should not hesitate to adopt the Company's position that this issue be resolved based on an update of all components of Staff's methodology for true-up purposes.

III.
Conclusion

Wherefore, for the foregoing reasons, Laclede respectfully requests that the Commission issue an Order resolving the issue in this proceeding in the manner recommended herein.

Respectfully submitted,

Michael C. Pendergast

Gerald T. McNeive, Jr. #19649
Michael C. Pendergast # 31763
Thomas M. Byrne #33340
Ellen L. Theroff #40956
Attorneys for Laclede Gas Company
720 Olive Street, 15th Floor
St. Louis, MO 63101