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BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of The Empire District Electric Company's	)	
Request for Authority to File Tariffs Increasing Rates for Electric	)	Case No. ER-2019-0374
Service Provided to Customers in its Missouri Service Area	)	

MOTION FOR RECONSIDERATION
AND/OR APPLICATION FOR REHEARING

COMES NOW The Empire District Electric Company, a Liberty Utilities company ("Empire" or "Company"), and pursuant to RSMo. §386.500, submits its Motion for Reconsideration and/or Application for Rehearing concerning the *Amended Report and Order* issued by the Missouri Public Service Commission ("Commission") in the above-captioned matter on July 23, 2020.

1. The *Amended Report and Order* (the "*Order*") is unlawful, unreasonable, unjust, arbitrary, and an abuse of discretion for one or more or all of the reasons hereinafter set forth. For the reasons stated in the following paragraphs, the decision of the Commission should be reconsidered or reheard, and the *Order* should be amended or superseded to address and correct the matters of error raised herein by the Company.

Return on Equity

2. The Commission found that a 9.25 percent return on equity ("ROE") was appropriate for the setting of rates in this case. *Order*, p. 38.

3. Generally, a rate of return is considered fair if it "covers utility operating expenses, debt service, and dividends, if it compensates investors for the risks of investment, and if it is sufficient to attract capital and assure confidence in the enterprise's financial integrity." *State ex rel. Mo. Office of the Pub. Counsel v. PSC of Mo.*, 293 S.W.3d 63, 80 (Mo. Ct. App.

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2009), *citing Assoc. Natural Gas Co. v. Public Service Com.*, 706 S.W.2d 870, 875 (Mo.App. 1985).

4. In reaching its decision on ROE, the Commission does not take into account its capital structure decision described below. The impact of capital structure on return on equity has been described by the Court of Appeals as follows:

> "[A] company with a capital structure that includes a high percentage of debt is more risky for shareholders [who] will consequently demand a higher rate of return to compensate them for the increased risk caused by the high level of debt." *Mo. Gas Energy*, 186 S.W.3d at 383 (internal quotations omitted). Essentially, the corporation's shareholders are subordinate to its creditors, and face a greater financial risk in the event of failure than they would otherwise face in an entity with less debt. *Id*. "The more equity there is in a company's capital structure, the higher the rate of return and the more attractive a company is as an investment, because a high rate of return imposes higher costs on customers, thus increasing a company's cash flow." *Id*.

State ex rel. Mo. Office of the Pub. Counsel v. PSC of Mo., 293 S.W.3d 63, 81 (Mo. Ct. App. 2009). The Courts have further stated:

> Section 393.130.1, RSMo, requires "[a]ll charges made or demanded" by a natural gas utility "for gas . . . or any service rendered or to be rendered shall be just and reasonable and not more than allowed by law or by order or decision of the commission." Under *Hope*, the fixing of just and reasonable rates involves "a balancing of the investor and the consumer interests[,]" and "the making of 'pragmatic adjustments.'" *Id*. at 602-03.

State ex rel. Office of the Pub. Counsel v. PSC, 367 S.W.3d 91, 108 (Mo.App. 2012).

5. The Commission's determination of a ROE without consideration of the extremely low equity percentage in the capital structure used to determine Empire's rate of return precludes the Company from receiving a return commensurate with returns received on investments in other enterprises having corresponding risks as required by *Hope* and *Bluefield*.

6. The total effect of the use of the adjusted, hypothetical capital structure in conjunction with the 9.25 percent ROE is unjust and unreasonable. As such, Empire requests that

the Commission reconsider or rehear this portion of the *Order* and revise the return on equity to be used for the setting of rates after consideration of the above.

Capital Structure

7. As of January 31, 2020, Empire continues to have its own capital structure, with its own debt, including $588 million of first mortgage bonds, $102 million of senior unsecured notes, and $90 million of intercompany note payable, for a total long term debt of $780 million. Ex. 7 (Richard True-Up Direct), Sch. SDR-6. The Commission's finding that "Empire now relies on LUCo for all of its financing functions, which includes access to short-term debt and long-term debt" is in error and is not supported by the competent and substantial evidence in the record. As such, the use of the capital structure of Liberty Utilities, Co. ("LUCo"), as a hypothetical capital structure for the setting of Empire's rates in this proceeding, is in error. Although Empire relies on LUCo for some of its financing functions, Empire continues to have its own bond platform and its own commercial paper program, and its debt is rated by S&P and Moody's.

8. The Commission states that if Empire's capital structure is different than that of the entity or entities it relies on for its financing needs, Condition 5 of the Merger Stipulation approved in File No. EM-2106-0213 requires Empire to provide evidence in its rate cases as to why its per book capital structure is the most economical for purposes of determining a fair and reasonable allowed rate of return. *Order*, p. 38. The Commission erred by finding that Condition 5 of the Merger Stipulation was triggered by Empire's direct filing in this case. The Commission also erred to the extent it determined that the merger condition required Empire to demonstrate that its capital structure was the "most economical" as compared to LUCo's capital structure as adjusted by the Office the Public Counsel ("OPC").

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9. Empire's per book capital structure differed very slightly from LUCo's per book capital structure. It would be unreasonable to interpret the merger condition in such a way as to have required an additional analysis due to the minimal, ten basis point difference. Additionally, a difference to warrant application of the merger condition appears only when OPC's suggested adjustment is made to LUCo's capital structure.

10. Assuming the ten basis point difference between the two per book capital structures did rise to the threshold of a difference for the purpose of the merger condition, and/or assuming that the merger condition required Empire to compare its capital structure to LUCo's capital structure as adjusted by OPC, the central issue is whether Empire's capital structure is the "most economical." Although the merger condition does not contain a definition of "economical," Empire witness Hevert presented substantial and credible evidence demonstrating that the capital structure requested by Empire (Empire's actual capital structure) is more economical than the adjusted, hypothetical capital structure requested by OPC.

11. The competent and substantial evidence in the record required a conclusion from the Commission that an "economical" capital structure is one that looks to optimize the proportions of equity and debt, based on multiple factors. The Commission erred in concluding that any capital structure with less debt is the most economical. "Because utilities have similar financing objectives and face common constraints, the practice of capital structure optimization is best viewed in the capital structures in place among utility operating companies." Exh. 38 (Hevert Surrebuttal), p. 54. "The Cost of Equity is inextricably linked to debt leverage. Mr. Murray's recommendation is so heavily leveraged relative to industry practice that it certainly would increase risks to debt and equity investors, increasing the returns required by them . . ."

Exh. 38 (Hevert Surrebuttal), p. 55. The competent and substantial evidence in the record required a finding that OPC's recommended 46% equity ratio was not the "most economical."

12. In arriving at what it found to be the "most economical" capital structure for purposes of this case, the Commission started with LUCo's capital structure, thereby improperly using a hypothetical capital structure for the setting of Empire's rates in this proceeding. The per books capital structure of LUCo was 53 percent equity and 47 percent debt. This demonstrates a minimal difference between the capital structures of Empire and LUCo.

13. The Commission states it "has a history of using LUCo's capital structure for LUCo's affiliate companies," noting that the Commission "approved LUCo's capital structure for two of Empire's affiliates, Liberty Utilities (Midstates Natural Gas) and Liberty Utilities LLC [sic] (Missouri Water), in File Nos. GR-2014-0152 and WR-2018-0170." *Order*, p. 35.

14. Empire on one hand, and Midstates Natural Gas and Missouri Water on the other hand, are not similarly situated in terms of their capital structures or the performance of their own financing functions. There was no evidence presented in this case to demonstrate that the circumstances of the prior cases, including with regard to the make-up of LUCo's capital structure at the time, were in any way similar or analogous to the circumstances of this Empire case and/or the make-up of LUCo's capital structure at the time. As such, it was improper for the Commission to rely on these prior, fact-based decisions, which were not in evidence in this case.

15. Additionally, in this case, the Commission started with LUCo's capital structure of 53 percent equity and 47 percent debt, but then adjusted that per books LUCo capital structure to include what it described as "off balance sheet debt" in the capital structure calculation. The adjustments to LUCo's capital structure resulted in 46 percent equity and 54 percent debt. *Order*, pp. 32, 35.

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16. Based on its analysis, the Commission found LUCo's adjusted capital structure of 46 percent common equity and 54 percent long-term debt to be the appropriate capital structure to use in setting rates in this case. *Order*, p. 39.

17. In the prior case decisions (File Nos. GR-2014-0152 and WR-2018-0170) referenced by the Commission in the *Order*, there is no discussion of this "extra" adjustment to LUCo's capital structure.

18. The use of any capital structure other than that of Empire is the use of a hypothetical capital structure. It is true that a decision to use a hypothetical capital structure for ratemaking purposes is within the Commission's discretion. *State ex rel. Mo. Office of the Pub. Counsel v. PSC of Mo.*, 293 S.W.3d 63, 84 (Mo. Ct. App. 2009). That discretion, however, may not be abused. It is also stated that adopting a hypothetical capital structure for ratemaking purposes may be proper, "particularly where it is in the public interest to do so, i.e., when a utility's actual capital structure contains too much equity and not enough debt, thereby necessitating an inflated rate of return." *State ex rel. Mo. Gas Energy v. PSC*, 186 S.W.3d 376, 386, n.10 (Mo. Ct. App. 2005). That is not the situation at hand. Empire's capital structure was very similar to those of the proxy group and reasonable unto itself. There is no evidence in this case to the contrary.

19. Here, the Commission not only used a hypothetical capital structure by ignoring Empire's actual capital structure in favor of the LUCo structure, it effectively created a hypothetical, hypothetical structure by then adjusting the per books capital structure of LUCo in order to treat underlying debt of other entities as a part of the LUCo capital structure.

20. This adjusted, hypothetical capital structure used by the Commission was unreasonable in regard to the capital structures of the comparable companies used for the

analysis. Schedule RBH-R7 to Empire witness Hevert's Rebuttal Testimony demonstrated the average equity ratio among the utility proxy companies was 53.59 percent. Exh. 37. The 46% equity ratio ultimately ordered by the Commission falls over two standard deviations below that proxy group average. Exh. 38 (Hevert Surrebuttal), p. 56. Moreover, the capital structure used by the Commission falls in the bottom 3rd percentile of the proxy company equity ratios. *Id*. In other words, 97% percent of the observed equity ratios were higher than 46.00 percent hypothetical equity percentage used by the Commission. *Id*. at FN. 120.

21. Further, in constructing the adjusted, hypothetical capital structure, the Commission erroneously treated guarantees as "debt." A guarantee is not debt. Debt has been defined as follows:

> An amount owed. The general name for notes, bonds, mortgages, and the like that are evidence of amounts owed and have definite payment dates.

Public Utility Finance & Accounting, Joel Berk, p. 385 (2nd Ed., 1989). Similarly, *Black's Law Dictionary* (5th ed.) defines debt in primary part as follows:

> A sum of money due by certain and express agreement. A specified sum of money owing to one person from another, including not only the obligation of debtor to pay but right of creditor to receive and enforce payment.

22. A guaranty, on the other hand, is contingent in nature. It is a "promise to answer for payment of debt or performance of obligation if person liable in first instance fails to make payment or perform obligation." *Black's Law Dictionary* (5th ed.). There is no specified sum of money owing to one person from another merely because of the existence of a guarantee, and there may never be. Only if the specified contingency comes about (i.e. the person (or entity) liable in the first instance fails to make payment or perform obligation), is there "debt." Until that contingency has occurred, a guaranty is not debt and should not be used to impact the capital structure.

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23. The capital structure ordered by the Commission is in error, as it is not representative of the capital Empire uses in its operations. Empire is a stand-alone, separate legal entity and is not burdened by LUCo's risks. The minimal difference between the per book capital structures of Empire and LUCo is due to certain debt, the risk of which is fully borne by LUCo's shareholders. For example, LUCo's capital structure includes $750 million of debt that is not tied to utility rate base and on which LUCo is not earning a return. If the Commission were to adopt a hypothetical capital structure using LUCo's capital structure, the Commission would be required to make an adjustment to remove this debt.

24. The $750 million of debt noted above, which was issued by Liberty Utilities Finance GP1 and guaranteed by LUCo, was used to finance most of the goodwill incurred in the Empire acquisition (amount paid to former Empire shareholders above the utility's rate base). Ex. 299-17 (Murray Reply), p. 3; Ex. 212 (Murray Surrebuttal), Sch. DM-S-5C. Per the terms of the referenced merger stipulation approved in File No. EM-2106-0213, none of this goodwill was pushed down onto Empire's own books, nor are Empire's customers bearing any risk associated with this additional leverage. Yet, in adopting OPC's suggested adjusted, hypothetical capital structure, Empire is now laden with a capital structure which includes the debt associated with this goodwill. This runs contrary to the intention of the aforementioned merger stipulation. Furthermore, the risk profile of Empire is negatively impacted by the resulting material reduction in its allowed equity thickness, a fact that will most certainly not escape the credit rating agencies.

25. Notably, when the $750 million of debt attributable to financing Empire's acquisition goodwill is removed, LUCo's capital structure (adjusted as suggested by OPC) is

nearly identical to Empire's per books capital structure.[1] This is further evidence that the Commission erred in finding Condition 5 of the Merger Stipulation approved in File No. EM-2106-0213 to be applicable to this case and in looking past Empire's actual capital structure and using a hypothetical capital structure for the setting of rates for Empire.

26. The Commission first erred by using a hypothetical capital structure and ignoring Empire's actual capital structure in favor of the LUCo structure. Even if it were proper for the Commission to look to LUCo's capital structure and/or to make the "off balance sheet debt" adjustment, the Commission erred by not making a further adjustment to LUCo's capital structure to address the $750 million of debt attributable to financing Empire's acquisition goodwill. OPC failed to demonstrate how its proposed capital structure was reasonable in regard to the capital structures of the comparable companies, representative of the capital Empire uses in its operations, or the "most economical." As such, the Commission erred in adopting OPC's recommendation in this regard.

27. If the Commission decides to use a hypothetical capital structure, it should use a capital structure that is reasonable for a company of similar risk profile to Empire. Further, where it determines a parent capital structure is appropriate to use as such hypothetical, that capital structure should be based on a reasonable calculation of the equity and debt. Empire requests that the Commission reconsider or rehear this portion of the *Order* and revise the capital structure to be used for the setting of rates after consideration of the above.

WHEREFORE, Empire submits this Motion for Reconsideration and/or Application for Rehearing.

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[1] LUCo's adjusted capitalization yields a 46% debt / 54% equity capital structure based on LUCo's financial statements at December 31, 2019. Empire's per book capital structure, at December 31, 2019, is 46.9% debt and 53.1% equity.

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Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that the above document was filed in EFIS on this 31st day of July, 2020, with notification of the same being sent to all counsel of record.

/s/ Diana C. Carter

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