BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Summit Natural Gas of Missouri Inc.'s Filing of Revised Tariffs To Increase its Annual Revenues For Natural Gas Service	))))	Case No. GR-2014-0086

SNGMO'S INITIAL BRIEF

COMES NOW Summit Natural Gas of Missouri, Inc. (SNGMO or Company), and, as its Initial Brief, states as follows to the Missouri Public Service Commission (Commission):

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INTRODUCTION

SNGMO has been instrumental in bringing natural gas service to areas of the state that did not previously have access to this fuel source. In this case, SNGMO is asking the Commission to set rates that will allow it to continue to provide this service in a safe and adequate manner, and that will provide it the incentive to continue its growth in areas of the state where this fuel source will be useful and desired by Missouri citizens.

I. COST OF CAPITAL

A. What is the appropriate cost of capital that the Commission should apply in this case to determine a revenue requirement for SNGMO?

i. What is the appropriate cost of common equity?

ii. What is the appropriate cost of long-term debt?

B. What Capital Structure should the Commission use in this case to determine a revenue requirement for SNGMO?

Introduction

The cost of capital in a utility rate case is influenced by three elements: (1) The utility's cost of equity capital; (2) its cost of long-term indebtedness (a fixed contractual obligation); and, (3) its capital structure, that is, the overall ratio of long-term debt capital to equity capital funding its operations. The Commission's challenge in this as well as any other rate case is to determine the SNGMO's weighted cost of capital.

To illustrate this concept, assume that a company's cost of debt is 7% and its cost of equity is 12%. Further assume that the percentages of debt and equity in the company's capital structure are 45% and 55%, respectively. The company's weighted cost of capital is 7% x 0.45 + 12% x 0.55, or 9.75%.

In this case, SNGMO has proposed that an appropriate return on common equity is 12%.[1] Further, its case is based on its current cost of long-term indebtedness at 3.21% applied to a capital structure as of test year ending September 30, 2013 of 43% debt to 57% equity. These metrics result in a weighted cost of capital for SNGMO of 3.21% x .43 + 12% x .57, or 8.22%.

Credentials and Experience of SNGMO's Cost of Capital Witnesses

SNGMO has offered the testimony of two witnesses on the topic of cost of capital. The first company witness is James M. Anderson.

Mr. Anderson is Senior Vice President of Municipal Capital Market Group, a Financial Industry Regulatory Authority-regulated broker/dealer which is engaged in the origination and sales of securities. Mr. Anderson has been engaged in the securities industry since 1971 and,

[1] The Company's cost of capital witness, James Anderson, opines that its ROE should be in the range of 12%-to 17.6%.

throughout his working career, has been engaged in the origination and sale of securities, including determining the fair value of private securities. During his 43 years in the investment banking business, he has originated debt and equity securities for a number of utilities including Colorado Natural Gas, Inc. (SNGMO's sister operating company) and Summit Utilities Inc., (SNGMO's parent company). (Exh. 1, Anderson Dir. p. 4-7) He has also been involved in assisting municipalities, municipal utilities, investor-owned utilities and other corporations in obtaining credit ratings. This has involved preparing presentations for credit rating agencies, meeting with credit rating agencies and debt issuers and representing debt issuers in continuing credit rating reviews by the credit rating agencies. Over the past 25 years, he and his firm have obtained credit ratings for over 200 separate debt or bond issues. (Exh. 2, Anderson Reb., p. 5-6)

Unlike many of the academically-based witnesses on this topic, Mr. Anderson has real-world experience placing securities and interacting with investors. While other witnesses use models to develop their opinions on investors' expectations, Mr. Anderson knows what investors' expectations are because he actually does for a living what other witnesses only theorize about. His real-world experience is extensive and worthy of the Commission's careful consideration.

In addition, Mr. Anderson is uniquely familiar with SNGMO and its affiliated companies. Beginning in 1996 his firm assisted the founders of Summit Utilities with its initial capitalization by selling equity and debt to both individual and institutional investors. Over the next ten years, until Summit was acquired by its current owners, his firm originated and sold all of the equity and debt securities offered by Summit Utilities. He has served as a member of a special subcommittee on the Summit's Board of Directors and he was on the Board of Directors of Summit Utilities, Missouri Gas Utility and Colorado Natural Gas from 1997 to 2011. (Exh. 1,

Anderson Dir., p. 6) Mr. Anderson has no current holdings of the stock of Summit or SNGMO, so he is financial indifferent concerning the Commission's determination in this case of an appropriate return on equity for SNGMO. (Tr. 145)

Also testifying for the Company was Rick H. Lawler on the topic of capital structure. Mr. Lawler's rebuttal testimony in this case supported the use of the company's actual capital structure of 43% debt to 57% equity for ratemaking purposes. His testimony specifically addressed the amount of debt capital included in SNGMO's overall capital structure. Mr. Lawler holds a Masters in Business Administration from Oklahoma City University and is also a Certified Public Accountant. He currently is the Chief Financial Officer for Summit Utilities and has held that position since 2008. (Exh. 7, Lawler Reb., p. 1-2)

Return on Equity

The Company's witness on the topic of return on equity is Mr. Anderson. Mr. Anderson testified that an appropriate return on equity for SNGMO in this case would be in a range of 12-17.6%, adjusted for a risk premium of 4.4%. Mr. Anderson's recommendation is based on the results of three cost of capital models those being discounted cash flow (DCF) model, the capital asset pricing model (CAPM) and the Total Return model.[2] For purposes of Mr. Anderson's DCF model, he used data pertaining to eleven (11) proxy gas distribution companies followed by Value Line. (Exh. 1, Anderson Dir., p. 44, Table 2) The midpoint of the three approaches used

[2] While the Total Return model is not commonly used in the context of setting rates, it is widely used by investment professionals as a financial analysis tool. It is used routinely by investors in determining a fair price for their equity investments or deciding whether to continue holding shares of a company. Most brokerage firms make the Total Return model available to their clients on their websites. This is not the case with the DCF and CAPM models. (Exh. 3, Anderson Sur., p. 27) If the purpose of expert testimony is to measure investor expectations, as was claimed by Staff in its June 10th motion to compel discovery (EFIS Doc. No. 49), the Total Return model certainly is a particularly persuasive tool to achieving that end.

by Mr. Anderson is 15%, a figure he recommends as the appropriate rate to be used for ratemaking purposes for SNGMO in this case. (Exh. 1, Anderson Dir., p. 42-47)

Significantly, and as noted above, SNGMO is seeking a return on equity of only 12% which is at the very low end of Mr. Anderson's recommended range of fair returns. The company believes basing rates on the low end of Mr. Anderson's range of reasonable returns best balances the interest of ratepayers, the company's investors and positions the company to address the market for competitive fuels. (Exh. 4, Moorman Dir., p. 14)

The primary driver of Mr. Anderson's ROE recommendation is his risk premium adjustment of 4.4%. This addresses the principles set forth in the *Hope* and *Bluefield* cases[3] which state that an allowed rate of return should be commensurate with returns on equity in other companies having corresponding risks. Mr. Anderson addresses at length eleven (11) factors that he considered in reaching his recommended risk premium adjustment. These are all risks specific to an equity holder's investment in SNGMO. They take into account SNGMO's unique situation as compared to other natural gas distribution companies. (Exh. 1, Anderson Dir., p. 10-42; 47-56)

SNGMO is a very small company actively expanding into new markets. Essentially, SNGMO is equal parts gas distribution company and construction company. To provide some context for Mr. Anderson's risk analysis, the smallest of the 11 gas companies followed by Value Line report is Northwest Natural Gas, a company with a market capitalization of $1.1 billion. SNGMO by way of contrast has an adjusted book value of only a little over $132.5 million. (Exh. 1, Anderson Dir., p.49-50) The smallest of the 11 utilities, in terms of customers

[3] *Federal Power Commission v. Hope Natural Gas*, 64 S. Ct. 281 (1943); *Bluefield Water Works & Improvement Company v. Public Service Commission of West Virginia*, 43 S. Ct. 675 (1923).

is South Jersey Industries. That company has 348,000 customers compared to SNGMO's 15,106 and, in the case of SNGMO, very few of those customers are commercial-scale accounts. (Exh. 1, Anderson Dir., p. 20, 23, 53; Sch. JMA-2) Investment in net plant per customer is also a significant consideration. Compared to other Missouri gas utilities, SNGMO's plant investment per customer is much greater. (Exh. 1, Anderson Dir., p. 27-29; Sch. JMA-3) Likewise, the service areas served by the 11 Value Line companies used by Mr. Anderson are much more densely populated than are SNGMO's rural service areas. This is reflected in the data concerning market size and capitalization. (Exh. 1, Anderson Dir., p. 24, 44 (Table 2)) There are many other compelling considerations bearing upon SNGMO's higher level of risk such as its rate design and lower debt leverage in its capital structure, but the point made by Mr. Anderson is that an investment in SNGMO only makes sense if its return on equity is well above the average rate of return on publicly-traded gas utilities.

To provide a data point on the level of return at which the investor would be indifferent investing in the proxy group or in SNGMO, provided the risk is the same, Mr. Anderson presented the results from the application of the Total Return model which measures the rate of return representing the actual price appreciation of a stock with cash dividends reinvested over a given period of time. It is a commonly used tool by investors to evaluate the return on an equity investment. In this case, the Total Return model shows that, had an equity investor invested in the proxy group of gas distribution utilities contained in Mr. Anderson's DCF analysis from the period December of 2007 to October 2013, the return on that investment would have been 12.5%. (Exh. 1, Anderson Dir., p.8; Sch. JMA-7). Over that period of time, the investor would have doubled his money. (Tr. 148-149 (Anderson)) So a 12.5% ROE for SNGMO is a

conservative baseline because the proxy companies pay cash dividends, something an investor in SNGMO foregoes.

Ultimately, the debate in this case is not whether a significant risk premium is appropriate for SNGMO. Staff's witness David Murray recommends a 200 basis point adjustment to recognize the riskiness of investing in SNGMO when compared to a steady-state, mature gas utility. (Staff Revenue Requirement Cost of Service Report, Exh. 103, p. 35-37; Tr. 155) It is, therefore, a question of degree. In that regard, Mr. Anderson has provided a line-item break-down of the risk premium adjustments that he has applied to modeling results to compensate for the additional risks of SNGMO based on his intimate knowledge of the company, his familiarity with investor expectations and his years of experience in the securities business. (Exh. 1, Anderson Dir., p. 52) Staff's risk adjustment is understated due in large part to its quantification method and inputs. Staff's analytical shortcomings will be discussed below.

Staff, through the testimony of its cost of capital witness David Murray, recommends that the Commission establish a return on equity in the range of 9.8% to 10.8%, a range that includes a risk adjustment of 200 basis points, as noted above. (Tr. 155) Mr. Murray's midpoint recommendation is 10.3%. *Id.* As has been his practice in previous cases, Mr. Murray relies primarily on the use of the DCF model and he uses the CAPM as a check on the reasonableness of his DCF results. (Staff Revenue Requirement Cost of Service Report, Exh. 103, p. 6, ftnt.1) [4] Mr. Murray testified that if the Commission were to apply a return on equity at the high end of

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[4] Little reliance should be placed on Staff's CAPM analysis. Mr. Murray used a yield on long-term U.S. Treasury obligations as of April 30, 2014, even though Staff's test year ended December 31, 2013, thus violating the matching principle. Staff Revenue Requirement Cost of Service Report, Exh. 103, p. 32. Had Mr. Murray used the yield as of December 31, 2013, his CAPM result would have indicated an ROE of as much as 0.35% higher. (Exh. 2, Anderson Reb., p. 15.)

his recommended range of 10.8%, this would be a reasonable way to value equity capital in this case for ratemaking purposes. (Tr. 155-156) In light of this fact, the method employed by Mr. Murray to quantify his 200 basis point risk adjustment is a crucial consideration in this case.

SNGMO contends that Staff's recommended risk premium adjustment of 200 basis points is inadequate for three reasons. First, Mr. Murray's quantification of risk relies on an apples-to-oranges comparison. He relies on the spread between differently rated bond yields. This is a deeply conceptually flawed approach. It is inappropriate to use the risk of default on a debt obligation to estimate the risk of under-earning on an investment in common equity because debt holders have a superior claim on the revenues and resources of the borrower than do equity investors. Consequently, debt is generally considered less risky than equity. (Tr. 161-162 (Murray)) By basing his risk premium only on the risk cost of debt and disregarding the risks specific to SNGMO's equity holders, Mr. Murray violates the principles enunciated in the *Hope* and *Bluefield* opinions which state that the cost of equity be commensurate with the corresponding risks.

Second, Mr. Murray bases his calculation of bond yields on the assumption that SNGMO is borderline investment/non-investment (specifically, BBB to BB).[5] Unlike Mr. Anderson, Mr. Murray has never represented debt issuers in obtaining credit ratings from credit rating agencies. (Murray Tr. 164-165) Accordingly, his opinion about the bond rating that SNGMO would be able to obtain from a bond rating agency is entitled to little weight. In contrast, Mr. Anderson's testimony is that SNGMO would likely be rated lower at 'B', a noninvestment, or "junk", rating.

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[5] In his Surrebuttal Testimony, Mr. Murray uses the Moodys equivalents of Baa2 to Baa3. (Exh. 130, Murray Sur., p. 20)

(Exh. 2, Anderson Reb., p. 15-16; Sch. JMA-13) Mr. Anderson's views on this topic are by far the more credible in light of his vast experience in the field.

Finally, and most significantly, Mr. Murray's bond rating estimate causes him to use the wrong bond yield spread to estimate a risk premium for SNGMO.[6] As Mr. Murray notes on page 13 of his Surrebuttal Testimony, the average spread between the 'A'-rated yields and 'BB'-rated yields is 322 basis points. (Tr. 168-169) Had Mr. Murray applied this average spread (which applies <u>his</u> higher junk bond rating estimate) to his unadjusted ROE range of 7.8% to 8.8%, the resulting risk adjusted ROE range would have been approximately 11% to 12%, with an 11.5% midpoint.[7] This would have essentially eliminated the difference between SNGMO and Staff concerning an appropriate cost of equity capital.

Compelling extrinsic evidence confirms that the Company's choice to structure rates based on a 12% ROE is more than reasonable. IIF owns all of the capital stock of SNGMO's parent, Summit Utilities, Inc. (Summit). IIF is a fund consisting of a number of investors who have invested capital in an equity fund managed by J.P. Morgan Investment Management Inc. A private placement memorandum (PPM) was provided to each investor. **________________

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____** (Exh. 3, Anderson Sur., p. 4-5; Sch. JMA-11) Additionally, J.P. Morgan engaged two independent auditing firms to

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[6] This discussion assumes the correctness of using bond yield spreads as a proxy for a risk assessment on equity investments, something the Company does not condone.

[7] Had Mr. Murray used the spread between the yields on 'A'-rated bonds and the yield on bonds on Mr. Anderson's much more credible 'B'-rating estimate, the spread would have been greater still.

perform a valuation of the cost of Summit's common equity for the years 2009 to 2013. **____

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______________________** (Exh. 3, Anderson Sur., p. 5-6; Sch. JMA-12)

To summarize, the record in this case amply justifies setting revised rates based on a 12% ROE capital. Whether the Commission starts with Staff's upper end of 8.8% and adds 322 basis points to correctly adjust for investment risk based on the average spreads of an investment grade bond yield and a 'BB' junk bond yield or whether it starts with the lower end of the risk-adjusted ROE recommendation of SNGMO's cost-of-capital witness, Mr. Anderson, both approaches lead to the same destination: Roughly 12%

Cost of Long-Term Debt

SNGMO's case as filed is based on the use of its actual, current cost of long-term debt at 3.21%. As with the case of capital structure which will be addressed in the next section, the Company believes it is appropriate to use this interest rate on long-term debt to calculate the company's weighted cost of capital because it correctly matches the cost of the Company's debt capital with all other test year expenses and revenues.

By way of contrast, Staff's cost of capital witness, David Murray has recommended that the Commission assume that the cost of debt for SNGMO is 5.37%, which represents the cost of long-term debt of SNGMO's sister company, Colorado Natural Gas (CNG).[8] It is difficult to follow Mr. Murray's rationale for this adjustment, but it appears to be based on his expectation that SNGMO should be able to capitalize itself with similarly priced debt as that of CNG at some

[8] Exh. 130, Murray Sur., p. 8.

unspecified time in the future. SNGMO believes the Commission should reject this approach because it is speculative and violates the fundamental matching principle of ratemaking.[9]

If the Commission should nevertheless decide to apply the *pro forma* approach recommended by Mr. Murray, the 5.37% figure he recommends is inadequate. As Mr. Anderson points out in his Surrebuttal Testimony, the cost of debt for 'B'-rated corporations currently is 7.25%. SNGMO's cost of 20-year debt likely would be somewhat less. Accordingly, Mr. Anderson states an appropriate cost for long-term debt cost for SNGMO should be set in the range of 6.5% to 7.0%.[10]

Capital Structure

As noted previously, the Company's case as-filed is based on its actual capital structure as of September 30, 2013. At that time, SNGMO was capitalized with 43% debt and 57% equity. (Exh. 1, Anderson Dir., p. 7)

The reasons for doing this are threefold. First, the test year upon which the Company based its filing ended as of September 30, 2013. Second, the use of the Company's actual capital structure properly matches the cost of capital that has been deployed to provide service to the company's customers throughout its service areas with all other test year revenues and expenses. Finally, there is no evidence offered to suggest that the Company's ratio of long-term debt to equity capital is inefficient or unreasonable. To the contrary, a capitalization of this nature is to be expected from a company like SNGMO which is in the early stages of infrastructure

[9] The parallel made by Mr. Murray fails on numerous levels. CNG's interest rate on long-term debt was set over two years ago. CNG has a higher EBITDA than SNGMO and less debt, it has more customers and its interest rate is variable. (Exh. 2, Anderson Reb., p. 4)

[10] Exh. 3, Anderson Sur., p. 9, 15-16.

development when capital is being invested in new plant, but revenues in many of the service areas are lagging and have not yet caught up with projections.

SNGMO contends that it has produced evidence establishing the actual ratio of debt and equity capital funding its regulated operations as of the end of its test year. This fact is undisputed. Further, its capital structure is *prima facie* just and reasonable, particularly given its unique circumstances. *See, McCloskey v. Koplar*, 46 S.W.2d 557, 563 (Mo. banc 1932). Therefore, it is incumbent upon the party advocating the use of a projected capital structure to bear the burden of producing evidence that basing rates on a other than SNGMO's actual capitalization is appropriate. *See, White v. Director of Revenue*, 321 S.W.3d 298, 304-305 (Mo. banc 2010).[11] As will be shown below, Staff has not met its burden.

Staff witness Murray has suggested the Commission use a capital structure of 60% debt to 40% equity based on his belief that a steady-state SNGMO at some indeterminate time in the future will be thusly capitalized. Mr. Murray bases this recommendation on a statement made by the Company in response to a data request in 2011 that its targeted capital structure was approximately 60:40. Mr. Murray also points to the capitalization of SNGMO's sister company CNG which he claims is currently capitalized with 60% debt.[12]

Staff's use of a *pro forma* or <u>projected</u> capital structure for ratemaking purposes should be rejected by the Commission. First of all, such an approach violates the matching principle of ratemaking in that using something other than the Company's actual capital structure as of the

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[11] Just this past month, the Western District Court of Appeals elaborated on these evidentiary dynamics in the context of an appeal of a Commission Report and Order. *In the Matter of Emerald Pointe Utility Company v. Office of Public Counsel*, Case No. WD76996, Slip. Op. at 11-12 (August 12, 2014).

[12] Mr. Anderson challenges the premise of Staff's argument by pointing out that CNG is currently capitalized at 57.4% debt to 42.6% equity. (Exh. 3, Anderson Sur., p. 13)

end of the test period assigns a cost of capital that does not reflect the actual cost of capital deployed to render service to SNGMO's customers.[13] This is akin to using a "future" or "budgeted" test year which is a concept often disapproved by the Commission.[14] Recently, the Commission addressed its policy position on this topic by observing that "[t]he use of a True-Up audit and hearing in ratemaking is a compromise between the use of a historical test year and the use of a projected or future test year. It involves adjustment of the historical test year figures for **known and measurable** subsequent or future changes." *Re Kansas City Power & Light Company*, 2009 Mo. PSC LEXIS 198 (2009), p.1. (Emphasis added)[15]

Staff attempts to recast the narrative by calling its proposal a "hypothetical" capital structure. (Exh. 130, Murray Sur., p. 3; Tr. 178, 180) This dog doesn't hunt either. The limited times when the Commission may adopt a hypothetical capital structure for ratemaking purposes were addressed in *State ex rel. Associated Natural Gas Company v. Public Service Commission*,

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[13] The matching principle requires that all cost-of-service components (revenues, investment, expenses and the cost of capital) must be considered and evaluated at a similar period in time.

[14] In a 2001 Report and Order in its Case No. WO-98-223, the Commission observed that it had rejected St. Louis Water Company's proposal in Case No. WR-95-145 to use a future test year stating "[t]he Commission rejected the Company's proposed future test year methodology as necessarily including **speculative amounts** in the rate calculation." (Emphasis added) The Commission noted that it again "refused to adopt a future test year methodology" in the rate case that followed, Case No. WR-96-263. *Re St. Louis County Water Company*, 10 Mo.P.S.C. 3d 56, 2001 Mo. PSC LEXIS 515, pp. 3-4.

[15] The Commission has only rarely approved the use of a future test year for ratemaking purposes and, then, only in response to very unique circumstances. Most notably, the Commission agreed to the use of a future test year in Southwest Bell Telephone Company's 1983 rate case, but only because divestiture of the Bell system on January 1, 1984, was going to completely change the way toll revenues would be handled on a going-forward basis. The Commission noted the "extreme uniqueness and complexity of the issues" as being "instrumental in Staff's and Public Counsel's decision to agree to a budgeted test year." *Re Southwestern Bell Telephone Company*, 26 Mo. P.S.C. (N.S.) 442, 446-447 (1983).

706 S.W.2d 870 (Mo. App. W.D. 1985). In that case, the Court of Appeals stated that there are two circumstances in which a utility commission might disregard a utility's actual capital structure in favor of a hypothetical capital structure. The first circumstance is when a utility's actual debt-to-equity ratio is deemed inefficient and unreasonable because it contains too much equity and not enough debt.[16] The second circumstance is when the utility is part of a holding company system and the utility's booked capital structure and capital cost may not be a true reflection of the system's capital cost with respect to the operating company.[17] *Id.* at 878. Importantly, however, neither of those circumstances is indicated in the case of SNGMO.

The Commission's prevailing practice has been to reject the use of a hypothetical capital structure. On numerous recent occasions, this Commission, at Staff's urging, has rejected proposals that it apply a hypothetical capital structure in the context of setting rates for Missouri Gas Energy when it was a division of Southern Union Company and for setting rates for the Missouri Public Service and St. Joseph Light & Power divisions of Aquila (formerly UtiliCorp).

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[16] The Commission adopted a hypothetical capital structure for a Missouri electric utility in 1993 concerning St. Joseph Light & Power Company (SJLP). In that case, the Commission adopted Public Counsel's recommendation that it use a hypothetical capital structure consisting of 48.29% long term debt and 51.71% common equity rather than the company's actual debt-to-equity ratio of 40.9%:59.1%. OPC's ratio was based on an average from a group of proxy companies claimed to represent a more customary or normal capitalization for established, mature energy companies. *Re St. Joseph Light & Power Company* 2 Mo. P.S.C. 3rd 248. The Commission's rationale in that case was that SJLP management had chosen to use an excessive amount of common equity rather than employing a more highly leveraged capital structure would have resulted in a lower and more reasonable capital expense. In this case, by way of contrast, SNGMO's conscious objective is to achieve a capital structure that is more highly leveraged, but its operational and income circumstances will not allow it to do so at this time or in the foreseeable future. Ultimately, there is no equivalence between the circumstances faced by SNGMO presently and those of SJLP in 1993.

[17] Recently in 2007, the Commission adopted a hypothetical capital structure for a very small water utility that was capitalized with 100% equity. The Commission, at the suggestion of the company, used instead the capital structure of the utility's parent company. *Re Algonquin Water Resources LLC*, Report and Order, Case No. WR-2006-0425.

Instead, the Commission looked to the consolidated corporate capital structure, based on the rationale that it better represented the actual test year capital expense for the utility. This line of decisions suggests that the Commission strongly favors the use of a utility's actual capital structure for ratemaking purposes and it only detours from that policy as necessary to address unique and compelling circumstances. That default policy should be followed in this case because Staff has provided no compelling justification for deviating from the general rule.

Setting those conceptual considerations aside, Staff's reliance on the Company's statement in 2011 that its objective was to achieve a capitalization of approximately 60:40 is the weakest of rationales for using that ratio for ratemaking purposes in this case. The statement made in response to a data request in Case No. GO-2012-0102 upon which Mr. Murray relies was merely aspirational. For SNGMO, getting to something approaching that ratio remains a desirable objective, but the facts on the ground make achieving that goal impossible during the period of time that the revised rates are likely to be in effect. That Staff has chosen to hang its hat on this dated, isolated, out-of-context statement is the most superficial of justifications.

Mr. Lawler for SNGMO addresses the obstacles faced by the Company in achieving a more leveraged capital structure. Until lenders can be shown that revenue and EBITDA[18] streams stemming from the SNGMO divisions in this rate case can be sustained at a 5 times multiple of trailing 12-month EBITDA, the Company will not be deemed creditworthy of being capitalized at 60% debt to total equity. (Exh. 7, Lawler Reb., p. 5) Based on Mr. Lawler's communications with SNGMO's lenders and the financial standards establishing the availability of debt capital, "it is highly probable that the Company's debt level will remain at or even below

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[18] EBITDA is a commonly-used accounting abbreviation for "earnings before interest, taxes, depreciation and amortization."

the current 43% of total capital level." (Exh. 7, Lawler Reb., p. 9) Given Mr. Lawler's uncontroverted testimony, the Commission cannot adopt Staff's projected capital structure proposal because it is not an adjustment that is known and measurable. To the contrary, it appears certain that the Company will not achieve the capital structure ascribed to it by Staff during the period new rates will be in effect.

Additionally, Mr. Murray's reliance on CNG's capitalization as a proxy (in fact, the only proxy)[19] for SNGMO is simply misguided. There is no logical parallel between the attributes of the two companies that justifies attributing CNG's capitalization to SNGMO. As stated by Mr. Lawler, "SNGMO and CNG are significantly dissimilar entities in terms of maturity and degree of operational risk." (Exh. 7, Lawler Reb., p. 4) CNG is a steady-state operating utility with proven, sustainable revenue streams. By way of contrast, SNGMO is still very much in an infrastructure build-out mode with customer penetration numbers and, consequently, revenues currently below expectations. CNG has less debt and a larger customer base. As such, it is viewed by lenders, rightfully, as less risky. It is clear that Mr. Murray's attempt to characterize CNG and SNGMO as operational and financial twins is groundless.

It appears that Staff's ultimate rationale for advocating the use of a projected capital structure is its claim that but for the Company's build-out into the Lake of the Ozarks area, its

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[19] It is notable that Staff's Revenue Requirement Cost of Service Report (Exh. 103) provides the Commission with no information concerning the capitalization of the proxy companies used by Mr. Murray to perform his DCF study. (Tr. 172) The only information in the record on this topic is contained in the testimony of SNGMO witness Anderson. That evidence shows that the average capitalization of other Missouri natural gas companies averages 50:50. (Exh. 1, Anderson Dir., Sch. JMA-6) The average debt-to-equity ratio of the eleven Value Line gas companies used by Mr. Anderson is 48:52. (Exh. 1, Anderson Dir., p. 44, Table 2) These are ratios which are nowhere close to Staff's proposed 60:40. One would have thought that if Staff truly was advocating the use of a hypothetical capital structure, that its proposal would be based in some meaningful fashion on an industry-representative capitalization.

capital structure now would have been in the neighborhood of 60:40 during the test year. (Tr. 196-197 (Murray)) This adventurous method of reverse-engineering a natural gas utility's capital structure for ratemaking purposes would be admirable had the notion not already been rejected by the Commission. In 2004, the Commission refused to adopt MGE's proposal to apply a capital structure derived by removing non-recourse debt attributable to a corporate subsidiary of Southern Union Company because "it does not exist in the real world." The Commission used the unadjusted capital structure because it was how "Southern Union actually operates in the marketplace." *Re Missouri Gas Energy*, 2004 Mo. PSC LEXIS 1446, page 5; *affirmed*, *State ex rel. Missouri Gas Energy v. Public Service Commission*, 186 S.W.3rd 376, 388-390 (Mo. App. W.D. 2005). Staff's argument should be disregarded for the same reason the Commission rejected a suppositional capital structure in the MGE rate case.

Moreover, the facts simply do not bear out Staff's claim. SNGMO and its predecessor company, Missouri Gas Utilities (MGU), have never achieved a ratio of 60% long-term debt to equity. The closest MGU ever got to that number was in 2009 at 57:43. Since its merger with Southern Missouri Natural Gas in 2012, the highest level of debt in the capital structure of SNGMO has been 43%. (Exh. 3, Anderson Sur., p.12)

One can confirm this by looking at the manner in which the Company has funded its construction program. Mr. Anderson, in his surrebuttal testimony, identifies the debt capital committed to the company's construction program at the Lake of the Ozarks. Backing that indebtedness out of the Company's total capitalization results in a debt to equity ratio of 42:58 for the four operating divisions in this rate case whose revised rates will be established. (Exh. 3, Anderson Sur., p. 12-13) No matter how one looks at it, the Company's Lake of the Ozarks expansion has not been the decisive factor leading to the company's current capitalization ratio.

Accordingly, Staff's conjectural capital structure argument is a false narrative. It should be rejected by the Commission.

There is no evidence in the record that shows that SNGMO's actual capital structure is not a true and fair reflection of its current operating cost. Quite the contrary is true. The record is replete with evidence about the unique circumstance of SNGMO as a combination LDC and construction company necessitating a higher degree of equity capital associated with this current state of operations. Again, Mr. Lawler's unrefuted rebuttal testimony contains a detailed explanation of why its lenders will not extend additional long-term debt capitalization given the company's current circumstances at this time.

Concluding Remarks

It is easy to get lost in the weeds on this topic and to lose sight of the big picture. This issue is not about Monopoly money in a board game. The choice of the capital structure to use for setting revenue requirement is a critical consideration in this case with real-world consequences. Just to illustrate the practical impact of what Mr. Murray has recommended, at his 10.3% ROE midpoint, the effective return on common equity for SNGMO using Staff's projected capital structure would only be 6.37%. (Exh. 2, Anderson Reb., p.15) This, after testifying that his recommended ROE range of 9.8 to 10.8% is the return he believes is needed for SNGMO to attract capital and to maintain its financial integrity. (Tr. 156) Not only is this less that his risk-adjusted low end of 9.8%, but it is below the 7.8% low end of his unadjusted range. (Tr. 157) This is the very manifestation of an arbitrary and confiscatory ROE. If the Commission were to issue an order that only contemplates giving investors an opportunity to earn less than 7% on equity capital deployed to facilitate the expansion of the Company's

operations in Missouri, it is highly doubtful that any additional capital expansion in Missouri will be funded. (Exh. 2, Anderson Reb., p. 9-10).

The Commission's overarching ratemaking objective in this case should be to provide reasonable accommodation as necessary to encourage the development and expansion of natural gas service to communities in this state which previously have not had access to it. This is what SNGMO is doing. Last winter's alarming spike in propane prices should be a factor that is considered. The Company's customers are saving a lot on their energy bills, which frees up money for discretionary spending which is good for local economies.[20] As important is the role that natural gas availability plays in allowing communities to attract large commercial and industrial businesses. This will serve to expand the local tax base and boost employment. Finally, the ultimate safeguard to keeping SNGMO's natural gas rates reasonable is the presence of fuel competition in its service areas. This competitive reality is as much or more a consumer protection than is rate regulation which is merely a surrogate for competition.

II. REVENUE REQUIREMENT

A. Should the Commission grant the Company a rate increase? If so, in what amount?

The Commission should grant SNGMO a rate increase in each of the four operating divisions that are the subject of this case (Gallatin, Warsaw, Rogersville, and Branson). The current rates should be adjusted because SNGMO has added facilities in these operating divisions and certain of its costs have increased.

[20] At the local public hearing in Lebanon, Missouri, Sherman Davis testified as follows: "But I want to thank Summit Natural Gas for coming to Lebanon. I have had excellent service, and I have saved more than a thousand dollars a year on my heating bills previously." Tr. 8.

The Staff has identified its proposed increases in Exhibits 135-138. The Staff increases should be further adjusted to reflect a return on equity of 12%, a cost of debt of 3.21% and the Company's actual capital structure of 43% debt and 57% equity, for the reasons described above.

With the referenced adjustments, the revenue requirement increase by division is as follows:

- Gallatin - $396,162;
- Warsaw - $901,896;
- Rogersville - $5,117,387; and,
- Branson - $1,812,581.

Account 105 Transfer

The revenue requirement suggested by Staff (and the Company) contemplates that the Commission find certain portions of SNGMO's mainline investments in Warsaw and Branson to be excess capacity. SNGMO proposed and supports such a determination. The consequence is that Staff asks (and SNGMO agrees) that the Commission direct SNGMO to move the current plant and depreciation reserve balances associated with the excess capacity in Warsaw and Branson into Plant Held for Future Use, FERC Account 105. This results in the following adjustments to net rate base:

BRANSON	$27.64 Million
WARSAW	$6.97 Million

(Exh. 128, McMellen Sur., p. 7)

If the Commission so directs this transfer to Account 105, the Uniform System of Accounts requires that the Commission also include in its order a process for repatriating those transferred amounts based on future growth. (Exh. 6, Johnston Sur., p. 21) SNGMO proposes that the following analytical process be used for such repatriation:

(1) Annual determination based on December 31 (year-end) plant balances;

(2) Warsaw only - Calculate the amount of FERC Account 376 and FERC Account 378 that should be assigned to Lake of the Ozarks based on most recent winter peak usage/transportation percentages. The amount by which to multiply the percentages will be the sum of year end FERC Accounts 105-376 and 105-378 for plant and reserves, and the year end FERC Accounts 101-376, 101-378, 108-376, and 108-378 balances;

(3) Warsaw only - The applicable Warsaw plant amounts from the calculation in (2) will be subjected to the same calculation shown in Schedule TRJ-4 after subtracting the portion applicable to Lake of the Ozarks;

(4) Warsaw only - The resultant unutilized capacity investment will be compared to the plant balances in FERC Account 105, and an accounting adjustment made to transfer a portion of the year-end balance of FERC Account 105 to FERC Accounts 101-376, 101-378, 108-376 and, 108-378;

(5) Branson calculations will occur similar to Warsaw except without the need for the intermediate analytical step to split shared assets;

(6) Depreciation expense will not be calculated on FERC Account 105 gross plant balances; and,

(7) Depreciation expense on repatriated gross plant will begin on January 1 of the year that succeeds the year-end calculations.

(Exh. 6, Johnston Sur., p. 21-22)

B. Should the Commission require SNGMO to impute a level of volumes, customer levels, and/or revenues in any of the four rate divisions in this rate case?

SNGMO[21] has grown from the approximately 740 customers it had when it began operation of the Gallatin and Hamilton systems in January of 2005. Today, it has approximately 17,800 customers.

The OPC suggests there should be no rate increase in any of the divisions or, at a minimum, some level of volume imputation, customer levels and/or revenues, based upon its comparison of actual experience and the projections found in the original feasibility studies

[21] It was then known as Missouri Gas Utility, Inc.

provided with certificate applications. The OPC's attempt to use feasibility studies as the base for this type of analysis is misplaced.

Feasibility studies do not purport to represent a minimum level of customers or volumes necessary to make a project economic or viable. Commission Rule 4 CSR 240-3.205(1)(A)5 directs that the feasibility study contain "an estimate of the number of customers, revenues and expenses during the first three years of operation." This estimate says nothing about minimum levels of customers that are necessary for a project to be economic. To test actual results against the "estimate" required by the Commission Rule would misconstrue what the Commission has asked for and what the companies have provided.

The only certificate case associated with SNGMO (aka Missouri Gas Utility, Inc.) or Southern Missouri Natural Gas wherein the Commission set a standard associated with economic viability was Case No. GA-94-127 (the original certificate for what is now the Rogersville Division). Therein, the Stipulation and Agreement stated that the applicant "agrees that a normalized volume level of at least 1,797,000 Mcf shall be used in . . . all subsequent rate cases and actual cost adjustment cases (ACA) for determining the appropriate rates." *No other certificate case* purported to establish any minimum level of service for economic viability or future rate cases.

Further, SNGMO's expansions must be viewed within the context of the projects. SNGMO provides a service in less-populated areas of Missouri that saves customers money and is often critical to economic growth. (Exh. 6, Johnston Sur., p. 5, 6) It does this in competition with others. Its customers are not prohibited from fuel switching, (*Id*. at p. 5) and Missouri Propane Gas Association witness Brooks confirmed that its members compete with SNGMO in all five of the Company's operating divisions. (Tr. 302-303)

This situation has resulted in sentiments such as that expressed at one of the local public hearings in this case where a gentleman stated ". . . I want to thank Summit Natural Gas for coming to Lebanon. I have had excellent service, and I have saved more than a thousand dollars a year on my heating bills previously." (Tr. Vol. 5, p. 8) Perhaps this witness was referring to the fact that most recently, the access to natural gas provided by SNGMO insulated many of its customers from dramatically higher winter propane prices. (Exh. 6, Johnston Sur., p. 6)

Financial Responsibility

The OPC quotes language from various certificate cases generally stating that the shareholders will accept full financial responsibility for the success of the projects. This language varies somewhat from case to case. However, as mentioned above, with the exception of the original Rogersville certificate case (Case No. GA-97-127), no case sets a specific customer or volume level as a test.

SNGMO has satisfied both this specific provision (which we will discuss below within the context of the Rogersville Division) and the more general proposition. SNGMO's ownership has borne the financial responsibility for all the growth in Missouri. (Exh. 6, Johnston Sur., p. 5) Building new distribution systems into areas with existing homes always results in lower revenues during the time the system is under construction and for a number of years after construction, as customers gradually convert to natural gas. (*Id.*) This tends to put the company in a situation where the return authorized by the Commission will not be realized until the third year of operation at the least, on smaller systems, and much later on larger investments such as Branson. (*Id.*) The historical summary of actual returns to common equity provided by SNGMO witness Anderson supports this assertion. (Exh. 1, Anderson Dir., Sched. 1)

Having said this, SNGMO recognizes that there is some level of underutilization of its assets as to the Warsaw and Branson Divisions. Accordingly, SNGMO has asked the Commission to direct it to transfer a portion of SNGMO's mainline investments in Warsaw and Branson into Plant Held for Future Use, FERC Account 105. Doing so will recognize the underutilization of mainline assets at Branson and Warsaw and no imputation of volumes, customer levels, and/or revenues is necessary in light of this transfer.

SNGMO will address each of the subject operating divisions in greater detail in the following paragraphs.

Gallatin

The Gallatin Division systems were small, troubled, municipal systems when they were purchased. The original Gallatin and Hamilton systems were built as municipal systems in 1995. By the summer of 2004, both the Gallatin and Hamilton town councils had elected to cease payments on the Certificates of Participation used to finance the original system, and the banks representing the holders of those Certificates had foreclosed on the systems. The banks had made arrangements with the towns to continue to operate the systems, but neither the towns nor the banks were willing to enter into contracts for the gas necessary to provide service for the 2004/2005 heating season. The gas transportation contract for the Gallatin and Hamilton system included some storage capacity, but the gas remaining in that storage would have only sufficed to supply the system until early December, 2004. SNGMO's parent became aware of this situation in late September, 2004, and was able to obtain approval from this Commission to form Missouri Gas Utility, purchase this system and take over the operations by January 1, 2005. (Exh. 6, Johnston Sur., p. 7-8)

Gallatin's assets were brought onto SNGMO's books at a heavily discounted purchase price, and it was that amount, rather than the significantly higher outstanding municipal debt related to the system's cost of construction, that became the foundation for Gallatin's rate base going forward. Gallatin's customers, who would otherwise have been required to pay the costs associated with the original system investment, were relieved of that responsibility. SNGMO's quick takeover of this system was instrumental in allowing the Gallatin customers to avoid loss of a heat source during the winter of 2004-2005. (Exh. 6, Johnston Sur., p. 8-9)

SNGMO has brought stability to the Gallatin Division. During the time SNGMO has owned and operated the Gallatin system, it has grown the customer base from approximately 740 customers to almost 1,600 customers. (*In the Matter of the Application of Missouri Gas Utility, Inc*., Order Approving Stipulation and Agreement, Case No. GO-2005-0120 (December 14, 2004); Exh. 203, Meisenheimer Sur., p. 3) Further, because the assets were brought onto SNGMO's books at a much lower value than the actual construction costs, the Gallatin customers are already the beneficiaries of a rate base that recognizes the system's past deficiencies. There is no justification for any imputation in regard to this system.

Rogersville

As mentioned above, the Rogersville Division is the only division where a specific standard was identified in a certificate case. The original certificate for this system was granted by Commission order issued on September 16, 1994. (Case No. GA-94-127). The Commission Order contained an open-ended requirement for base rates, and base rates in subsequent cases, to use a minimum throughput of 1,797,000 Mcf. (*Id.*)

The annual volumes for the Rogersville Division, as updated through December 31, 2013 (the update period), total 1,869,737 Mcf. (Exh. 15, Porter Sur, p. 7, as corrected at Tr. 275)

These volumes are also reflected on Appendix E to the Partial Stipulation Agreement agreed to by SNGMO, Staff, and OPC, which was filed with the Commission on August 18, 2014 and approved by the Commission's order issued on September 3, 2014.

Therefore, SNGMO has exceeded the minimum level of volumes set in Case No. GA-94-127 during the test year/update period applicable to this case. There is no factual basis for an imputation of volumes based upon the standard set by the Commission.

SNGMO further requests that the Commission eliminate the Case No. GA-94-127 Rogersville throughput requirement on a going-forward basis because changes in circumstances make this standard no longer meaningful or in the public interest. (Exh. 6, Johnston Sur., p. 18) The analysis that formed the basis for the Rogersville requirement was performed around 1994 and included an average residential customer usage of 100 mcf per year. (*Id*. at p. 18-19) The average residential usage in the Rogersville Division has steadily decreased over time. (*Id*. at p. 19). Today, it is 55.82 Mcf per year, less than 60% of the figure used in 1994. (*Id*.)

Although there are undoubtedly numerous reasons for the decrease, a substantial portion of that decrease is likely related to enhanced customer conservation. (*Id*.) Given today's emphasis on conservation efforts, it is unclear why the Commission would want to be connected with a provision that directly incentivizes a utility to increase customer usage.

Moreover, the Case No. GA-94-127 feasibility study uses customer counts and volumes for three communities where no gas system was ever constructed – Houston, Licking, and Mountain View. (Exh. 15, Porter Sur., p. 5; Tr. 276-277, 279-280) As a result, the GA-94-127 1,797,000 Mcf rate condition contains 197,626 MCF associated with systems for which there is no plant and no plant investment. (*Id*. at p. 5-6) If the Commission makes no other change to this

condition, it should at least reduce the required volumes to account for the systems that were never constructed.

Warsaw

SNGMO believes an adjustment is necessary in the Warsaw Division in order to recognize the underutilization of mainline assets in that Division. SNGMO proposes that this adjustment take the form of a transfer of a portion of those assets into Plant Held for Future Use, FERC Account 105.

Warsaw's existing rate base contains a materially underutilized investment in Distribution Mains, FERC Account 101-376. SNGMO believes it is inappropriate to burden existing customers with the full cost recovery for that investment. The distribution mains installed were designed to serve a larger population than currently exists in this area, due in large part to the reduction in growth caused by the recession. The manner in which the reduction in recovery was calculated was intended to only assign the existing customers the proportionate cost recovery for the fraction of the capacity of the system which they are using. (Exh. 6, Johnston Sur., p. 11)

Staff has taken a similar approach to the situation at Warsaw and has proposed its own Account 105 transfer. (Exh. 128, McMellen Sur., p. 7) Staff proposes that $6.97 Million of SNGMO's mainline investment in the Warsaw Division be transferred to Account 105. (*Id.*) Staff calculated the adjustments by taking 100 percent less the mainline capacity usage factors computed by Staff witness Jenkins. (*Id.*) Staff believes that adoption of this adjustment would alleviate any concerns regarding the economic performance of the Warsaw Division. (*Id.* at p. 7-8)

SNGMO agrees with Staff's proposed transfer. This approach is faithful to the prior requirements that the ownership accept financial responsibility for underutilization of assets. (Exh. 6, Johnston Sur., p. 12)

Finally, in analyzing the OPC request for imputation, the Commission must keep in mind that the OPC feasibility numbers are overstated as they include customers and volumes for the Buffalo and Bolivar expansion certificate that was approved by the Commission in Case No. GA-2010-0189. (Exh. 6, Johnston Sur., p. 10; Tr. 280). That certificate was never exercised, no construction ever took place, no investment made, and, consequently, no customers are served in those areas. (*Id.*)

Branson

SNGMO has also asked the Commission to direct it to transfer a portion of SNGMO's mainline investments in Branson into Plant Held for Future Use, FERC Account 105, in order to recognize the underutilization of mainline assets.

Like Warsaw, Branson's existing rate base contains a materially underutilized investment in Distribution Mains, FERC Account 101-376. As mentioned previously for Warsaw, SNGMO believes it is inappropriate to burden existing customers with the full cost recovery for that investment. Much of this underutilization is in the 8 inch and 6 inch steel mainline that brings natural gas to the Branson area from the meter station on the Southern Star Central Gas Pipeline located just north and west of the town of Aurora, MO. SNGMO sized this line to serve the existing natural gas load in Branson and also load from the anticipated future growth in the area. The area around Branson includes over 20,000 platted residential lots in subdivisions that were designed and registered prior to the recession. SNGMO does not believe it would have been prudent to build this line without building in the capacity to supply these developments. Most of

the developers had stated their intention to work with the company to provide access to natural gas for these future residents. (Exh. 6, Johnston Sur., p. 16-17) However, due to the economy and other factors, certain of this capacity is not currently utilized.

Staff proposes an "excess capacity" adjustment to net rate base of $27.64 Million for Branson. (Exh. 128, McMellen Sur., p. 7) Staff calculated the adjustments by taking 100 percent less the mainline capacity usage factors computed by Staff witness Jenkins. (*Id.*) Staff believes that adoption of this adjustment would alleviate any concerns regarding the economic performance of the Branson Division. (*Id*. at p. 7-8)

SNGMO agrees with Staff's adjustment. The Account 105 transfer approach will be faithful to the requirement that the shareholders accept financial responsibility for the system. (*Id*. at p. 17)

C. How should the former SMNG assets be booked to plant in service in light of MGU's merger with SMNG that was approved in GM-2011-0354?

The assets of the legacy Southern Missouri Natural Gas systems were brought to SNGMO's books at net original cost. This is consistent with long-standing Commission practice and the provisions of the Uniform System of Accounts adopted by Commission rule (4 CSR 240-40.040). There is no reason to deviate from that practice in this case, especially in that the ultimate owner of the assets did not change as a result of the merger. The merger purchase price should have no impact or import to the Commission's decision in this case.

Past Practice

This Commission has stated in *In the Joint Matter of UtiliCorp United In. and St. Joseph Light & Power Company*, Case No. EM-2000-292, 12 Mo.P.S.C.3d 388, 389-390 (February 26, 2004):

> *The net original cost rule was developed in order to protect ratepayers from having to pay higher rates simply because ownership of utility plant has changed, without any actual change in the usefulness of the plant.*
>
> ***
>
> Missouri has traditionally applied the net original cost standard when considering the ratemaking treatment of acquisition adjustments. That means that the purchasing utility has not been allowed to recover an acquisition premium from its ratepayers. But it also means that ratepayers do not receive lower rates through a decreased rate base when the utility receives a negative acquisition adjustment. *Even if a company acquires an asset at a bargain price, it is allowed to put the asset into its rate base at its net original cost.*

(emphasis added)

Uniform System of Accounts

The Commission requires natural gas utilities to utilize the Uniform System of Accounts (USOA). Commission Rule 4 CSR 240-40.040(1) states, in part, "Beginning January 1, 1994, every gas company subject to the commission's jurisdiction shall keep all accounts in conformity with the Uniform System of Accounts Prescribed for Natural Gas Companies Subject to the Provisions of the Natural Gas Act, as prescribed by the Federal Energy Regulatory Commission (FERC) and published at 18 CFR part 201 (1992) and 2 FERC Stat. & Regs. paragraph 20,001 and following (1992), except as otherwise provided in this rule."

The Commission rules, by way of the USOA, require plant to be recorded at net original cost. Commission Rule 4 CSR 240-40.040(3)(C) states that each gas corporation subject to the Commission's jurisdiction shall – "Record gas plant acquired as an operating unit or system at original cost, estimated if not known, except as otherwise provided by the text of the intangible plant accounts, when implementing the provisions of Part 201 Gas Plant Instructions 2.A. and paragraph 20,042.2.A." Part 201 Gas Plant Instructions 2.A. states, in part, that "All amounts included in the accounts for gas plant acquired as an operating unit or system, except as

otherwise provided in the texts of the intangible plant accounts, shall be stated at the cost incurred by the person who first devoted the property to utility service."

It appears that the accounting proposed by the OPC would be contrary to Commission rule and likely require a waiver, if SNGMO has sought to book the assets at anything other than net original cost.

Value of the Assets?

One of the justifications for using net original cost is the fact that relying on a purchase price requires the Commission to get into the business of assessing the validity of the purchase price. This would be hard enough in situations such as Laclede's recent purchase of the Missouri Gas Energy assets, where the purchase price greatly exceeded the net book value of the assets. In that situation, there was at least a bid process and a transaction agreed to at arm's length by 2 sophisticated companies. In this case, there was no arm's length transaction. It is a transaction between two subsidiaries of the same ultimate parent.

OPC Witness Meisenheimer (Exh. 202, Meisenheimer Reb., p. 21-22), in regard to the merger of SMNG into SNGMO, states that "since the transaction *was not an arms length transaction*, MGU should not be allowed any advantage by valuing the assets at a value higher than it paid for the assets." (emphasis added) As stated above, this sort of question about the purchase price, whether it has been derived through an arm's length transaction or not, is one of the reasons that the USOA uses net original cost when regulated assets are transferred from one regulated entity to another. Historically, Commissions became worried that if purchase price were used, the value of rate base would be inflated. It is ironic that in this case, *because OPC does not trust the validity of the purchase price*, it wants to abandon the use of net original cost.

Affiliate Transaction

OPC further argues that the SMNG assets should be booked at something other than net book value because of the affiliate transaction rule (Commission Rule 4 CSR 240-40.015).

The affiliate transaction rule is not applicable in this situation. The affiliate transaction rule states that it "is intended to prevent regulated utilities from subsidizing their non-regulated operations." (Commission Rule 4 CSR 240-40.015, Purpose) The subject merger transaction was between two Missouri-regulated entities.

More importantly, the affiliate transaction rule sets out requirements for the provision of "goods and services." (Commission Rule 4 CSR 240-40.015(2)(A)) A merger of two regulated entities is not the provision of goods and services.

Lastly, even if one were to attempt to apply the affiliate transaction rule pricing standards to the merger, the Commission does not have sufficient information to determine the amount at which the assets should be recorded. Commission Rule 4 CSR 240-40.015(2)(A) provides, in part:

> A regulated gas corporation shall not provide a financial advantage to an affiliated entity. For the purposes of this rule, a regulated gas corporation shall be deemed to provide a financial advantage to an affiliated entity if—
>
> 1. It compensates an affiliated entity for goods or services above the lesser of—
>
> A. The *fair market price*; or
>
> B. The *fully distributed cost to the regulated gas corporation to provide the goods or services for itself.*

(emphasis added)

Thus, where goods and services are provided by an affiliate, the regulated utility purchasing the goods and services must record the purchase at the lower of the fair market price or the fully distributed cost for the regulated utility to provide the goods and services for itself.

There is no evidence of the fair market value of the SMNG assets. The purchase price

identified by the OPC is certainly not fair market value. OPC witness Meisenheimer has testified that the "transaction was not an arms length transaction." (Exh. 202, Meisenheimer Reb., p. 21-22) Staff witness McMellen indicated that Staff did not do any analysis to determine whether the purchase price represented fair market value. (Tr. 429)

The cost for SNGMO to provide the SMNG natural gas system for itself would certainly be much higher than the net original cost, which represents construction costs from some number of years ago, minus the accumulated depreciation. Regardless, there is no evidence to establish what it would have cost SNGMO to construct the SMNG system itself as of the merger date.

The affiliate transaction rule is not applicable to the transfer of goods between two regulated entities; the transfer of gas plant constituting an operating system or unit is not the transfer of "goods or services"; and, if it were, neither evidence of the fair market value of the system nor the fully distributed cost for SNGMO to provide the system for itself is available to the Commission.

Bargain Purchase Price

OPC witness Keri Roth identifies the negative acquisition adjustment resulting from the merger of SMNG into SNGMO as a "bargain purchase discount." (Exh. 200, Roth Reb., p. 4) She suggests that the negative acquisition adjustment should be accounted for in SNGMO's resulting rate base.

Ms. Roth defines a "bargain purchase discount" as a "business combination in which one corporate entity is acquired by another for a dollar amount less than *fair market value* of its assets." (Exh. 200, Roth Reb., p. 4) (emphasis added) However, Ms. Roth does not provide any evidence of the *fair market value* of the SMNG assets. Ms. Roth instead uses the *net original cost* of those assets for her comparison.

During cross examination, Ms. Roth was unable to answer whether she believed net original cost to be the same thing as fair market value. (Tr. 433-434) She further did not know if the fair market value of the recently sold MGE assets would be greater than the net original cost, if one assumes the price paid by Laclede was greater than the net original cost. (Tr. 435) This is a question with some basis in fact in that the price paid by Laclede was greater than net book value. (Tr. 423)

As support for her theory, Ms. Roth cites a 1977 Commission case (*In the matter of Kansas City Power & Light*, Case No. ER-77-118, 21 Mo.P.S.C. (N.S.) 543 (1977). (Exh. 200, Roth Reb., p. 7) This case contains no discussion of the "bargain price discount" concept. (Tr. 432) In four sales transactions conducted by Kansas City Power & Light:

- two were sales of Kansas property to a Kansas City, Kansas municipal utility;
- one was a transmission line sold to the City of Independence; and,
- one was the sale of property that had been identified as plant for future use.

(Tr. 432-433)

None of the transactions discussed in the *Kansas City Power & Light* case concerned the sale of a Missouri plant from one regulated entity to another. (Tr. 433)

Lastly, the underlying conclusion of the Commission in the *Kansas City Power & Light* case is as follows:

> It is the Commission's position that ratepayers do not acquire any right, title and interest to Company's property simply by paying their electric bills. It should be pointed out that Company investors finance Company while Company's ratepayers pay the cost of financing and do not thereby acquire an ownership position. Therefore, the Commission finds that the disposal of Company property at a gain does not entitle its ratepayers to benefit from that gain nor does the disposal of Company property at a loss require that Company's ratepayers absorb that loss.

(*Kansas City Power & Light*, at 21 Mo.P.S.C. (N.S.) 543, 576)

This traditional regulatory treatment of gain and loss is consistent with the use of net original cost in the situation at hand. By utilizing construction cost (provided it is prudent), minus accumulated depreciation for ratemaking, the ratepayers are separated from the questions of fair market value and gain or loss.

III. MISCELLANEOUS TARIFF ISSUES

A. Should the Commission approve SNGMO's proposed Conversion Program?

B. What conversion costs should SNGMO be required to charge?

C. Should SNGMO's conversion practices be revised?

The Commission should approve SNGMO's conversion program as proposed by the Company. The evidence supports SNGMO's request to continue providing its in-home conversion service, but with the actual cost of each conversion being paid by the customer receiving the service. The Company currently has a tariff which provides for free conversion in certain circumstances. SNGMO's proposed tariff continues the service offering, but requires the customer to pay the actual cost of the service in all circumstances. (Exh. 18, Wankum Dir., p. 14; Exh. 20, Wankum Sur., p. 8-9) Additionally, when converting appliances from propane to natural gas, SNGMO shall follow all applicable national and local codes and manufacturers' specifications relating to the conversion of appliances. *See Partial Stipulation and Agreement as to Dual Fuel and Conversion of Appliances*, para. 1.

The Office of the Public Counsel initially opposed the Commission's approval of the conversion program, but this opposition was due to a misunderstanding. Tr. Vol. 12, p. 305. At the evidentiary hearing, SNGMO witness Martha Wankum clarified that the Company's request is to continue offering the service, but without any "no cost" component and with the customer

paying the "full cost" of the conversion service. *Id.* at 307-310. No other party filed testimony in opposition to the Company's proposal, and Staff stated support for the Company's proposal. "Staff recommends SNGMO be required to charge the actual cost of conversions." *Staff Statement of Position*, p. 4.

IV. RATE DESIGN

A. What is "rate shock"? If it exists, should the Commission address rate shock in this case and, if so, how?

Once the revenue requirement has been determined, the next step is to design the rates – how the revenue requirement will be collected from customers. While "rate shock" as used in the context of rate design is not a defined term, and has no known remedy, the size of rate increases is certainly something that SNGMO is mindful of and something the Company has made efforts to address.

First, SNGMO, as discussed above, has asked the Commission to direct it to transfer a total of $34.6 Million of the Company's mainline investments in Warsaw and Branson into Plant Held for Future Use, FERC Account 105. Doing so will recognize the underutilization of mainline assets at Branson and Warsaw and decrease the rate increase that might otherwise result.

Secondly, the Company, along with other parties, has agreed to the continued use of a customer charge, plus volumetric charge, rate design and has rejected the use of straight fixed variable (SFV) Rate Design. (*Partial Stipulation and Agreement*) While SNGMO generally believes that the use of SFV Rate Design, as a tool by which to decouple utility non-gas costs from gas usage, makes sense in an overall context and also promotes conservation, it is not

appropriate for SNGMO or its customers. This is because a majority of SNGMO's investment in plant has occurred in the last ten years, providing little time for investment recovery. Consequently, the investment per customer and corresponding non-gas revenue requirement per customer would drive a significant SFV charge. Additionally, SNGMO exists in a competitive environment. SNGMO believes SFV pricing may artificially drive customers to competitive fuels because low usage customers may migrate away from SNGMO's system harming those customers that remain. (Exh. 5, Johnston Reb., p. 2-3)

Lastly, SNGMO has agreed to customer charges in amounts less than that called for by its class cost of service study. (*Partial Stipulation and Agreement as to Energy Efficiency, Weatherization, and Other Matters*, Para. 5) This approach places a greater emphasis on the commodity charge paid by the customer, a portion of the rate over which the customer has at least some influence based on customer usage.

Perspective

In reviewing this issue, the Commission needs to look beyond percentages that may be thrown around, so that it understands the basis of the percentage. Some percentages are percentage increases in *non-gas costs*. The non-gas cost of a person's bill is generally a significantly smaller percentage of the bill than the gas cost portion.

While this number can still be significant, it is something different than the percentage that would represent a customer's increase in relation to his or her total gas bill. As a point of reference, SNGMO's minimum filing requirements in this case reflected that the original increase request of approximately $7.4 million represented a 26.5% increase in relation to the overall cost of natural gas service.

Schools

The Missouri School Boards' Association has been the primary driver of this issue. Its primary concern is the increases that may be seen by the schools that are a part of the School Aggregation Program. These schools are allowed to purchase their own natural gas, but pay SNGMO for the use of its system to transport the gas to the schools.

The subject schools are all located in the old SMNG territory. The school districts were treated as transport customers, and paid a single discounted customer charge, since before Summit Utilities (SNGMO's parent) took control of SMNG.

In SMNG's last small company rate proceeding, amounts of revenue were imputed to reflect the difference between the full transport tariff rate and the discounted transport rate that had been given to the schools. In response, SNGMO began to move the schools to the full transport tariff rate. Most of that movement took place in the fall of 2013.

Additionally, it has become apparent that the Company's tariff requires the schools to be billed at the companion sales rate and to be billed a customer charge for each meter. That change has been contemplated in the billing determinants and pro forma revenues developed for this case by Staff and embraced by SNGMO. It has also been agreed-to and clarified in the Partial Stipulation and Agreement that has been filed and approved by the Commission in this case. (*Partial Stipulation and Agreement*, para. 5.a.)

Treating the schools in this fashion allows the rates to be faithful to the provisions of Section 393.310.5, RSMo (the school aggregation statute), which requires that the tariff not have "any negative financial impact on the gas corporation, its other customers or local taxing authorities, and that the aggregation charge is sufficient to generate revenue at least equal to all incremental costs caused by the experimental aggregation program." Different treatment in the

past has created a negative financial impact on the gas corporation. Other approaches would create a negative financial impact on SNGMO's other customers.

The combination of taking the schools to the appropriate companion sales rate and of the billing by meter results in a significant increase for the schools. In fact, a significant part of the increase cited by the schools is due to these factors and not the impact of the revenue requirement to be set at the conclusion of this case. (Exh. 404)

Staff prepared a schedule to analyze the total rate increase percentage applicable to the schools. Because Staff is not privy to the schools' actual cost of gas, it used the Company's PGA rate (the rate paid by SNGMO's sales customers) as a proxy. The Staff's calculations showed that the rate increase would result in total gas bill increases from 9.06%-24.87% for the various transporting schools. (Exh. 139) While these percentages are certainly significant, they are not close to the percentages that have been suggested by the MSBA.

If one did decide to address the school increase issue in some fashion, the next question would be who will pay the costs instead of the schools. One alternative would be the other customers in that operating division. However, no one has suggested this remedy.

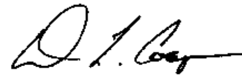
When MSBA witness Ervin was asked what to do if the schools did not pay all of the costs assigned to them, he suggested a "phase-in" of rates. (Tr. 347) While perhaps attractive at first blush, a "phase-in" has a couple of problems. First, if revenues are to be deferred, as suggested by Mr. Ervin, the Commission must address carrying charges for the deferred revenues. (Tr. 347-348) Analysis of these situations usually reveals that a phase-in does not solve the problem. It merely compounds it in future years. In a future rate case, not only would the schools have to address any rate increases that might be awarded, but they would also have to

address rate increases associated with the deferred revenues and carrying charges originating with the phase-in.

Second, there is a question as to whether this Commission has the authority to direct a phase-in for a natural gas company. The only express authority which allows the Commission to authorize a rate increase that is less than the full amount of a utility's revenue deficiency is found in Section 393.155, RSMo, which applies only to electrical corporations. Thus, there is no express statutory authority for the Commission to phase-in rates for a natural gas utility, such as SNGMO.

WHEREFORE, SNGMO respectfully requests that the Commission consider this Initial Brief.

Respectfully submitted,



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CERTIFICATE OF SERVICE

I do hereby certify that a true and correct copy of the foregoing document has been sent by electronic mail this 16th day of September, 2014, to:

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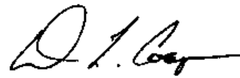

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