

**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)
Service Provided to Customers in its)
Missouri Service Area)
Case No. ER-2019-0374

**Public Counsel’s Response to Empire’s
Motion for Reconsideration and/or Application for Rehearing**

COMES NOW the Office of the Public Counsel and responds to *Empire’s Motion for Reconsideration and/or Application for Rehearing* as follows:

1. In its *Motion for Reconsideration and/or Application for Rehearing* Empire challenges the Commission’s decisions for return-on-equity and capital structure. As to return-on-equity, Empire asserts the Commission failed to realize the interdependence between return-on-equity and capital structure. As to capital structure Empire asserts only its expert witness Hevert’s opinion of “economical capital structure” governs. Both arguments are wrong.

2. That the Commission and the parties understand the interdependence between return-on-equity, cost of capital, and cost-of-debt is reflected in them being listed as subparts of the rate-of-return issue in the list of issues:

- 1. Rate of Return—Return on Equity, Capital Structure, and Cost of Debt**
 - a. Return on Common Equity – what return on common equity should be used for determining rate of return?*
 - b. Capital structure – what capital structure should be used for determining rate of return?*
 - c. Cost of debt – what cost of debt should be used for determining rate of return?*

3. Public Counsel highlighted the interdependence of return on common equity and capital structure in each of its three briefs. It did so in the first paragraph under the subissue of return on common equity in its initial brief, response brief, and reply brief (the only paragraph where it, respectively, stated the following:

The Commission should award Empire an allowed return on equity (ROE) of 9.25% if the Commission adopts Public Counsel's recommended capital structure. If the Commission adopts Empire's recommended capital structure, Empire should be awarded an allowed ROE of 8.5%.¹

Public Counsel's position has not changed from that it argued in its Initial Brief. If the Commission adopts Public Counsel's recommended capital structure of 46% common equity and 54% long-term debt for Empire for purposes of setting rates in this case, then the Commission should use a return on equity (ROE) of 9.25%. However, if the Commission adopts Empire's recommended capital structure of 53.07% common equity and 46.93% long-term debt, then the Commission should use a ROE of 8.5%.²

Public Counsel's position has not changed from its initial brief. If the Commission adopts Public Counsel's recommended capital structure of 46% common equity and 54% long-term debt for Empire for purposes of setting rates in this case, then the Commission should use a return on equity (ROE) of 9.25%. However, if the Commission adopts Empire's recommended capital structure of 53.07% common equity and 46.93% long-term debt, then the Commission should use a ROE of 8.5%.³

4. The issue of rate-of-return and its subissues of return on common equity, capital structure, and cost of debt are not novel. For decades The Commission repeatedly has decided them in rate cases, and on occasion the courts have been called upon to address them. A court case in addition to the one to which Empire cites is *State ex rel. Associated Nat. Gas Co. v. Pub. Serv. Com.*, 706 S.W.2d 870 (Mo. App. 1985). In that case the court defined cost of capital (rate-of-return), as follows:

1. Cost of Capital -- amount a utility must pay to secure financing from debt and equity (stock) investors; cost of capital is essentially the equivalent of fair rate of return.

Calculation of cost of capital entails three steps:

(a) determine the cost of different components of capital, i.e., debt and equity

¹ The Office of the Public Counsel's Initial Brief, p. 8.

² The Office of the Public Counsel's Response Brief, p. 5.

³ The Office of the Public Counsel's Reply Brief, p. 4.

(b) determine weighted cost for each item -- multiply cost of item by its ratio to total capital

(c) add weighted costs -- sum equals rate of return⁴

Further, *State ex rel. Associated Nat. Gas Co.* is germane here because in it the Court was first faced with double leveraging—where a parent company owns stock in a subsidiary which allows it to manipulate the capital structure of the subsidiary to its financial advantage. In its opinion the Court stated, “It appears to be an accepted regulatory practice to disregard the actual book capital structure of a utility when it is deemed to be in the public interest to do so.”⁵ The Court held it was within the Commission’s discretion to use the parent company’s capital structure for determining the capital structure of the utility where the utility’s capital structure was determined by the management of the companies.⁶ That is the circumstance here. Moreover, Liberty Utilities Company (“LUCo”) is, and will be in the future, the entity upon whom financiers’ rely when buying debt used for Empire’s needs. A copy of *State ex rel. Associated Nat. Gas Co.* is appended to this pleading. Also germane is the Commission’s October 24, 2018, Report and Order in Case No. WR-2018-0170⁷ where the Commission determined the return-on-equity and capital structure to use for setting the rates of Empire’s affiliate utility Liberty Utilities (Missouri Water), LLC d/b/a Liberty Utilities. In that case the Commission determined to use a return-on-equity of 9.75% and LUCo’s then capital structure of 42.83% common equity and 57.17% long-term debt for determining Missouri Water’s rates. A copy of that Report and Order is also appended to this pleading.

5. As to Empire’s argument that its expert witness Hevert’s opinion of “economical

⁴ *State ex rel. Associated Nat. Gas Co. v. Pub. Serv. Com.*, 706 S.W.2d at 875.

⁵ *Id.* at 878.

⁶ *Id.* at 881.

⁷ Affirmed on appeal, *Silverleaf Resorts, Inc. v. Mo. Pub. Serv. Comm'n'n (In re Liberty Utils. (Mo. Water), LLC)*, 592 S.W.3d 82 (Mo. App. 2019).

capital structure” governs, financing Condition 5 of the Merger Stipulation the Commission approved in Case No. EM-2016-0213 does not bind the Commission in any way, nor does it purport to. It merely requires Empire to provide evidence in a particular circumstance:

5. If Empire’s per books capital structure is different from that of the entity or entities in which Empire relies for its financing needs, Empire shall be required to provide evidence in subsequent rate cases as to why Empire’s per book capital structure is the most economical for purposes of determining a fair and reasonable allowed rate of return for purposes of determining Empire’s revenue requirement.

Further, as it said, “The Commission finds OPC’s witness Murray more persuasive than either Staff’s or Empire’s witnesses with regard to capital structure.”⁸ “The determination of witness credibility is left to the Commission, which is free to believe none, part, or all of the testimony.”⁹

Wherefore, the Office of the Public Counsel responds to Empire’s Motion for Reconsideration and/or Application for Rehearing as set forth above.

Respectfully,

/s/ Nathan Williams

Nathan Williams
Chief Deputy Public Counsel
Missouri Bar No. 35512

Office of the Public Counsel
Post Office Box 2230
Jefferson City, MO 65102
(573) 526-4975 (Voice)
(573) 751-5562 (FAX)
Nathan.Williams@opc.mo.gov

⁸ *Report and Order*, p. 30.

⁹ *State ex rel. Praxair, Inc. v. PSC*, 328 S.W.3d 329, 342 (Mo. App. 2010).

Attorney for the Office
of the Public Counsel

CERTIFICATE OF SERVICE

I hereby certify that copies of the foregoing have been mailed, hand-delivered, transmitted by facsimile or electronically mailed to all counsel of record this 16th day of July 2020.

/s/ Nathan Williams

State ex rel. Associated Natural Gas Co. v. Public Service Com.

Court of Appeals of Missouri, Western District

December 31, 1985

No. WD 36576

Reporter

706 S.W.2d 870 *; 1985 Mo. App. LEXIS 3868 **

STATE EX REL. ASSOCIATED NATURAL GAS COMPANY, Relator-Appellant, v. **PUBLIC SERVICE COMMISSION** OF MISSOURI, Respondent, and OFFICE OF THE PUBLIC COUNSEL OF THE STATE OF MISSOURI, Intervenor-Respondent

Subsequent History: **[**1]** Application to Supreme Court for Transfer Denied April 15, 1986.

Prior History: Appeal from the Circuit Court of Cole County, Honorable Byron L. Kinder, Judge

Core Terms

leveraging, double, stock, subsidiary, financed, ratemaking, ratio, investor, hypothetical, confiscatory, methodology, arrive, borrow, dividends, imputed, staff

Case Summary

Procedural Posture

Appellant public utility challenged a decision from the Circuit Court of Cole County (Missouri), in favor of respondent Missouri **Public Service Commission** (Commission) for a rate increase for gas service, which would generate gross revenues in an amount

substantially less than that requested by the utility, by employing a concept known as "double leveraging."

Overview

In issue was whether, in the ratemaking process, the Commission was permitted to consider the financial structure of a corporate parent in determining the service rates of the subsidiary. The utility was a wholly owned subsidiary of another Missouri electric utility. All of this parent company's common stock was owned by a public utility holding utility. The holding utility's common stock was market traded whereas the utility's and the parent company's were not. On appeal, the utility contended the Commission's use of "double leveraging" lowered the rate increase below what reasonable. According to the utility, because the parent company acquired equity ownership of the utility in a stock for stock transaction, its acquisition could not be traced to a debt issue, and therefore double leveraging was inapplicable. The court disagreed. The court held that the ratepayer should not be placed at an unfair disadvantage simply because the parent company chose to invest in the utility through a stock for stock exchange rather than through direct debt financing. The Commission fulfilled its function when it established a fair and reasonable rate of return by employing double leveraging.

Outcome

The court affirmed the rate increase determined below.

LexisNexis® Headnotes

Energy & Utilities Law > ... > Rates > Ratemaking Factors > Operating Expenses

Energy & Utilities Law > Regulators > Public Utility Commissions > Ratemaking Procedures

Energy & Utilities Law > Utility Companies > Rates > General Overview

Energy & Utilities Law > ... > Rates > Ratemaking Factors > Rate of Return

[HN1](#) **Ratemaking Factors, Operating Expenses**

An essential function of the Missouri **Public Service Commission** in the ratemaking process is to determine an appropriate rate of return. Typically, the rate of return is designed to provide sufficient revenue to cover the utility's total cost of service. Such costs include both the operating expenses of the utility and an adequate "return" on the investment in property and equipment serving the public.

Energy & Utilities Law > Utility Companies > Rates > General Overview

[HN2](#) **Utility Companies, Rates**

A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties.

Energy & Utilities Law > ... > Rates > Ratemaking Factors > Operating Expenses

Energy & Utilities Law > Utility Companies > Rates > General Overview

Energy & Utilities Law > ... > Rates > Ratemaking Factors > Rate of Return

[HN3](#) **Ratemaking Factors, Operating Expenses**

The ratemaking function must provide sufficient income to cover the utility's operating expenses and debt service. In addition, there must be enough revenue generated as a return to the owners of the company's stock to assure confidence in the continued financial services of the business and to attract equity investors. The rate of return should not be higher than is necessary to achieve these goals. Otherwise, utility customers will pay excessive prices, something regulation seeks to prohibit.

Energy & Utilities Law > Administrative Proceedings > Judicial Review > General Overview

Energy & Utilities Law > Administrative Proceedings > General Overview

Energy & Utilities Law > Regulators > Public Utility Commissions > General Overview

Energy & Utilities Law > ... > Public Utility Commissions > Hearings & Orders > Judicial Review

Energy & Utilities Law > Utility Companies > Rates > General Overview

[HN4](#) **Administrative Proceedings, Judicial Review**

The proceedings and order of the Missouri **Public Service Commission** are administrative by nature. Appellate review of such orders and proceedings is governed by [Mo. Const. art. V, § 18](#): Such review shall include the determination whether the same are authorized by law, and in cases in which a hearing is required by law, whether the same are supported by competent and substantial evidence on the whole record.

basis.

Energy & Utilities Law > Regulators > Public Utility
Commissions > Authorities & Powers

Energy & Utilities Law > Administrative
Proceedings > Judicial Review > General Overview

Energy & Utilities Law > ... > Public Utility
Commissions > Hearings & Orders > Judicial
Review

[HN5](#) **Public Utility Commissions, Authorities & Powers**

On appeal, the court's role is to determine whether the Missouri **Public Service Commission**'s report and order is lawful and reasonable. The lawfulness of a **Public Service Commission** order depends on whether it issued under statutory authority. In determining the statutory authorization for or lawfulness of the order, the court need not defer to the Commission. However, as to matters of reasonableness, the court cannot substitute its judgment for that of the Commission if it is supported by substantial and competent evidence on the record as a whole.

Administrative Law > Judicial Review > Standards
of Review > Arbitrary & Capricious Standard of
Review

Energy & Utilities Law > Administrative
Proceedings > Judicial Review > General Overview

Energy & Utilities Law > ... > Public Utility
Commissions > Hearings & Orders > Judicial
Review

[HN6](#) **Standards of Review, Arbitrary & Capricious Standard of Review**

Since the reviewing court is not authorized to weigh the evidence heard by the Missouri **Public Service Commission**, the Commission's findings are prima facie correct. The burden is on the party attacking the validity of an order of the Commission. Under [Mo. Rev. Stat. § 386.430](#) (1978), the challenger carries the burden of showing by "clear and satisfactory evidence" that the order or decision is unlawful or unreasonable. The Commission's action warrants reversal only if it appears arbitrary, capricious, and without reasonable

Energy & Utilities Law > ... > Rates > Ratemaking
Factors > Rate of Return

Energy & Utilities Law > Utility
Companies > Rates > General Overview

[HN7](#) **Ratemaking Factors, Rate of Return**

Cost of capital: amount a utility must pay to secure financing from debt and equity (stock) investors; cost of capital is essentially the equivalent of fair rate of return. Calculation of cost of capital entails three steps: (a) determine the cost of different components of capital, i.e., debt and equity (b) determine weighted cost for each item, multiply cost of item by its ratio to total capital, (c) add weighted costs, sum equals rate of return.

Energy & Utilities Law > ... > Rates > Ratemaking
Factors > Operating Expenses

Energy & Utilities Law > Utility
Companies > Rates > General Overview

Energy & Utilities Law > ... > Rates > Ratemaking
Factors > Rate of Return

[HN8](#) **Ratemaking Factors, Operating Expenses**

Fair rate of return: a rate of return that 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. This return should be roughly equivalent to the return offered by similarly situated businesses in the same industry.

Business & Corporate Law > ... > Corporate
Finance > Initial Capitalization & Stock
Subscriptions > General Overview

Energy & Utilities Law > Utility
Companies > Rates > General Overview

Business & Corporate
Law > Corporations > Corporate Finance > General
Overview

[HN9](#) Corporate Finance, Initial Capitalization & Stock Subscriptions

Corporations typically are financed with both debt (borrowed money) and equity capital (proceeds from stock offerings). "Leveraging" is a financial term used to describe the situation in which a corporation is funded by debt in addition to the equity supplied by stockholders.

Energy & Utilities Law > ... > Rates > Ratemaking Factors > **Rate of Return**

Tax Law > ... > Income Taxes > Corporations & Unincorporated Associations > General Overview

Energy & Utilities Law > Utility Companies > General Overview

Energy & Utilities Law > Utility Companies > Rates > General Overview

[HN10](#) Ratemaking Factors, Rate of Return

A corporation is "leveraged" to the extent that debt is included in its **capital structure**. The leverage arises from the advantage equity holders gain through the rental of capital at a lower rate than the return they receive on their equity. Leverage allows equity owners to earn an over-all **rate of return** in excess of the cost of capital. The added earnings above the cost of borrowed capital inure to the benefit of the stockholders who receive a higher **rate of return** than if the corporation had been financed entirely by equity. Utility regulators prevent these excess earnings by analyzing the utility's **capital structure** and allocating a different weighted cost to each of the individual elements of the **capital structure**, including debt. Therefore, utility owners can earn on debt only what it costs them to secure the leverage.

Energy & Utilities Law > Utility Companies > Rates > General Overview

[HN11](#) Utility Companies, Rates

Double leveraging is an extension of the leveraging concept to a parent-subsidiary corporate relationship. For example, Company A is an operating utility financed partly with debt capital and partly with equity capital. It

uses leverage as explained above. However, the common stock of Company A is owned by Company B, the parent company. Company B obtained the funds it invested in the common stock of Company A by raising its own capital through the sale of stock and from a debt issue. Thus Company A enjoys its own leverage factor plus the leverage factor of Company B. This is the essence of the meaning of double leverage.

Energy & Utilities Law > ... > Rates > Ratemaking Factors > Rate of Return

Energy & Utilities Law > Utility Companies > Rates > General Overview

[HN12](#) Ratemaking Factors, Rate of Return

The double leverage approach recognizes that a wholly owned subsidiary does not raise capital in the open market. In fact, the subsidiary's true cost of equity depends on the parent company's combined cost of capital which is substituted for the subsidiary's cost of equity in computing the utility's rate of return. The attractiveness of the company as an investment is dependent on how attractive the parent company is as an investment.

Energy & Utilities Law > ... > Rates > Ratemaking Factors > **Rate of Return**

Energy & Utilities Law > Utility Companies > General Overview

Energy & Utilities Law > Utility Companies > Rates > General Overview

[HN13](#) Ratemaking Factors, Rate of Return

There are two circumstances in which a utility commission might disregard a utility's actual **capital structure** and adopt a hypothetical **capital structure** for ratemaking purposes. The first occurs when the utility's actual debt-equity ratio is deemed inefficient and unreasonable because it contains too much equity and not enough debt, necessitating an inflated **rate of return**. The second circumstance that justifies adopting a hypothetical construct occurs when the utility is part of a holding company system. In such situations, the utility's book **capital structure** and capital costs may not be a true reflection of the system's capital costs with

State ex rel. Associated Natural Gas Co. v. Public Service Com.

respect to a particular operating company. Double leveraging represents one approach utilized by regulatory agencies to account for a utility's status as a subsidiary in a holding company system. Moreover, it is only the parent's alleged use of its low cost debt to purchase stock in its subsidiary that serves as the principle behind the application of double leveraging.

Energy & Utilities Law > Utility
Companies > Rates > General Overview

Energy & Utilities Law > Regulators > Public Utility
Commissions > Ratemaking Procedures

[HN14](#) **Utility Companies, Rates**

The rate-making process i.e., the fixing of "just and reasonable" rates, involves a balancing of the investor and the consumer interests.

Energy & Utilities Law > Administrative
Proceedings > Judicial Review > General Overview

Energy & Utilities Law > Utility
Companies > Rates > General Overview

[HN15](#) **Administrative Proceedings, Judicial Review**

If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry is at an end.

Energy & Utilities Law > Administrative
Proceedings > Judicial Review > General Overview

Energy & Utilities Law > Utility
Companies > Rates > General Overview

Energy & Utilities Law > ... > Rates > Ratemaking
Factors > Rate of Return

[HN16](#) **Administrative Proceedings, Judicial Review**

[Mo. Rev. Stat. § 393.150](#) (Supp. 1985) authorizes the Missouri **Public Service Commission** to fix gas rates after a formal hearing. The statute neither prescribes nor limits the methodology that the Commission may use in determining rates. The complexities inherent in a

rate of return determination necessarily require that the Commission be granted considerable discretion.

Energy & Utilities Law > Utility
Companies > Rates > General Overview

[HN17](#) **Utility Companies, Rates**

Because ratemaking is not an exact science, the utilization of different formulas is sometimes necessary.

Energy & Utilities Law > Utility
Companies > Rates > General Overview

Energy & Utilities Law > Regulators > Public Utility
Commissions > Ratemaking Procedures

[HN18](#) **Utility Companies, Rates**

Consideration must be given to the actual equity owner in the ratemaking process.

Energy & Utilities Law > Utility
Companies > Rates > General Overview

[HN19](#) **Utility Companies, Rates**

Once the utility asks for higher rates, a commission may inquire into the utility's capital structure and apply a hypothetical construct.

Energy & Utilities Law > Administrative
Proceedings > Judicial Review > General Overview

Energy & Utilities Law > Administrative
Proceedings > General Overview

Energy & Utilities Law > Utility
Companies > Rates > General Overview

[HN20](#) **Administrative Proceedings, Judicial Review**

The discretion accorded the **public service commission** in ratemaking limits judicial review. The method for determining rates are for the commission, and on this point the court is concerned only if constitutional limitations are transgressed. As to

State ex rel. Associated Natural Gas Co. v. Public Service Com.

whether the resultant rate is confiscatory, the utility has the burden of proof. The commission's order will not be set aside unless confiscation is clearly established. If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry is precluded. That the method employed to reach the result may contain infirmities is not important.

Counsel: Charles G. Siebert, August L. Griesedieck, Ann E. Buckley, Schlafly, Griesediech, Toft & Virtel, St. Louis, Missouri - Attorneys for Relator-Appellant Associated Natural Gas Company.

Martin C. Rothfelder, Assistant General Counsel, Missouri **Public Service Commission**, Jefferson City, Missouri.

Richard W. French, First Assistant Public Counsel, Jefferson City, Missouri, Attorney for Respondent Office of the Public Counsel.

Judges: Manford, P.J., Pritchard and Harold L. Lowenstein, JJ.

Opinion by: LOWENSTEIN

Opinion

[*872] In December, 1982, the appellant Associated Natural Gas Company (Company), a public utility, applied with the Missouri **Public Service Commission** (Commission) for a rate increase for gas service provided in its Missouri service area. After hearing, the Commission issued an order permitting a rate increase which would generate gross revenues in an amount substantially less than that requested by the appellant. At the heart of this appeal is the issue whether in the ratemaking process the Commission can consider [*2] the financial structure of a corporate parent in determining the service rates of the subsidiary, a Missouri utility. This court considers the validity of the

use of this concept, known as "double leveraging," for the first time. Its use by the commission under the facts of this case is strenuously attacked by the utility company.

The Company, whose home office is in Blytheville, Arkansas, is a wholly owned subsidiary of Arkansas Power and Light (APL), an electric utility doing business and regulated in Missouri. In turn, all of APL's common stock is owned by Middle South Utilities (MSU), a public utility holding company. MSU's common stock is market traded whereas the Company's and APL's is not.

The Company supplies natural gas to a total of about 45,000 customers in southeast Missouri and in the Butler and Kirksville areas. The Company applied for increases in residential rates to raise gross revenues by \$1,857,323. The Commission authorized tariffs which increased gross revenues by \$437,111. The circuit court affirmed the Commission.

In substance, the Company contends the Commission's use of "double leveraging" lowered the rate increase below what was just and reasonable. [*3] The Commission consolidated the capital structure of the Company and APL and MSU to arrive at a rate increase it deemed fair and permissible. Stripped of all the jargon, the Company asserts that only its financial figures should have been used in the rate determination and that the Commission's formula lowered the return to the company by 15%, resulting "in a loss of about \$1,100,000."

HN1 [↑] An essential function of the Commission in the ratemaking process is to determine an appropriate rate of return. Typically, the rate of return is designed to provide sufficient revenue to cover the utility's total cost of service. Such costs include both the operating expenses of the utility and an adequate "return" on the investment in property and equipment serving the public. [*Central Maine Power Co. v. Public Utilities Commission*, 455 A.2d 34, 38 \(Me. 1983\).](#)

[*873] Two leading United States Supreme Court decisions are instructive in arriving at what constitutes a just and reasonable rate:

HN2 [↑] A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being [*4] made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding

State ex rel. Associated Natural Gas Co. v. Public Service Com.

risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties.

[Bluefield Water Works & Improvement Co. v. Public Service Commission, 262 U.S. 679, 692-93, 67 L. Ed. 1176, 43 S. Ct. 675 \(1923\).](#)

The Commission [is] not bound to the use of any single formula or combination of formulae in determining rates. Its rate-making function, moreover, involves the making of "pragmatic adjustments." And when the Commission's order is challenged in the courts, the question is whether that order "viewed in its entirety" meets the requirements of the Act. Under the statutory standard of "just and reasonable" it is the result reached not [**5] the method employed which is controlling. It is not theory but the impact of the rate order which counts. *If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the Act is at an end.* The fact that the method employed to reach that result may contain infirmities is not then important. Moreover, the Commission's order does not become suspect by reason of the fact that it is challenged. It is the product of expert judgment which carries a presumption of validity. And he who would upset the rate order under the Act carries the heavy burden of making a convincing showing that it is invalid because it is unjust and unreasonable in its consequences.

The rate-making process under the Act, i.e., the fixing of "just and reasonable" rates, involves a balancing of the investor and the consumer interests. . . . It is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding [**6] risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise.

[Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 602-03, 88 L. Ed. 333, 64 S. Ct. 281 \(1944\)](#) (citations omitted) (emphasis added).

In other words, [HN3](#) [↑] the ratemaking function must provide sufficient income to cover the utility's operating expenses and debt service. [United States v. Federal Communications Commission, 227 U.S. App. D.C. 413, 707 F.2d 610, 612 \(D.C. Cir. 1983\)](#). In addition, there must be enough revenue generated as a return to the owners of the company's stock to assure confidence in the continued financial services of the business and to attract equity investors. [Hope Natural Gas, supra, 320 U.S. at 603](#). The rate of return should not be higher than is necessary to achieve these goals. Otherwise, utility customers will pay excessive prices, something regulation seeks to prohibit. [In re Permian Basin Area Rate Cases, 390 U.S. 747, 791-92, 20 L. Ed. 2d 312, 88 S. Ct. 1344 \(1968\)](#).


As is applicable here, the ratemaking process requires the regulatory body to determine the utility's cost of capital (debt and equity [**7] costs). These calculations result in a percentage figure which is then [**874] multiplied by the value of assets used in production of the utility service to ultimately arrive at a rate charge that will not be burdensome to the customer and at the same time will be just and reasonable to the Company.

The Company raises numerous points and subpoints on appeal whereby it contends that the trial court erred in affirming the Commission's report and order: 1) the Company primarily complains of the Commission's use of the double leverage methodology under the facts in this case in arriving at a rate of return; 2) the Commission erred in using the figures of independent, unregulated, out-state utilities which provide a different product; 3) the effect of the order was confiscatory and violative of due process; and 4) the Commission erred in following the testimony of the staff witness.

[HN4](#) [↑] The proceedings and order of the Missouri [Public Service Commission](#) are administrative by nature. Appellate review of such orders and proceedings is governed by [Mo. Const. art. V, § 18](#): "Such review shall include the determination whether the same are authorized by law, and in cases in which a hearing [**8] is required by law, whether the same are supported by competent and substantial evidence on the whole record."

[HN5](#) [↑] On appeal, this court's role is to determine whether the Commission's report and order was lawful and reasonable. [State ex rel. Utility Consumers Council](#)


of Missouri, Inc. v. Public Service Commission, 585 S.W.2d 41, 47 (Mo. banc 1979). The lawfulness of a **Public Service Commission** order depends on whether it issued under statutory authority. State ex rel. Gulf Transport Co. v. Public Service Commission, 658 S.W.2d 448, 452 (Mo. App. 1983). In determining the statutory authorization for or lawfulness of the order, the court need not defer to the Commission. State ex rel. Utility Consumer's Council of Missouri, supra, 585 S.W.2d at 47. However, as to matters of reasonableness, the court cannot substitute its judgment for that of the Commission if it is supported by substantial and competent evidence on the record as a whole. *Id.*

HN6  Since the reviewing court is not authorized to weigh the evidence heard by the Commission, the Commission's findings are prima facie correct. In other words, the order is presumed valid. State ex rel. Ashcroft v. Public Service Commission, 674 S.W.2d 660, 662 (Mo. App. 1984). The burden is on the party attacking the validity of the Commission's order. State ex rel. Utility Consumer's Council of Missouri, supra, 585 S.W.2d at 47. Under § 386.430, RSMo 1978 (all statutory references are to RSMo 1978 unless otherwise indicated), the Company as the challenger carries the burden of showing by "clear and satisfactory evidence" that the order or decision is unlawful or unreasonable. The Commission's action warrants reversal only if it appears arbitrary, capricious, and without reasonable basis. State ex rel. Missouri Power and Light Co. v. Public Service Commission, 669 S.W.2d 941, 944 (Mo. App. 1984).

Although ratemaking guidelines appear simple, the actual implementation of ratemaking employs complicated and sophisticated theories accompanied by few givens and many variables. The transcript and exhibits in this case are extensive. The Company and the Commission have done little to explain the expert testimony and exhibits. Jargon and terms commonly used by economists in this area have little or no meaning to persons lacking expertise in the methodology of utility finance. Counsel are urged ****10** in these cases to make some effort to explain in their briefs and to make an understandable record of what "double leverage" and similar terms are and what they mean. Otherwise, court review is reduced initially to a project analogous to translating and deciphering the Rosetta Stone. As stated by the court in New England Telephone & Telegraph Co. v. Public Utilities Commission, 459 A.2d 1381 (R.I. 1983), the "terminology and the testimony of expert witnesses . . .

achieve ****875** flights of rare sophistication into the arcane and the incomprehensible." Id. at 1386.

For the benefit of the reader, the court now sets out a glossary of financial terms related to the "double leverage" concept:

HN7  1. Cost of Capital -- amount a utility must pay to secure financing from debt and equity (stock) investors; cost of capital is essentially the equivalent of fair rate of return.

Calculation of cost of capital entails three steps:

- (a) determine the cost of different components of capital, i.e., debt and equity
- (b) determine weighted cost for each item -- multiply cost of item by its ratio to total capital
- (c) add weighted costs -- sum equals rate of return

****11**


New England Telephone and Telegraph Co. v. Public Utilities Commission, 390 A.2d 8, 32 (Me. 1978).

 [Go to table1](#)

2. Cost of Equity Stock Using Discounted Cash Flow (DCF) Model -- dividend yield plus expected growth in value of equity investors' investment, i.e., yield + growth = bare cost of equity. General Telephone Company of the Midwest v. Iowa State Commerce Commission, 275 N.W.2d 364, 369 (Iowa 1979); New England Telephone and Telegraph, supra, 390 A.2d at 36.

 [Go to table2](#)

3. Rate of Return -- cost of capital. (See #1 *supra*). Rate of return may be expressed as the return a utility earns on its investment in property serving the public. New England Telephone and Telegraph, supra, 390 A.2d at 30.

HN8  4. Fair Rate of Return -- a rate of return that "covers utility operating expenses, debt service, and dividends, if it compensates

investors **[**12]** for the risks of investment, and if it is sufficient to attract capital and assure confidence in the enterprise's financial integrity." [Massachusetts Electric Co. v. Department of Public Utilities, 376 Mass. 294, 381 N.E.2d 325, 328 \(Mass. 1978\)](#). This return should be roughly equivalent to the return offered by similarly situated businesses in the same industry. [General Telephone Company of the Midwest, supra, 275 N.W.2d at 368](#).

5. Rate Base -- utility property that provides the service for which rates are charged, *i.e.*, total property investment used and useful at the time of the rate commission inquiry. [United Telephone Company of Iowa v. Iowa State Commerce Commission, 257 N.W.2d 466, 468 \(Iowa 1977\)](#); [New England Telephone and Telegraph, supra, 390 A.2d at 14](#).

6. Ratemaking Equation -- rate base X rate of return = profit. [General Telephone Company of the Midwest, supra, 275 N.W.2d at 370](#).

[*876] Since the propriety of double leveraging in this case is one of first impression in Missouri, it may also be useful to explain what double leveraging is and what it accomplishes. [HN9](#) Corporations typically are financed with both debt (borrowed **[**13]** money) and equity capital (proceeds from stock offerings). "Leveraging" is a financial term used to describe the situation in which a corporation is funded by debt in addition to the equity supplied by stockholders. [Arkansas Public Service Commission v. Lincoln-Desha Telephone Co., 271 Ark. 346, 609 S.W.2d 20, 22 \(Ark. 1980\)](#); [New England Telephone and Telegraph Co., supra, 390 A.2d at 40](#); [General Telephone Company of the Southwest v. Corporation Commission, 98 N.M. 749, 652 P.2d 1200, 1205 \(1982\)](#).

[HN10](#) A corporation is "leveraged" to the extent that debt is included in its **capital structure**. The leverage arises from the advantage equity holders gain through the rental of capital at a lower rate than the return they receive on their equity. Leverage allows equity owners to earn an over-all **rate of return** in excess of the cost of capital. The added earnings above the cost of borrowed capital inure to the benefit of the stockholders who receive a higher **rate of return** than if the corporation had been financed entirely by equity. [Arkansas Public Service Commission, supra, 609](#)

[S.W.2d at 22](#). Utility regulators prevent these excess earnings by analyzing the utility's **capital** **[**14]** **structure** and allocating a different weighted cost to each of the individual elements of the **capital structure**, including debt. Therefore, utility owners can earn on debt only what it costs them to secure the leverage. [New England Telephone and Telegraph Co., supra, 390 A.2d at 41](#); [General Telephone Company of the Southwest, supra, 652 P.2d at 1205](#). In sum, it generally costs less for a corporation to borrow money and pay interest than to issue stock and pay dividends. If the cost of debt is 8% and the cost of equity capital is 10%, to the extent a utility can borrow at 8% and earn a 10% rate of return, it gains excess earnings.

Today, it is becoming more common for a utility to operate as a wholly owned subsidiary of a parent holding company. [HN11](#) Double leveraging is an extension of the leveraging concept to a parent-subsidary corporate relationship. For example, Company A is an operating utility financed partly with debt capital and partly with equity capital. It uses leverage as explained above. However, the common stock of Company A is owned by Company B, the parent company. Company B obtained the funds it invested in the common stock of Company A by raising its own **[**15]** capital through the sale of stock and from a debt issue. Thus Company A enjoys its own leverage factor plus the leverage factor of Company B. This is the essence of the meaning of double leverage. [New England Telephone and Telegraph, supra, 390 A.2d at 41](#).

The objective of leveraging or double leveraging is to apply a rate of return on the rate base in proportion to the weighted cost of capital. [New England Telephone & Telegraph Co., supra, 459 A.2d at 1386](#). The principle behind the double leverage adjustment is to account for the parent's alleged use of low cost debt to acquire equity in its subsidiary, upon which it may earn a higher rate of return than it pays for the debt. If the cost of capital to the utility is considered without regard to the double leverage enjoyed in a parent-subsidary relationship, an *excessive return* to the ultimate common stockholders could result at the expense of utility ratepayers. [New England Telephone and Telegraph, supra, 390 A.2d at 41](#); [General Telephone Company of the Southwest, supra, 652 P.2d at 1205](#); see also [Southwestern Bell Telephone Co. v. Arkansas Public Service Commission, 267 Ark. 550, 593 S.W.2d \[**16\] 434, 444 \(1980\)](#); [United Telephone Company of Iowa, supra, 257 N.W.2d at 480](#). Double leveraging also prevents discrimination against

State ex rel. Associated Natural Gas Co. v. Public Service Com.

companies not involved in leveraging on a parent-subsubsidiary basis. [New England Telephone and Telegraph, supra, 390 A.2d at 42.](#)

HN12 [↑] The double leverage approach recognizes that a wholly owned subsidiary like the Company does not raise capital in the open **[*877]** market. In fact, the subsidiary's true cost of equity depends on the parent company's combined cost of capital which is substituted for the subsidiary's cost of equity in computing the utility's rate of return. *Tennessee-American Water Company v. Tennessee **Public Service Commission***, No. __, slip op. at __ (Tenn. Ct. App. Apr. 11, 1985). "The attractiveness of the company as an investment is dependent on how attractive the parent company is as an investment." [General Telephone Company of the Midwest, supra, 275 N.W.2d at 369.](#)

In applying the double leverage concept in this case, the Commission emphasized that the economic relationships existing between the parent and subsidiary companies made it possible to assign the *cost of parent capital* as the subsidiary's **[**17]** *cost of equity*. In other words the Company is the wholly owned subsidiary of APL and APL is the wholly owned subsidiary of MSU. The common stock of both subsidiaries is not market traded. By contrast, MSU's common stock is market-traded, which means that a more direct and objective measure of its cost may be obtained. Guided by this rationale, the Commission assigned APL's *cost of capital* to the Company's *cost of equity*.

The Company wanted only its capital structure used in determining the increase. It asked for rates sufficient to earn a 16.5% return on equity, which would result in a 12.76% return on the rate base. The Commission's order, which applied double leveraging and was approved by the trial court, authorized a 14% return on the Company's equity, which computed to between an 11.17% and 11.66% return on its rate base. In doing so, the Commission approved a 15.15% return on equity for APL and MSU. The Commission made no adjustments between APL & MSU for return on equity because MSU's borrowed capital amounted to only 2.7% of its total **capital structure**. Thus, for purposes of determining the Company's **rate of return**, APL & MSU's return on equity were considered **[**18]** as the same. The Appendix to the opinion generally shows where the final figures came from. The Commission said the 14% figure for the Company was a fair **rate of return** and the 15.15% return on equity for MSU compared favorably with that of other electric utilities.

Several courts have approved the concept and application of "double leverage" in the ratemaking process. See [Southwestern Bell Telephone Company v. Arkansas **Public Service Commission**, 267 Ark. 550, 593 S.W.2d 434 \(Ark. 1980\); United Telephone Company of Iowa v. Iowa State Commerce Commission, 257 N.W.2d 466 \(Iowa 1977\); New England Telephone & Telegraph Co. v. Public Utilities Commission, 448 A.2d 272 \(Me. 1982\); Mountain States Telephone and Telegraph Co. v. Department of Public Service Regulation, 624 P.2d 481 \(Mont. 1981\); General Telephone Company of the Southwest v. Corporation Commission, 98 N.M. 749, 652 P.2d 1200 \(1982\); Bristol County Water Co. v. Harsch, 120 R.I. 223, 386 A.2d 1103 \(1978\); General Telephone Company of the Southeast v. **Public Service Commission** of the State of Tennessee, No. 84-321-II, slip op. at __ \(Tenn. Ct. App. Feb. 6, 1985\). General Telephone Company **\[**19\]** of the \[Southwest v. Public Utility Commission of Texas, 628 S.W.2d 832 \\(Tex. Ct. App. 1982\\).\]\(#\)](#)

The Company alleges the funds APL used to purchase the Company's stock must be traced. It objects to the Commission's imposition of a hypothetical structure upon the Company through double leveraging. In fact, the Company itself has no quarrel with the use of double leveraging by regulatory bodies, for in its reply brief the Company states: "Associated does not contend that double leverage may not be used in a lawful manner on some given fact situations, but simply that such facts are not present in this case." This position is somewhat at odds with the Company's negative stance in its main brief. The crux of the Company's argument is that the Commission should not have used double leveraging in this case because APL did not borrow any money to acquire the company's stock. APL acquired its interest in the Company in a stock for stock exchange. According to the Company, **[*878]** double leveraging is permissible only in situations in which a parent corporation issues unrestricted debt, the proceeds of which are used to invest in the stock of its subsidiary.

The Commission based **[**20]** the use of double leveraging on the testimony of staff witness Kemp. The Company further complains that staff witness Kemp based his testimony on theoretical assumptions. Kemp recognized that as a practical matter APL did not use debt proceeds to purchase the Company's stock. However, he testified that double leveraging is appropriate here because all sources of APL's available capital could theoretically be used to finance the investment in the subsidiary company. Because APL

acquired equity ownership of the Company in a stock for stock transaction, the Company contends that its acquisition cannot be traced to a debt issue by APL, and therefore double leveraging in this case is inapplicable.

Though this court can point to no cases in which a regulatory body applied double leveraging in a stock for stock exchange context, there are several cases which lead the court to reject the Company's argument. [General Telephone Company of the Southwest, supra](#), states the double leverage approach "assumes the parent corporation finances its subsidiary's equity capital in proportion to its own debt and equity and imputes that levered cost of equity as the cost of equity to the subsidiary." **[**21]** [628 S.W.2d at 838](#) (emphasis added). The rationale behind the *assumption* is that it is impossible to trace all investment dollars contributed by the parent to the subsidiary. [Id. at 843](#). This is so even though the particular acquisition of the subsidiary might involve a *stock transaction* because "the actual company is financed as a total entity and, therefore, the double leverage will still apply." *Id.*

Though the opinion in [New England Telephone and Telegraph v. Public Utility Commission, 459 A.2d 1381 \(R.I. 1983\)](#), does not elaborate on the facts in that case, it does suggest that AT & T, the parent, used its shares of stock to purchase the remaining outstanding interest in its subsidiary, New England Telephone (NET). [Id. at 1387](#). The court found that fact irrelevant with respect to double leveraging since the Commission's order provided a reasonable **rate of return** to be applied to the common stockholders of AT & T, who were the equity owners in NET. [Id. at 1386-87](#).

What the Missouri Commission has in effect done is to adopt a hypothetical **capital structure** for ratemaking purposes without regard to the manner in which APL acquired equity ownership of **[**22]** the Company. It appears to be an accepted regulatory practice to disregard the actual book **capital structure** of a utility when it is deemed to be in the public interest to do so. [New England Telephone and Telegraph, supra, 390 A.2d at 39](#). **HN13**[↑] There are two circumstances in which a utility commission might disregard a utility's actual **capital structure** and adopt a hypothetical **capital structure** for ratemaking purposes.

The first occurs when the utility's actual debt-equity ratio is deemed inefficient and unreasonable because it contains too much equity and not enough debt, necessitating an inflated **rate of return**. *Id.* This situation existed in [Communications Satellite Corp. v.](#)


[Federal Communications Commission, 198 U.S. App. D.C. 60, 611 F.2d 883 \(D.C. Cir. 1977\)](#) (COMSAT), in which the company was 100% equity financed. The Commission there imputed a 45% debt ratio which was admittedly a hypothetical construct. [Id. at 898, 902](#). In approving the Commission's action, the United States Court of Appeals for the District of Columbia stated that the "authority of a public utility commission . . . to assume hypothetical debt for a company derives from its jurisdiction over **[**23]** rates charged by the company, that they be 'just and reasonable.'" [Id. at 903](#).

The second circumstance that justifies adopting a hypothetical construct occurs when the utility is part of a holding company system. In such situations, the utility's book capital structure and capital costs may not be a true reflection of the system's capital costs with respect to a particular **[*879]** operating company. Double leveraging represents one approach utilized by regulatory agencies to account for a utility's status as a subsidiary in a holding company system. [New England Telephone and Telegraph, supra, 390 A.2d at 39](#). Moreover, it is only the parent's *alleged* use of its low cost debt to purchase stock in its subsidiary that serves as the principle behind the application of double leveraging. [Id. at 41](#).

The case cited by the Company in support of its proposition that double leveraging by its own terms requires that a parent use debt issue proceeds to acquire equity in its subsidiary states: "The principle behind the double leverage adjustment is to account for the parent's *accessibility* to lower cost debt to purchase equity in its subsidiary, upon which it may earn **[**24]** a higher rate of return than it pays for the debt." [General Telephone Company of the Southwest, supra, 652 P.2d at 1205](#) (emphasis added). Actually, the *General Telephone* court cites to the *New England Telephone and Telegraph* case, which refers to the "alleged" use of debt, for the quoted statement. See [New England Telephone and Telegraph, supra, 390 A.2d at 41](#). Neither case states that application of double leverage mandates that a parent use debt proceeds to purchase the equity in a subsidiary.


The Commission's assumption that *all* sources of capital available to APL could theoretically be used to finance the investment in the company squares with the principle behind double leveraging. This assumption renders a stock for stock exchange irrelevant. The Commission's action is analogous to the COMSAT case, *supra*, where the Commission imputed hypothetical debt financing even though the company


was 100 percent equity financed. In the present case, the Commission imputed hypothetical debt and equity financing (leveraging) by APL even though APL's investment in the Company was the result of a stock for stock exchange.

Perhaps the ultimate authority for imputing **[**25]** debt and equity financing when necessary to protect ratepayers from excessive charges is the Supreme Court's statement in *Hope Natural Gas*: [HN14](#)  "The rate-making process under the Act, *i.e.*, the fixing of 'just and reasonable' rates, involves a balancing of the investor and the consumer interests." [Hope Natural Gas, supra, 320 U.S. at 603](#). The ratepayer should not be placed at an unfair disadvantage simply because APL chose to invest in the Company through a stock for stock exchange rather than through direct debt financing.


APL's method of acquiring the Company was determined by the management of the two companies, not by the rate order of the Commission. The record establishes that the Commission applied the double leverage adjustment in order to protect Missouri rate payers from paying excessive gas utility rates. The Commission fulfilled its function when it established a fair and reasonable rate of return by employing double leveraging. See [Mountain States Telephone and Telegraph Co., supra, 624 P.2d at 486](#).

The Company's argument that the fact that all other costs (income tax expense and cost of debt) were based on consideration of appellant as an independent **[**26]** company warrants independent treatment of the company in calculating its cost of equity is also without merit.

In approving the Commission's application of double leverage in this case, the court emphasizes that it is not methodology or theory but the impact of the rate order which counts in determining whether rates are just, reasonable, lawful, and nondiscriminating. [Southwestern Bell Telephone Co., supra, 593 S.W.2d at 445](#); [New England Telephone and Telegraph, supra, 390 A.2d at 32](#). In the words of the Supreme Court: [HN15](#)  "If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry . . . is at an end." [Hope Natural Gas, supra, 320 U.S. at 602](#).

[HN16](#)  [Section 393.150, RSMo Supp. 1985](#), authorizes the Commission to fix gas rates **[*880]** after a formal hearing. The statute neither prescribes nor limits the methodology that the Commission may use in

determining rates. The complexities inherent in a rate of return determination necessarily require that the Commission be granted considerable discretion. [United Telephone Company of Iowa, supra, 257 N.W.2d at 480](#).

[HN17](#)  Because ratemaking is not an exact science, the utilization of different **[**27]** formulas is sometimes necessary. [United States v. Federal Communications Commission, 227 U.S. App. D.C. 413, 707 F.2d 610, 618 \(D.C. Cir. 1983\)](#). For this reason, the fact that the Missouri Commission has never before applied double leveraging in determining rates for the Company is of no consequence. The Supreme Court of Arkansas, in dealing with this issue, stated that there is no "judicial mandate requiring the Commission to take the same approach to every rate application, or even to consecutive applications by the same utility, when the commission, in its expertise, determines that its previous methods are unsound or inappropriate to the particular application." [Southwestern Bell Telephone Co., supra, 593 S.W.2d at 445](#).

Not only can the Commission select its methodology in determining rates and make pragmatic adjustments called for by particular circumstances, but it also may adopt or reject any or all of any witnesses' testimony. [In re Permian Basin Area Rate Cases, supra, 390 U.S. at 800](#). Evaluation of expert testimony was for the Commission. [Southwestern Bell Telephone Co., supra, 593 S.W.2d at 445-46](#). The testimony and exhibits incorporated into the record **[**28]** provide a sufficient foundation for the Commission's application of double leverage in the Company's case. The rate of return on equity of 14% was based upon competent and substantial evidence on the whole record. The result reached by the Commission was reasonable and lawful, and as stated in [Hope Natural Gas, supra](#), judicial inquiry is at an end.

II.

The Company's second point alleges a violation of equal protection and due process because the Commission was not statutorily authorized to consider MSU's cost of equity in the Company's rate hearing. The Company sets out several factors to bolster this proposition: (a) MSU is not regulated in Missouri; (b) MSU is an electric supplier, not a gas supplier; (c) MSU is totally separate from the Company; (d) All other costs of the Company used in setting the rates were based on consideration of the Company as an independent entity, with the exception that the Commission used MSU's cost of equity in determining the Company's cost of equity; and

State ex rel. Associated Natural Gas Co. v. Public Service Com.

(e) Sections 393.140(12) and 393.230(3) and (4), RSMo. Supp. 1985, prohibit the consideration of unregulated activities of a company, and therefore the order went beyond the law.

This argument **[**29]** and the proposed statutory interpretation are without citation of authority and not well taken. None of the cases mentioned in Part I contain any language that precludes the application of double leveraging because the parent is from out-of-state or is not in business to supply the exact same service as the applicant. In fact, the jurisdictional argument as presented here was specifically rejected in *General Telephone Company of the Southwest, supra*, 628 S.W.2d at 836-38. Section 393.140(12), which does prohibit regulation of "any other business" of the utility "not otherwise subject to the jurisdiction of the commission," also states that it shall not restrict the Commission's "right to inquire as to, and prescribe the apportionment of, capitalization, earnings, debts and expenses fairly and justly to be . . . borne by" the utility in question.

Again, without citation of authority, the Company argues the underscored language of section 393.270(4) prohibits the consideration of finances of any company other than the applicant for a rate increase:

4. In determining the price to be charged for gas, electricity, or water the commission may consider all facts which **[*881]** **[**30]** in its judgment have any bearing upon a proper determination of the question although not set forth in the complaint and not within the allegations contained therein, with due regard, among other things, to a reasonable average return upon capital actually expended and to the necessity of making reservations out of income for surplus and contingencies.

This argument fails to give any credence to the language that says "due regard" should be given to capital actually expended and to the language that says the Commission may "consider all facts" in its judgment that bear upon the question of price. In any event, what the Company cannot counter is that it is a wholly owned subsidiary which means the equity owner(s) are APL and ultimately MSU.

As stated earlier, *Hope Natural Gas, supra*, 320 U.S. at 603, makes it clear **HN18**[↑] consideration must be given to the actual equity owner in the ratemaking process. *Hope Natural Gas* specifically approves the Commission's consideration of the return to the "investor" or "equity owner." The use of a cost-of-capital approach as to the ultimate shareholder seems totally

consistent with that language. See Copeland, *Double Leverage* **[**31]** *One More Time*, 105 Pub. Util. Fort. 19 (1977). The conscious and voluntary corporate business decision that resulted in the hierarchy as exists here should not and cannot shield pertinent financial data from the Commission's scrutiny just because the ultimate owner does not provide the same service as the applicant and is not regulated. Also, **HN19**[↑] once the utility asks for higher rates, a commission may inquire into the utility's capital structure and apply a hypothetical construct. Cf. *Northwestern Bell Telephone Co. v. Iowa State Commerce Commission*, 359 N.W.2d 491, 497 (Iowa 1984). This **capital structure** was determined by the management of the companies, not by the rate order of the Commission. See *Mountain States Telephone and Telegraph, supra*, 624 P.2d at 486. Despite the Company's contention that it is operationally and financially independent from APL or MSU, it is hard to believe a wholly owned subsidiary could be as autonomous as is here claimed. Application of the double leverage method to determine a fair **rate of return** has not deprived the company of due process or equal protection of the law. *General Telephone Company of the Southwest, supra*, 652 P.2d **[**32]** at 1206.

III.

The Company next complains that substituting APL's weighted cost of capital for the Company's cost of contributed equity reduced the Company's return on equity to the extent it was confiscatory. It argues the Commission's adoption of a 14% return on equity for the Company reduces the "financial value of Associated's investment in Missouri rate base by up to 15% . . . and deprives its investor of their [sic] property . . . without due process of law in violation" of the U.S. Const. amend. XIV and *Mo. Const. art. I, § 10*. The Company does not address the issue of the stockholder's (APL) right to a fair and reasonable return on its investment. See *State ex rel. Missouri Water Co. v. Public Service Commission*, 308 S.W.2d 704, 718 (Mo. 1957); *State ex rel. Missouri Public Service Commission v. Fraas*, 627 S.W.2d 882, 886 (Mo. App. 1981).

As stated previously, **HN20**[↑] the discretion accorded the Commission in ratemaking limits judicial review. The method for determining rates are for the Commission, and on this point the court is concerned only if constitutional limitations are transgressed. As to whether the resultant rate is confiscatory, the utility has the burden **[**33]** of proof. The Commission's order will not be set aside unless confiscation is clearly

established. *St. Joseph Stock Yards Co. v. United States*, 298 U.S. 38, 53, 80 L. Ed. 1033, 56 S. Ct. 720 (1936); *Los Angeles Gas & Electric Corp. v. Railroad Commission*, 289 U.S. 287, 304-05, 77 L. Ed. 1180, 53 S. Ct. 637 (1933). If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry is precluded. That the method employed to reach the result may contain infirmities is **[*882]** not important. *Hope Natural Gas*, supra, 320 U.S. at 602-03.

When the Company talks of the harm to its investor (here it refers to APL) and the confiscatory effect of the Commission's order, it bolsters the use of double leveraging and consideration of the parent's cost of capital in determining the utility's needs. The utility on one hand cannot ask to be treated as a stand alone entity and on the other hand argue its sole stockholder and ultimate parent must be given consideration in the setting of the Company's rates. As previously stated, the corporate structure and ownership here has been created willingly in a business enterprise. "Double leverage methodology **[**34]** recognizes the financing of equity for a subsidiary . . . [results] from boardroom decisions made by a parent corporation which controls, to a great extent, the ultimate cost of a subsidiary's equity." *General Telephone Company of the Southwest*, supra, 628 S.W.2d at 838.

Also without merit is the Company's argument that the low rate of return incurred through the use of double leveraging will deter a potential purchaser from buying the Company. As a sidelight to this action, the court notes in 1971 the Securities and Exchange Commission (SEC) ordered MSU to divest its gas properties. Since that time, MSU has accepted no offers, and the Commission found no offers imminent even before this action and the use of the double leverage adjustment. In the order under review, the Commission correctly found the SEC order irrelevant because the rates would have to be adjusted and re-figured depending on the status of the new owner.

The Company's confiscation argument is unsupported by evidence and is merely a recitation of the Company's conclusion. See *Beaumont, S.L. & W. Ry. v. United States*, 282 U.S. 74, 88-89, 75 L. Ed. 221, 51 S. Ct. 1 (1930). Other than abstractly concluding **[**35]** the 14% rate of return is confiscatory, the Company has not come close to carrying the burden of showing the rate fell outside the "zone of reasonableness." *In re Permian Basin Area Rate Cases*, supra, 390 U.S. at 747. As such, the Company has not supplied sufficient proof of

the confiscatory effect of the Commission's order. *Fraas*, supra, 627 S.W.2d at 886; *General Telephone Company of the Southeast*, supra. There is no basis in the record for this court to hold that the Commission's order results in a confiscation, *New England Telephone & Telegraph Company*, supra, 448 A.2d at 291, or that no new purchasers of the utility's common stock will come forward. The Commission merely attempts to preclude the investor from earning an excessive return at the expense of Missouri ratepayers. *Mountain States Telephone and Telegraph*, supra, 624 P.2d at 483. Because it failed to show under *Hope Natural Gas*, supra, that the rate order was unreasonable, the Company has not met its burden to warrant a reversal.

IV.

In its last point the Company argues the Commission should have accepted the testimony of its witness, Mr. Turner, as opposed to that of the staff witness, Mr. **[**36]** Kemp. The Company says its witness gave the only "competent testimony" on cost of equity. The innuendo is that witness Kemp was not competent. This argument has not been preserved nor is it meritorious. The Commission as the trier of fact was free to choose between conflicting testimony. *General Telephone and Telegraph Company*, supra, 390 A.2d at 36. The Commission accepted the testimony of Kemp, who was qualified as an expert. It was not error to do so.

The judgment is affirmed.

HAROLD L. LOWENSTEIN, JUDGE

APPENDIX

The Commission first had to determine APL's cost of capital. APL's capital structure consisted of three components: common equity, preferred stock, and long-term debt. Long term debt accounted for 57.23 percent of APL's capitalization. Preferred stock accounted for 13.04 percent and common equity accounted for 29.73 percent of **[*883]** capitalization. The Commission determined the cost of long term debt to be 10.43 percent and the cost of preferred stock to be 9.36 percent. These costs were derived solely from the recorded capital structure of APL.

As to APL's cost of equity, the Commission established that figure to be the same as MSU's. The Commission **[**37]** developed a cost of equity for MSU by using a variation of the discounted cash flow (DCF) model and adjusting the DCF result for flotation costs. The computations resulted in a 14.53 percent to 15.77 percent range of return on equity for MSU, with 15.15

percent being the midpoint. The Commission then plugged these figures into APL's cost of equity to arrive at APL's weighted cost of capital which ranged from 11.51 percent to 11.88 percent. Commission staff witness Kemp explained that he made no adjustments in APL's return on equity for the double leverage that existed between MSU and APL because the adjustments would have been insignificant given MSU's low debt ratio of 2.7 percent. **[**40]**

Using the 15.15 percent figure, the midpoint of MSU's cost of equity, the Commission calculated APL's weighted cost of capital (**rate of return**) to be 11.69 percent:

 [Go to table3](#)

[38]** At this point, the Commission employed the double leverage concept. The next step was to determine the Company's **capital structure**, which consisted of two components: long term debt and common equity. The Company's capitalization computed to a debt ratio of 47.95 percent and an equity ratio of 52.05 percent. The Company's cost of long term debt was 8.62 percent.

The Commission next categorized the common equity component as contributed equity and retained earnings. These items computed to a contributed equity ratio of 18.30 percent and a retained earnings ratio of 33.75 percent, totalling a common equity ratio of 52.02 percent. The following table simplifies the Company's **capital structure**:

 [Go to table4](#)

The Commission applied double leveraging in two respects to arrive at a **rate of return** for the Company. First, it assigned APL's *weighted cost of capital* (11.69%) as the Company's *cost of contributed equity*. Second, it assigned APL's *cost of equity* (15.15%), which equates with MSU's cost of equity, as the **[**39]** Company's *cost of retained earnings*.

[*884] The following table illustrates and hopefully simplifies the Commission's application of double leverage. The Company is identified as "Associated":

 [Go to table5](#)

 [Go to table6](#)

State ex rel. Associated Natural Gas Co. v. Public Service Com.

Table1 ([Return to related document text](#))

Example:

Item	<u>Capital Structure</u>		Cost		Weighted Cost
Debt	40%	X	8%	=	3.2%
Equity	60%	X	12%	=	7.2%
				=	10.4%
			<u>Rate of Return</u>		

Table1 ([Return to related document text](#))**Table2** ([Return to related document text](#))

Example:

Dividend Yield	+	Growth	=	Bare Cost of Equity
8.5%	+	1.25%	=	9.75%

Table2 ([Return to related document text](#))**Table3** ([Return to related document text](#))

	% of Total Capital		Cost		Weighted Cost of Capital
Common Equity	29.73%	X	15.15% (MSU's Cost of equity)	=	4.50%
Preferred Stock	13.04%	X	9.36%	=	1.22%
Long Term Debt	57.23%	X	10.43%	=	5.97%
				=	11.69%
			<u>Rate of Return</u>		

Table3 ([Return to related document text](#))**Table4** ([Return to related document text](#))

Component	% of Total Capital
Long Term Debt	47.95%
Common Equity	
(1) Contributed Equity	18.30%
(2) Retained Earnings	33.75%
	100.00%

Table4 ([Return to related document text](#))

State ex rel. Associated Natural Gas Co. v. Public Service Com.

Table5 ([Return to related document text](#))

Component	Capital Ratio		Associated's Cost	APL's Cost		Associated's Weighted Cost of Capital
Long Term Debt	47.95%	X	8.62%		=	4.13%
Contributed Equity *	18.30%	X		** 11.69%	=	2.13%
Retained Earnings	33.75%	X		*** 15.15%	=	5.11%
Totals	100.00%		Rate of Return		=	11.37%

Table5 ([Return to related document text](#))**Table6** ([Return to related document text](#))

Capital Ratio				APL's Cost		Associated's Weighted Cost
	APL-Associated					
APL Long Term Debt	57.23%	¹ 10.47%	X	10.43%	=	1.09
APL Preferred Stock	13.04%	² 2.39%	X	9.36%	=	.22
APL Common Equity	29.73%	³ 5.44%	X	15.15%	=	.82
Totals	100.00%	18.30%		Rate of Return	=	2.13

Table6 ([Return to related document text](#))

End of Document

** 11.69% represents APL's weighted cost of capital.

* Associated's cost of contributed equity equates with APL's Cost of capital (11.69%). The calculations are broken down as follows:

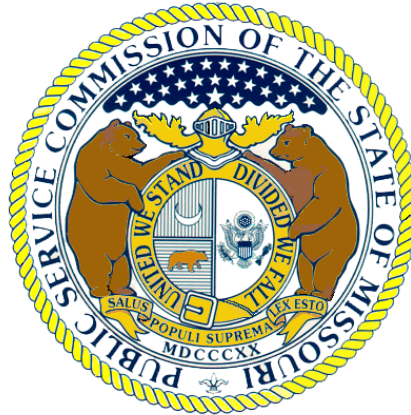
*** 15.15% represents APL's (and necessarily MSU's) cost of equity.

¹ 57.23% (APL) X 18.30% (Associated Contributed Equity) = 10.47%

² 13.04% (APL) X 18.30% (Associated Contributed Equity) = 2.39%

³ 29.73% (APL) X 18.30% (Associated Contributed Equity) = 5.44%

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



In the Matter of the Application of Rate)
Increase Request for Liberty Utilities)
(Missouri Water), LLC d/b/a Liberty Utilities)

File No. WR-2018-0170

REPORT AND ORDER

Issue Date: October 24, 2018

Effective Date: November 3, 2018

TABLE OF CONTENTS

Appearances	2
I. Procedural History	3
A. Case Filing and Consolidation	3
B. Intervention	4
C. The Partial Disposition Agreement	4
D. Local Public Hearings.....	5
E. The Non-Unanimous Stipulation and Agreement	5
F. Test Year	7
G. Motion to Strike Testimony of Keith Magee	8
H. Evidentiary Hearing	9
I. Case Submission	9
II. General Matters	10
A. General Findings of Fact	10
B. General Conclusions of Law	13
III. The Issues	16
A. Revenue Requirement	16
1. Return on Equity	21
2. Capital Structure	26
3. Rate Case Expense.....	30
B. Rate Design	32
1. Customer Charge/ Consolidation	32
2. Phase-in Rates	38
C. Future Rate Case Exemption	43
D. Customer Service	47
Ordered Paragraphs.....	52

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

In the Matter of the Application of Rate)
Increase Request for Liberty Utilities) **File No. WR-2018-0170**
(Missouri Water), LLC d/b/a Liberty Utilities)

REPORT AND ORDER

APPEARANCES

LIBERTY UTILITIES (MISSOURI WATER), LLC d/b/a LIBERTY UTILITIES:

Paul A. Boudreau, Brydon, Swearingen & England, P.C., 312 East Capitol Avenue, P.O. Box 456, Jefferson City, Missouri 65102

THE STAFF OF THE MISSOURI PUBLIC SERVICE COMMISSION:

Jacob Westen, Deputy Counsel, **Alexandra Klaus**, Legal Counsel, P.O. Box 360, Governor Office Building, 200 Madison Street, Jefferson City, Missouri 65102

THE OFFICE OF THE PUBLIC COUNSEL:

Lera Shemwell, Senior Public Counsel, **Caleb Hall**, Counsel, P.O. Box 2230, Jefferson City, Missouri, 65102

ORANGE LAKE COUNTRY CLUB, INC. AND SILVERLEAF RESORTS, INC.:

Joshua Harden, Stinson Leonard Street, 1201 Walnut St., Suite 2900 Kansas City, Missouri 64106

OZARK MOUNTAIN CONDOMINIUM ASSOCIATION:

Sarah E. Giboney, Smith Lewis, P.O. Box 918, 111 South Ninth Street, Suite 200 Columbia MO 65205

REGULATORY LAW JUDGE: John T. Clark

I. Procedural History

A. Case Filing and Consolidation

Liberty Utilities (Missouri Water), LLC d/b/a Liberty Utilities (“Liberty Utilities” or “Liberty”) provides water service to approximately 1,954 connections in Cape Girardeau, Franklin, Jefferson, McDonald, Stone and Taney Counties in Missouri.¹ Liberty Utilities provides sewer service to approximately 416 connections in Cape Girardeau, Franklin, Jefferson, Stone and Taney Counties in Missouri.² Liberty Utilities is a public utility,³ and water corporation,⁴ and a sewer corporation,⁵ and a regulated utility under the Missouri Public Service Commission’s jurisdiction

On December 15, 2017, Liberty Utilities filed a letter with the Missouri Public Service Commission (“Commission”) requesting that the Commission approve increases in its annual water and sewer operating revenues, which resulted in the Commission opening two cases, File Nos. WR-2018-0170 and SR-2018-0171. Liberty Utilities requested an increase of \$995,844 in its annual water system operating revenues and an increase of \$196,617 in its annual sewer system operating revenues.⁶ The case was initiated under Commission Rule 4 CSR 240-3.050, Small Utility Rate Case Procedure, which describes the procedures by which small utilities, such as Liberty Utilities, may request increases in their overall annual operating revenues. This rule, while now rescinded and replaced with Commission Rule 4 CSR 240-10.75

¹ Exhibit No. 1, Schwartz Direct, Page 3.

² Exhibit No. 105, Harrison Direct, Schedule PRH-d2, Page 1.

³ Section 386.020(43).

⁴ Section 386.020(59).

⁵ Section 386.020(49).

⁶ EFIS No. 1, Request for Increase

(effective starting May 30, 2018), was effective when Liberty Utilities requested an increase and was used in this case. Under the Small Utility Rate Case Procedure a water or sewer company serving 8,000 or fewer customers may initiate a rate case by filing a letter requesting an increase with the secretary of the Commission.

On January 13, 2018, Liberty Utilities filed a *Motion to Consolidate*, which requested that the Commission consolidate the two cases because they involved related questions of law and fact under Commission Rule 4 CSR 240-2.110(3). The Commission granted the motion, consolidating both cases under File No. WR-2018-0170.⁷

B. Intervention

Orange Lake Country Club, Inc. and Silverleaf Resorts, Inc. (collectively “Silverleaf”) and Ozark Mountain Condominium Association (“OMCA”) filed motions to intervene pursuant to Commission Rule 4 CSR 240-2.075. Both Silverleaf and OMCA were granted intervention.⁸

C. The Partial Disposition Agreement

On May 24, 2018, the Staff of the Missouri Public Service Commission (“Staff”), filed a *Partial Disposition Agreement and Request for Evidentiary Hearing* (“Partial Disposition Agreement”). Staff, Liberty, and the Office of the Public Counsel (“OPC”) reached agreement on some of the issues related to Liberty Utilities’ rate increase request. The Partial Disposition Agreement was a partial resolution of Liberty Utilities water and sewer rate requests but left unresolved certain other issues for determination

⁷ EFIS No. 7, Order Consolidating Cases.

⁸ EFIS Nos. 8 and 12, Order Granting Applications to Intervene.

after an evidentiary hearing. The Partial Disposition Agreement states that the unresolved issues include: “(a) revenue requirement, (b) return on equity, (c) capital structure, (d) rate base, (e) rate case expense, (f) rate design and rate consolidation, and (g) compliance with § 393.140(4) RSMo, 4 CSR 240-50.030(1) and 4 CSR 204-61.020(1), the use of The Uniform System of Accounts.” Among the issues resolved in the Partial Disposition Agreement were some customer service issues, and depreciation issues. No objections to the Partial Disposition Agreement were received and the Commission finds reasonable and adopts the resolution of the issues contained therein.

D. Local Public Hearings

The Commission conducted local public hearings in Pineville and Branson Missouri on July 23, 2018, and in Pacific Missouri on July 25, 2018. At the conclusion of the local public hearings, the Commission had received the sworn testimony of nine witnesses, and admitted two exhibits onto the record. All of the parties were given the opportunity to cross-examine the witnesses.

E. The Non-Unanimous Stipulation and Agreement

On August 3, 2018, Liberty Utilities and Staff filed a *Non-Unanimous Stipulation and Agreement*.⁹ The agreement resolved most of the remaining issues between Liberty and Staff including revenue requirement, return on equity, and rate design. It left unresolved rate case expense and certain customer service issues.

Commission Rule 4 CSR 240-2.115(2) allows a party seven days from the filing of a non-unanimous stipulation and agreement to file an objection to it. Any party failing to file a timely objection waives its right to a hearing. Additionally if no party timely

⁹ EFIS No. 72, Non-Unanimous Stipulation and Agreement.

objects, the Commission may treat the non-unanimous stipulation and agreement as unanimous. Objections to the *Non-Unanimous Stipulation and Agreement* were due by August 10, 2018.

On August 13, 2018, Staff filed a *Notice of no Objections to Non-unanimous Stipulation and Agreement, Request to Modify Hearing Schedule, and Motion for Expedited Treatment*.¹⁰ Staff asked to modify the evidentiary hearing schedule to include only three issues: rate case expense, customer service issues, and adoption of the stipulation and agreement.

On August 13, 2018, OPC filed a response to Staff's notice of no objections, and later a clarification, stating that it did not oppose but does not support the *Non-Unanimous Stipulation and Agreement*. OPC did not oppose the overall revenue requirement, but was concerned that the information in the stipulation was incomplete, in that it contained a stated return on equity without an associated capital structure.

Also on August 13, 2018, Silverleaf filed a response to Staff's notice of no objections, stating that it did not support the return on equity or the lack of a capital structure, and therefore did not support the stipulation and agreement. It did not, however, specifically object to the *Non-Unanimous Stipulation and Agreement*.

Also on August 13, 2018, OMCA filed its *Objection to Non-Unanimous Stipulation and Agreement and Request for Leave to Late file Same*, stating that the public interest would be better served by deciding the case after a hearing on the merits.

Liberty Utilities filed objections to OMCA's request and a motion to strike OPC's response. The motion to strike OPC's response is denied.

¹⁰ EFIS No. 90, Notice of No Objections to Non-Unanimous Stipulation and Agreement, Request to Modify Procedural Schedule, and Motion for Expedited Treatment.

No party objected within seven days; therefore, no party timely objected to the Non-Unanimous Stipulation and Agreement. Nevertheless, the Commission agrees that given the late objections to the *Non-Unanimous Stipulation and Agreement* by multiple interveners and the concerns of OPC, the public interest would be best served by issuing a decision on the merits. The Commission is treating the *Non-Unanimous Stipulation and Agreement* as non-unanimous.

At the evidentiary hearing on August 16, 2018, objections and arguments regarding the *Non-Unanimous Stipulation and Agreement* were taken under advisement. Counsel for Liberty Utilities indicated that he was operating under the assumption that the *Non-Unanimous Stipulation and Agreement* was a joint recommendation of the signatories,¹¹ and counsel for Staff indicated that Staff viewed it a joint position statement of Staff and the company.¹² Accordingly, the Commission is treating the *Non-Unanimous Stipulation and Agreement* as the position statement of both Staff and Liberty Utilities

F. Test Year

The test year is a central component in the ratemaking process. Rates are usually established based upon a historical test year, which focuses on four factors: (1) the rate of return the utility has an opportunity to earn; (2) the rate base upon which a return may be earned; (3) the depreciation costs of plant and equipment; and (4) allowable operating expenses.¹³ From these four factors is calculated the “revenue requirement,” which is the amount of revenue ratepayers must generate to pay the

¹¹ Transcript, Page 44.

¹² Transcript, Page 51.

¹³ *State ex rel. Union Electric Company v. Public Service Comm'n*, 765 S.W.2d 618, 622 (Mo. App. 1988).

costs of producing the utility service they receive while yielding a reasonable rate of return to the investors.¹⁴ A historical test year is used because the past expenses of a utility can be used as a basis for determining what rate is reasonable to be charged in the future.¹⁵ Staff used a test year of the twelve months ending June 30 2017, with an update period through November 30, 2017, to annualize the available revenue and expense information and develop its revenue requirement recommendation.¹⁶

G. Motion to Strike Testimony of Keith Magee

On August 8, 2018, Counsel for Silverleaf filed a *Motion to Strike the Surrebutal Testimony of Keith Magee and Motion for Expedited Treatment*.¹⁷

On August 9, 2018, Liberty Utilities filed its *Response of Liberty Utilities to Motion to Strike the Surrebutal Testimony of Keith Magee*.¹⁸ Liberty observes that Keith Magee's testimony is responsive to other witnesses, and no rule prohibits the filing of surrebutal testimony by a witness that has not filed either direct or rebuttal testimony. Liberty states that Silverleaf filed no direct testimony, and only after Silverleaf filed rebuttal testimony was Liberty aware that a witness regarding the particular subject matter would be necessary. Additionally, Keith Magee's testimony from a Liberty Utilities gas rate case, GR-2018-0013, was attached to the filed direct testimony of Jill Schwartz.

On August 9, 2018, the Commission issued its *Order Denying Motion for*

¹⁴ *State ex rel. Capital City Water Co. v. Public Service Comm'n*, 850 S.W.2d 903, 916 n. 1 (Mo. App. 1993).

¹⁵ *See, State ex rel. Utility Consumers' Council of Missouri, Inc. v. Public Service Comm'n*, 585 S.W.2d 41, 59 (Mo. Banc 1979).

¹⁶ Exhibit No. 105, Harrison Direct, Page 4.

¹⁷ EFIS No. 82, Motion to Strike the Surrebutal Testimony of Keith Magee and Motion for Expedited Treatment

¹⁸ EFIS No. 83, Response of Liberty Utilities to Motion to Strike the Surrebutal Testimony of Keith Magee

Expedited Treatment, indicating the Commission would consider Silverleaf's motion in its report and order.¹⁹

Liberty Utilities complied with the Commission's discovery deadline. Silverleaf had notice of Keith Magee as a potential witness, and also the content of his testimony, from Jill Schwartz's direct testimony and the accompanying Keith Magee direct testimony from GR-2018-0013. Silverleaf's motion to strike Keith Magee's surrebuttal testimony is denied.

H. Evidentiary Hearing

The evidentiary hearing was held at the Commission's offices in Jefferson City, Missouri on August 16, 2018.²⁰ All parties (Liberty Utilities, Staff, OPC, Silverleaf, and OMCA) participated.²¹ During the hearing, the parties presented evidence relating to the unresolved issues previously identified by the parties. Those issues are: the revenue requirement including return on equity, capital structure, and rate case expense; Rate design including phase-in rates, customer charge, and commodity charge; the Silverleaf exemption; and customer service issues.²² The Commission admitted the testimony of twelve witnesses and received twenty-seven exhibits into evidence.

I. Case Submission

Post-hearing briefs were filed according to the post-hearing procedural schedule. The final post-hearing briefs were filed on September 11, 2018. Several of the parties offered testimony at the evidentiary hearing regarding the *Non-Unanimous Stipulation*

¹⁹ EFIS No. 84, Order Denying Motion for Expedited Treatment

²⁰ Transcript Volume 5.

²¹ Transcript, Page 26.

²² EFIS No. 86, List of Issues, Order of Witnesses, Order of Cross-Examination and Order of Opening Statements.

and Agreement. To better assist the Commission in making its decision, the Commission admitted the *Non-Unanimous Stipulation and Agreement* and its attachments onto the record as Commission Exhibit No. 1. The case was deemed submitted for the Commission’s decision on September 25, 2018.²³

II. General Matters

A. General Findings of Fact

1. Liberty Utilities which holds the water and sewer utility assets, is a subsidiary of Liberty Utilities Company (“LUCo”), an intermediate holding company, which is an indirect wholly owned subsidiary of Algonquin Power & Utilities Corp.²⁴ Liberty Utilities provides water service in Cape Girardeau, Franklin, Jefferson, McDonald, Stone and Taney Counties in Missouri. Liberty Utilities provides sewer service in Cape Girardeau, Franklin, Jefferson, Stone and Taney Counties in Missouri.²⁵

2. Liberty Utilities currently provides service to approximately 1,954 water customers and approximately 416 sewer customers in 14 certificated service areas with 11 different sets of tariffed rates.²⁶

3. The Office of the Public Counsel is a party to this case pursuant to Section 386.710(2), RSMo²⁷ and Commission Rule 4 CSR 240-2.010(10).

4. Staff is a party to this case pursuant to Section 386.071, RSMo, and Commission Rule 4 CSR 240-2.010(10).

²³ “The record of a case shall stand submitted for consideration by the commission after the recording of all evidence or, if applicable, after the filing of briefs or the presentation of oral argument.” Commission Rule 4 CSR 240-2.150(1).

²⁴ Exhibit No. 4, Magee Surrebuttal, Pages 1, 7-8.

²⁵ Exhibit No. 1, Schwartz Direct, Page 3

²⁶ Exhibit No. 105 – Direct Testimony of Paul Harrison, Schedule PRH-d2, Page 1.

²⁷ Unless otherwise stated, all statutory citations are to the Revised Statutes of Missouri, as codified in the year 2016 and subsequently revised or supplemented.

5. Liberty Utilities' KMB water systems include seven systems: Cedar Hills, Crestview, High Ridge Manor, Hillshine Community, Lakeview Hills, Town of Scotsdale, and Warren Woods. Each of these systems has its own tariffed rates for water service. Liberty Utilities' KMB sewer system includes Cape Rock Village, which has its own sewer tariffed rates.²⁸

6. Liberty Utilities' Silverleaf water systems include Holiday Hills, Ozark Mountain, and TimberCreek. All three Silverleaf water systems have the same water tariffed rate. Liberty Utilities' Silverleaf sewer systems include Ozark Mountain and Timber Creek. Both of these sewer systems are under one sewer tariffed rate.²⁹

7. Liberty Utilities' Noel water system has its own tariffed rates for the water services it provides to its customers.³⁰

8. The Commission last approved a rate increase for Liberty Utilities' KMB properties in File Nos. WR-2010-0345 and SR-2010-0346, effective February 1, 2011. The Commission last approved a rate increase for Liberty Utilities' Silverleaf properties in File Nos. WR-2006-0425 and SR-2006-0426, effective April 2, 2007. The Commission last approved a rate increase for Liberty Utilities' Noel properties in File No. WR-2009-0395, effective November 12, 2009.³¹

²⁸ Exhibit No. 105, Harrison Direct, Schedule PRH-d2, Page 1.

²⁹ Exhibit No. 105, Harrison Direct, Schedule PRH-d2, Page 1.

³⁰ Exhibit No. 105, Harrison Direct, Schedule PRH-d2, Page 1.

³¹ Exhibit No. 105, Harrison Direct, Schedule PRH-d2, Page 1.

9. In its original rate request letter, Liberty Utilities requested an increase of \$995,844 in its annual water system operating revenues and an increase of \$196,617 in its annual sewer system operating revenues.³²

10. Staff used a test year of the twelve months ending June 30 2017, with an update period through November 30, 2017, to annualize the available revenue and expense information and develop its revenue requirement recommendation.³³

11. On May 24, 2018, Staff filed a *Partial Disposition Agreement and Request for Evidentiary Hearing* on behalf of itself, Liberty Utilities, and OPC. The agreement was a partial resolution of Liberty Utilities' water and sewer rate requests but left unresolved certain other issues for which the signatories requested an evidentiary hearing. The agreement is attached hereto as Attachment A and incorporated herein by reference as if fully set forth.

12. The Commission finds that any given witness' qualifications and overall credibility are not dispositive as to each and every portion of that witness' testimony. The Commission gives each item or portion of a witness' testimony individual weight based upon the detail, depth, knowledge, expertise, and credibility demonstrated with regard to that specific testimony. Consequently, the Commission will make additional specific weight and credibility decisions throughout this order as to specific items of testimony as is necessary.³⁴

13. Any finding of fact reflecting that the Commission has made a

³² EFIS No. 1, Request for Increase.

³³ Exhibit No. 105, Harrison Direct, Page 4.

³⁴ Witness credibility is solely a matter for the fact-finder, "which is free to believe none, part, or all of the testimony". *State ex rel. Public Counsel v. Missouri Public Service Comm'n*, 289 S.W.3d 240, 247 (Mo. App. 2009).

determination between conflicting evidence is indicative that the Commission attributed greater weight to that evidence and found the source of that evidence more credible and more persuasive than that of the conflicting evidence.³⁵

B. General Conclusions of Law

1. Liberty Utilities is a “water corporation”, a “sewer corporation”, and a “public utility” as defined in Sections 386.020(59), 386.020(49), and 386.020(43), RSMo, respectively, and as such is subject to the supervision, control and regulation of the Commission under Chapters 386 and 393 of the Missouri Revised Statutes. The Commission’s statutory authority over Liberty Utilities’ rate increase request is established under Section 393.150, RSMo.

2. The Commission has exclusive authority to establish public utility rates,³⁶ and the tariffs it approves have the force and effect of law when they become effective.³⁷ A public utility has no right to fix its own rates and cannot charge or collect rates that have not been approved by the Commission;³⁸ neither can a public utility change its rates without first seeking authority from the Commission.³⁹ A public utility may submit rate schedules or “tariffs,” and thereby suggest to the Commission rates and classifications which it believes are just and reasonable, but the final decision is the Commission's.⁴⁰

3. Sections 393.130 and 393.140, RSMo, mandate that the Commission

³⁵ An administrative agency, as fact finder, also receives deference when choosing between conflicting evidence. *State ex rel. Missouri Office of Public Counsel v. Public Service Comm'n of State*, 293 S.W.3d 63, 80 (Mo. App. 2009).

³⁶ *May Dep't Stores Co. v. Union E.L.P. Co.*, *supra*, 107 S.W.2d 41 57 (Mo. 1937)

³⁷ *State Ex Rel. Utility Consumers Council v. Pub. Serv. Comm'n*, *supra*, 585 S.W.2d 41 49 (Mo. 1979).

³⁸ *State Ex Rel. Utility Consumers Council v. Pub. Serv. Comm'n*, *supra*, 585 S.W.2d 41 49 (Mo. 1979).

³⁹ *Deaconess Manor Ass'n v. Pub. Serv. Comm'n*, 994 S.W.2d 602, 610 (Mo. App., W.D. 1999).

⁴⁰ *May Dep't Stores Co. v. Union E.L.P. Co.*, *supra*, 107 S.W.2d 41 50 (Mo. 1937)

ensure that all utilities are providing safe and adequate service and that all rates set by the Commission are just and reasonable. Section 393.150.2, RSMo, makes clear that at any hearing involving a requested rate increase, the burden of proof to show the proposed increase is just and reasonable rests on the corporation seeking the rate increase. As the party requesting the rate increase, Liberty Utilities bears the burden of proving that its proposed rate increase is just and reasonable.⁴¹ In order to carry its burden of proof, Liberty Utilities must meet the preponderance of the evidence standard.⁴²

4. In determining whether the rates proposed by Liberty are just and reasonable, the Commission must balance the interests of the investor and the consumer.⁴³ In discussing the need for a regulatory body to institute just and reasonable rates, the United States Supreme Court has held as follows:

Rates which are not sufficient to yield a reasonable return on the value of the property used at the time it is being used to render the services are unjust, unreasonable and confiscatory, and their enforcement deprives the public utility company of its property in violation of the Fourteenth Amendment.⁴⁴

In the same case, the Supreme Court provided the following guidance on what is a just and reasonable rate:

What annual rate will constitute just compensation depends upon many circumstances and must be determined by the exercise of a fair and enlightened judgment, having regard to all relevant facts. A public utility is entitled to such rates as will permit it to earn a return on the value of the

⁴¹ 393.150.2, RSMo

⁴² *Bonney v. Environmental Engineering, Inc.*, 224 S.W.3d 109, 120 (Mo. App. 2007); *State ex rel. Amrine v. Roper*, 102 S.W.3d 541, 548 (Mo. banc 2003); *Rodriguez v. Suzuki Motor Corp.*, 936 S.W.2d 104, 110 (Mo. banc 1996), citing to, *Addington v. Texas*, 441 U.S. 418, 423, 99 S.Ct. 1804, 1808, 60 L.Ed.2d 323, 329 (1979).

⁴³ *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 603, (1944).

⁴⁴ *Bluefield Water Works & Improvement Co. v. Public Service Commission of the State of West Virginia*, 262 U.S. 679, 690 (1923).

property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties. A rate of return may be reasonable at one time and become too high or too low by changes affecting opportunities for investment, the money market and business conditions generally.⁴⁵

The Supreme Court has further indicated:

‘[R]egulation does not insure that the business shall produce net revenues.’ But such considerations aside, the investor interest has a legitimate concern with the financial integrity of the company whose rates are being regulated. From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.⁴⁶

In undertaking the balancing required by the Constitution, the Commission is not bound to apply any particular formula or combination of formulas. Instead, the Supreme Court has said:

Agencies to whom this legislative power has been delegated are free, within the ambit of their statutory authority, to make the pragmatic adjustments which may be called for by particular circumstances.⁴⁷

⁴⁵ *Bluefield Water Works & Improvement Co. v. Public Service Commission of the State of West Virginia*, 262 U.S. 679, 692-93 (1923).

⁴⁶ *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944) (citations omitted).

⁴⁷ *Federal Power Commission v. Natural Gas Pipeline Co.* 315 U.S. 575, 586 (1942).

Furthermore, in quoting the United States Supreme Court in *Federal Power Commission v. Hope Natural Gas Co.*, the Missouri Court of Appeals said:

[T]he Commission [is] not bound to the use of any single formula or combination of formulae in determining rates. Its rate-making function, moreover, involves the making of ‘pragmatic adjustments.’ ... Under the statutory standard of ‘just and reasonable’ it is the result reached, not the method employed which is controlling. It is not theory but the impact of the rate order which counts.⁴⁸

III. The Issues

A. Revenue Requirement

- ***What is the revenue requirement for Liberty Utilities water and sewer services?***

The Commission is tasked with determining the revenue requirement for Liberty Utilities. The revenue requirement is how much it costs Liberty Utilities, in operating expenses (“expenses”) and for a return on its capital assets (“rate base”), to provide safe and adequate service, and includes a return sufficient to service debt and equity and continue attracting capital.⁴⁹ Liberty Utilities has requested an increase in rates to compensate it for necessary investments made in its systems and to address increases in operation and maintenance expenses that have increased since the company’s last rate case.

Findings of Fact:

1. On December 15, 2017, Liberty Utilities filed a request for an increase of \$995,844 in annual water system operating revenues, and \$196,617 in annual sewer

⁴⁸ *State ex rel. Associated Natural Gas Co. v. Public Service Commission*, 706 S.W. 2d 870, 873 (Mo. App. W.D. 1985).

⁴⁹ *Fed. Power Comm’n v. Hope Nat. Gas Co.*, 320 U.S. 591, 603 (1944).

system operating revenues.⁵⁰ These requests totaled a combined increase of \$1,192,461. Liberty Utilities presented no evidence in its case in chief that substantiated those particular increase amounts.

2. Staff changed its recommended revenue requirement for the company several times during the course of the case. Staff's initial recommended revenue requirement was \$810,886 for water operations and \$179,323 for sewer operations.⁵¹ These totaled a combined increase of \$990,209. Staff filed accounting schedules in support of this specific increase.⁵²

3. On July 20, 2018, Staff updated its revenue increase recommendation from \$990,209 to \$978,569, to reconcile a difference in the amount of contribution in aid of construction rate base that the company was including in its cost of service.⁵³

4. Staff again updated the revenue requirement recommendation on August 7, 2018, to reflect rate case expense incurred as of April 2018 from \$978,569 to \$984,581.⁵⁴

5. Liberty Utilities did not keep the KMB operating books separate for the seven KMB systems. In order to determine the cost of service revenue requirement for the seven KMB systems Staff had to develop an allocation process to separate the seven systems.⁵⁵

6. Liberty Utilities has made significant improvements in the system since the last Liberty Utilities water and sewer rate cases. Liberty has invested approximately

⁵⁰ Exhibit No. 1, Schwartz Direct, Page 4.

⁵¹ Exhibit No. 105, Harrison Direct, Page 5.

⁵² Exhibit No. 105, Harrison Direct, Schedule PRH-d3.

⁵³ Exhibit No. 106, Harrison Rebuttal, Page 2.

⁵⁴ Exhibit No. 107, Harrison Surrebuttal, Page 2.

⁵⁵ Exhibit No. 105, Harrison Direct, Schedule PRH-d2, Pages 3-4.

\$1,952,614 for water improvements and \$621,830 for sewer improvements.⁵⁶ No party challenged the necessity of those improvements.

7. Liberty Utilities' operation and maintenance expenses have increased since its last rate case.⁵⁷

8. James Busch is the Staff witness supporting the *Non-Unanimous Stipulation and Agreement*.⁵⁸

9. The *Non-Unanimous Stipulation and Agreement* specifies, exclusive of rate case expense, that the annual revenue requirement increase for Liberty Utilities should be \$818,800 for water operations and \$196,792 for sewer operations.⁵⁹ These represent a total overall annual revenue requirement for Liberty Utilities' water system operations of \$1,690,117 and a total overall annual revenue requirement for Liberty Utilities' sewer system operations of \$455,163.

10. Silverleaf's witness, William Stannard, challenged the revenue requirements proposed by Staff due to an error he states would cause over-recovery. He also challenged Liberty Utilities' proposed revenue requirement for over-recovery based on commodity charges and meter size.⁶⁰

11. Staff witness Matthew Barnes filed testimony indicating that the error Stannard discovered in Staff's rate design recommendation involved application of the

⁵⁶ Exhibit No. 105, Harrison Direct, Pages 5-6, and Schedule PRH-d4.

⁵⁷ Exhibit No. 1, Schwartz Direct, Page 10.

⁵⁸ Exhibit No. 103, Busch Surrebuttal, Page 15.

⁵⁹ Commission Exhibit No. 1, Page 1.

⁶⁰ Exhibit No. 302, Stannard Refined Rebuttal, Pages 10-14.

wrong charge for the ¾ inch meter, which caused the commodity charges to be higher than appropriate. Barnes noted that the error has since been corrected.⁶¹

12. William Stannard noted that the *Non-unanimous Stipulation and Agreement* included a return on equity, but not a capital structure. Stannard is concerned because capital structure impacts the revenue requirement. Stannard states that if the Commission were to approve the 9.75 percent return on equity, it should be accompanied by a stated capital structure of 42.83 percent equity and 57.17 percent debt.⁶²

13. The revenue requirement amounts contained in the *Non-Unanimous Stipulation and Agreement* are numerically supported by the billing determinates attached to it, including the Rate Making Income Statements that establish a cost of service for each tariffed area.⁶³

14. No party other than Staff and Liberty Utilities has proposed a revenue requirement other than the one agreed to in Liberty Utilities' and Staff's position statement.

Conclusions of Law and Decision:

Sections 393.130 and 393.140, RSMo, mandate that utilities provide safe and adequate service and at rates set by the Commission that are just and reasonable. The United States Supreme Court advises that "the fixing of 'just and reasonable' rates, involves a balancing of the investor and the consumer interests."⁶⁴ Furthermore, "Rates

⁶¹ Exhibit No. 101, Barnes Rebuttal, Page 2.

⁶² Exhibit No. 302, Stannard Surrebuttal, Page 7.

⁶³ Commission Exhibit No. 1, Attachment A.

⁶⁴ *Fed. Power Comm'n v. Hope Nat. Gas Co.*, 320 U.S. 591, 603, 64 S.Ct. 281, 88 L.Ed. 333 (1944) (*Hope*).

which are not sufficient to yield a reasonable return on the value of the property used at the time it is being used to render the services are unjust, unreasonable and confiscatory.”⁶⁵

Liberty Utilities did not put forth sufficient evidence to sustain its burden that its originally requested increase of \$995,844 in annual water system operating revenues and \$196,617 in annual sewer revenues are just and reasonable. However, Liberty Utilities produced sufficient evidence to support that its requested rate increase of \$818,800 for water operations and \$196,782 for sewer operations in its joint position statement is just and reasonable. The standard of proof, as stated above in general conclusions of law, is preponderance of the evidence. The question before the commission is: balancing the interests of investors and ratepayers, is it more likely than not that the proposed increase of \$818,800 for water operations and \$196,782 for sewer operations will result in just and reasonable rates?

The Commission concludes that it is more likely than not that the increase will result in just and reasonable rates. Liberty Utilities has not come to the Commission for a rate increase for any of its water or sewer systems in more than seven years, and during that time, the ratepayers have enjoyed low rates that have not changed in more than half a decade. Silverleaf’s rates have not changed in more than a decade. Meanwhile, Liberty Utilities has made necessary improvements to the system in excess of 2.5 million dollars. Additionally it has experienced higher costs of service with increasing operation and management expenses.

⁶⁵ *Bluefield Water Works & Improvement Co. v. Public Service Commission of the State of West Virginia*, 262 U.S. 679, 690 (1923).

For the reasons discussed above, the Commission is ordering an annual revenue requirement for Liberty Utilities' water system operations of \$1,690,117 and an annual revenue requirement for Liberty Utilities' sewer system operations of \$455,163.

1. Return on Equity

- ***What is the appropriate return on equity for Liberty Utilities?***

The Commission must determine an appropriate return on equity for Liberty Utilities. Staff filed testimony with the Commission supporting a return on equity of 10 percent.⁶⁶ Liberty Utilities filed testimony with the Commission supporting a return on equity of 10.25 percent.⁶⁷ Silverleaf filed testimony supporting a return on equity within a range of 8 percent to 9 percent.⁶⁸

Staff and Liberty Utilities later filed with the Commission the *Non-Unanimous Stipulation and Agreement* of which they were both signatories. As part of that agreement, which the Commission is treating as a joint position statement of the signatories, Staff and Liberty both support a return on equity of 9.75 percent.

Findings of Fact:

1. James Busch is the Staff witness supporting the *Non-Unanimous Stipulation and Agreement*.⁶⁹
2. Liberty Utilities believes that the *Non-Unanimous Stipulation and Agreement* represents a reasonable compromise of all revenue requirement issues but

⁶⁶ Exhibit No. 109, Murray Substitute Rebuttal, Page 3.

⁶⁷ Exhibit No. 4, Magee Surrebuttal, Page 3.

⁶⁸ Exhibit No. 302, Stannard Refined Rebuttal, Page 10.

⁶⁹ Exhibit No. 103, Busch Surrebuttal, Page 15.

one.⁷⁰ A return on equity of 9.75 percent is one of the resolved revenue requirement issues in the *Non-Unanimous Stipulation and Agreement*.⁷¹

3. The Commission accepts that the proposed return on equity of 9.75 percent is just and reasonable. This return on equity is close to the return on equity proposals separately made by Staff and Liberty Utilities in their direct testimony.⁷²

4. Staff witness David Murray filed testimony in support of a 10 percent return on equity which was derived by adding 20 basis points to Spire Missouri's most recent Commission approved return on equity of 9.8 percent. The reason for this adjustment was because Liberty Utilities capital structure is more leveraged than Spire Missouri's.⁷³ Staff quantified the recommended 20 basis point increase by evaluating spreads between 'BBB' rated bonds and 'A' rates bonds.⁷⁴ Staff does not explain why either the reason or quantification substantiates the addition of 20 basis points.

5. Silverleaf witness William Stannard filed testimony in support of a return on equity range of 8 percent to 9 percent. Stannard added the Duff & Phelps equity risk premium of 5 percent to the 2.97 percent 30-year treasury rate for a return on equity of 7.97 percent, which supports his proposed return on equity range.⁷⁵

6. Staff finds Duff & Phelps to be an authoritative source for estimating cost of capital and relies on it for purposes of testing the reasonableness of Staff's cost of equity estimates.⁷⁶

⁷⁰ Exhibit No. 3, Schwartz Surrebuttal, Page 7.

⁷¹ Commission Exhibit No. 1, Page 2, Cost of Service/Revenue Requirement, C. Return on Equity.

⁷² Exhibit No. 105, Harrison Direct, Page 5, and Exhibit No. 1, Schwartz Direct, Page 6.

⁷³ Exhibit No. 110, Murray Surrebuttal, Page 3.

⁷⁴ Exhibit No. 110, Murray Surrebuttal, Page 3.

⁷⁵ Exhibit No. 302, Stannard Refined Rebuttal, Pages 9-10.

⁷⁶ Exhibit No. 110, Murray Surrebuttal, Page 2.

7. David Murray credibly testified that William Stannard did not apply Duff & Phelps' risk premium as Duff & Phelps intended by not adjusting the equity risk premium to reflect that utility stocks are less volatile than the broader markets. Applying Duff & Phelps' risk premium correctly yields a return on equity of 7 percent.⁷⁷

8. Staff does not use a 7 percent return on equity because David Murray used previous Commission decisions as guidance for a just and reasonable return on equity, giving the 9.8 percent return on equity in Spire Missouri's gas rate cases, GR-2017-0216 and GR-2017-0217, the most weight.⁷⁸

9. Keith Magee credibly testified for Liberty that Duff & Phelps understates the risk premium authorized for gas utilities and that the risk factors between natural gas companies are similar.⁷⁹ Magee testified that the method used by William Stannard to calculate return on equity has consistently produced return on equity estimates more than 100 basis points below average authorized returns since 2012.⁸⁰

10. Liberty Utilities proposes a 10.25 percent return on equity, within a range of 9.9 percent to 10.35 percent⁸¹ Keith Magee used a proxy group of comparable companies to arrive at an appropriate return on equity range.⁸²

11. In May 2018, the Commission approved a stipulation and agreement specifying a return on equity range of 9.5 percent to 10 percent for Missouri American Water Company.⁸³

⁷⁷ Exhibit No. 110, Murray Surrebuttal, Page 3.

⁷⁸ Exhibit No. 110, Murray Surrebuttal, Page 3.

⁷⁹ Transcript, Page 95.

⁸⁰ Exhibit No. 4, Magee Surrebuttal, Page 5.

⁸¹ Exhibit No. 4, Magee Surrebuttal, Page 3.

⁸² Exhibit No. 4, Magee Surrebuttal, Schedule KM-S13, Page 4.

⁸³ Exhibit No. 4, Magee Surrebuttal, Page 17.

12. Average authorized return on equity from January 2018 to June 2018 for Illinois, California, New Jersey, Missouri, and North Carolina encompass a return on equity range of 9.05 percent to 10.5 percent with an average return on equity of 9.69 percent.⁸⁴

Conclusions of Law and Decision:

A disputed issue in this case is the estimated cost of common equity, or the return on equity. Estimating the cost of common equity capital is a difficult task, as academic commentators have recognized.⁸⁵ Determining a rate of return on equity is imprecise and involves balancing a utility's need to compensate investors against its need to keep prices low for consumers.⁸⁶ Accordingly, the Commission cannot simply find a rate of return on equity that is unquestionably scientifically, mathematically, or legally correct. Such a "correct" rate does not exist. Missouri court decisions recognize that the Commission has flexibility in fixing the rate of return, subject to existing economic conditions.⁸⁷

Liberty Utilities has proposed the Commission authorize a return on equity of 10.25 percent, which is on the upper end of its proposed range of 9.9 percent to 10.35 percent. 10.25 percent is outside of the range of 9.5 percent to 10 percent recently approved by the Commission for a water utility. Liberty Utilities notes that the Commission authorized a return on equity of 12 percent for Indian Hills in February

⁸⁴ Exhibit No. 4, Magee Surrebuttal, Table 7: Average Authorized Water Utility Returns by State, Page 17.

⁸⁵ See Phillips, *The Regulation of Public Utilities*, Public Utilities Reports, Inc., p. 394 (1993).

⁸⁶ *State ex rel. Public Counsel v. Public Service Commission*, 274 S.W.3d 569, 574 (Mo. Ct. App. 2009).

⁸⁷ *State ex rel. Laclede Gas Co. v. Public Service Commission*, 535 S.W.2d 561, 570-571 (Mo. App. 1976).

2018.⁸⁸ However, Indian Hills was an extremely distressed water system with an extremely high cost of debt.

Silverleaf's proposed range of 8 percent to 9 percent starts outside the Commission's recently approved range of 9.5 percent to 10 percent. William Stannard calculated the return on equity using Duff & Phelps equity risk premium at 7.97 percent. David Murray credibly testified that Stannard miscalculated and that the correct return on equity using Duff & Phelps would be 7 percent. Keith Magee testified at the evidentiary hearing that Duff & Phelps underestimates the risk premium authorized for gas utilities.⁸⁹ Keith Magee also points out that Silverleaf's return on equity recommendation is based on a single model.

Staff's 10 percent return on equity, based upon the Commission's recently approved return on equity for Spire Missouri of 9.8 percent, seeks to add 20 basis points due to Liberty Utilities more leveraged capital structure. Staff states that the 20 basis point adjustment is quantified by evaluating the spreads between 'BBB' rated bonds, and 'A' rated bonds, but offers no explanation as to how that difference produces an additional 20 basis points. The Commission finds the addition of 20 basis points to the return on equity of 9.8 percent authorized for Spire Missouri to be unwarranted absent an explanation. The 9.8 percent return on equity recently authorized for Spire Missouri is not unreasonable and is within the range of 9.5 percent to 10 percent the Commission recently authorized for a water utility.

The evidence shows that both Liberty Utilities and Staff' agree that an appropriate return on equity is 9.75 percent. 9.75 percent is within a range of 9.5

⁸⁸ Exhibit No. 4, Magee Surrebuttal, Page 18.

⁸⁹ Transcript, Page 95.

percent to 10 percent that would be a reasonable and accurate estimate of the current market cost of capital for Liberty Utilities. Based on the competent and substantial evidence in the record and on its balancing of the interests of the company's ratepayers and shareholders, the Commission concludes that 9.75 percent is a fair and reasonable return on equity for Liberty Utilities.

2. Capital Structure

- ***What is the appropriate capital structure to apply to Liberty Utilities?***

The Commission is tasked with determining the appropriate capital structure to apply to Liberty Utilities. Capital structure is expressed as a debt-to-equity ratio that indicates how a company finances its operations and provides an overview of a company's risk. Only two capital structures were presented by the parties: Liberty Utilities position is that the capital structure should consist of 53 percent common equity and 47 percent long term debt.⁹⁰ Staff's position is that Liberty Utilities' capital structure should consist of 42.83 percent common equity and 57.17 percent long term debt.⁹¹ No alternative capital structures were proposed by any party.

Findings of Fact:

1. Liberty Utilities proposes applying the same capital structure Liberty Utilities' witness Keith Magee recommended for Liberty Midstates in GR-2018-0013.⁹²

2. A 53 percent equity and 47 percent debt capital structure was approved by the Commission as part of the settlement agreement in Liberty Midstates gas rate case

⁹⁰ Exhibit No. 4, Magee Surrebuttal, Page 3,4.

⁹¹ Exhibit No. 109, Murray Substitute Rebuttal, Page 3

⁹² Exhibit No. 4, Magee Surrebuttal, Page 3, Liberty Midstates is an affiliated natural gas utility.

(GR-2018-0013) for the limited purpose of calculating an infrastructure investment surcharge.⁹³

3. Liberty Utilities' witness Keith Magee's recommendation for capital structure is based on the mean equity ratio of several proxy gas companies with similar risk characteristics to Liberty Utilities, which he updated for this rate case to the eight quarters ending Q1 2018.⁹⁴

4. Staff witness David Murray disagrees with Liberty Utilities' capital structure because it assumes that Liberty Utilities is capitalized with more equity than what Algonquin Power and Utilities Corp. considers appropriate for its low-risk regulated utility assets.⁹⁵

5. David Murray also disagrees with Liberty Utilities capital structure recommendation because it is not consistent with its parent company, LUCo's corporate strategy of using a higher proportion of debt to finance its regulated utility assets.⁹⁶

6. David Murray's recommendation for capital structure is based on the actual capital structure of LUCo as of December 31, 2017.⁹⁷

7. LUCo is the intermediate holding company which supplies the debt financing for Algonquin's United States regulated utility assets, including Liberty Midstates and Liberty Utilities, through Liberty Utilities Finance GP1.⁹⁸

8. Liberty Utilities issues no independent debt.⁹⁹

⁹³ Transcript, Page 100.

⁹⁴ Exhibit No. 4, Magee Surrebuttal, Pages 9-10.

⁹⁵ Exhibit No. 109, Murray Substitute Rebuttal, Page 3.

⁹⁶ Exhibit No. 109, Murray Substitute Rebuttal, Page 4.

⁹⁷ Exhibit No. 109, Murray Substitute Rebuttal, Page 2.

⁹⁸ Exhibit No. 109, Murray Substitute Rebuttal, Page 2.

⁹⁹ Exhibit No. 109, Murray Subditute Rebuttal, Page 3.

9. LUCo's capital structure is used to finance LUCo's United States' regulated utility assets, including Liberty Midstates and Liberty Utilities. LUCo's capital structure contains 42.83 percent common equity.¹⁰⁰

10. The Commission has previously adopted Staff's recommended capital structure by using LUCo's capital structure in GR-2014-0152 for Liberty Midstates.¹⁰¹

11. LUCo is composed of over 30 water, gas, and electric utilities and Liberty Utilities' customers are less than 1 percent of the 762,000 customers served by LUCo.¹⁰²

12. Silverleaf witness William Stannard supports Staff's proposed capital structure as reasonable.¹⁰³ Stannard, states that if the Commission approves a 9.75 percent return on equity it should be accompanied by a stated capital structure of 42.83 percent equity and 57.17 percent debt.¹⁰⁴

13. OPC agrees with Staff's proposed capital structure.¹⁰⁵

Conclusions of Law and Decision:

The issue for determination is whether to apply a capital structure based upon the mean ratio of a set of proxy gas companies that Liberty Utilities' witness Keith Magee believes closely resembles the risk characteristics of Liberty Utilities, a hypothetical capital structure, or whether to apply a capital structure based upon Liberty Utilities' parent holding company, LUCo. Staff notes that its method of determining

¹⁰⁰ Exhibit No. 109, Murray Subdstitute Rebuttal, Page 3.

¹⁰¹ Exhibit No. 109, Murray Substitute Rebuttal, Page 3.

¹⁰² Exhibit No. 4, Magee Surrebuttal, Pages 11-12.

¹⁰³ Exhibit No. 302, Stannard Refiled Rebuttal, Page 9.

¹⁰⁴ Exhibit No. 303, Stannard Surrebuttal, Page 7.

¹⁰⁵ Transcript, Page 78.

capital structure using LUCo has been used by the Commission before for Liberty Utilities' affiliate company, Liberty Midstates, in GR-2014-0152.

Liberty Utilities argues that it is inappropriate to base its capital structure on a parent company that has grown significantly since 2014. Liberty argues that a sizable portion of the debt in LUCo's capital structure is not related to Liberty Utilities and should not be used to set Liberty Utilities capital structure.¹⁰⁶ Liberty also argues that LUCo's characteristics and circumstances are not the same as they were at the time of the company's last rate case as the company has been growing. However, Staff's recommendation is based on the more recent capital structure of LUCo on December 31, 2017, which takes into account the time elapsed since 2014.

Staff's witness, David Murray, testified that it is the intention of the company to do all its financing with third-party investors at the LUCo level.¹⁰⁷ Applying LUCo's capital structure is appropriate because LUCo's capital structure is used to finance LUCo's United States' regulated utility assets. Staff's approach to base Liberty Utilities' authorized capital structure on its parent intermediate holding company is more reasonable for the reason that LUCo is the company which provides all corporate debt financing both Liberty Utilities and Liberty Midstates.¹⁰⁸ It is logical to apply the actual capital structure of the company providing the financing for Liberty Utilities because Liberty Utilities issues none of its own debt.

¹⁰⁶ Exhibit No. 4, Magee Surrebuttal, Page 9.

¹⁰⁷ Transcript, Page 121-122

¹⁰⁸ Exhibit No. 109, Murray Substitute Rebuttal, Page 2.

The Commission concludes that the appropriate capital structure to apply to Liberty Utilities consists of 42.83 percent common equity and 57.17 percent long term debt.

3. Rate Case Expense

- ***What is the appropriate amount of rate case expense to allow Liberty Utilities to recover in its rates for expenses incurred presenting its case to the Commission?***
- ***What is the appropriate recovery period for rate case expense?***

The Commission will determine what amount of rate case expense, if any, that Liberty Utilities is allowed to recover in rates for expenses incurred in the preparation and presentation of its case to the Commission. Staff and Liberty Utilities agree that the company should be allowed to recover reasonable expenses through the end of the case. The parties disagree on the time period for recovery of rate case expense.

Findings of Fact:

1. Utility companies incur various expenses in the preparation and presentation of a rate case before the Commission. Included in these costs are expenses for outside counsel, expert witnesses, and miscellaneous expenses for items such as travel expenses and copying costs.¹⁰⁹

2. Jill Schwartz credibly testified that Liberty has incurred attorney and expert witness fees associated with processing this case.¹¹⁰ Jill Schwartz additionally testified that, “The Company is mindful of the costs of rate cases and has worked hard to keep rate case expenses low given the small customer base in this case.”¹¹¹

¹⁰⁹ Exhibit No. 105, Harrison Direct, Page 6.

¹¹⁰ Exhibit No. 1, Schwartz Direct, Page 7.

¹¹¹ Exhibit No. 2, Schwartz Rebuttal, Page 2.

3. Liberty proposes that rate case expense be normalized over two years.¹¹² Liberty asks for the shorter period of time because it expects that another rate case will be filed in several years due to the acquisition of additional water systems.¹¹³

4. Staff originally recommended normalizing rate case expense over five years. Staff based its initial recommendation on how often Liberty Utilities has filed for a rate increase in the past. It has been seven to eleven years since any Liberty Utilities water or sewer system has had a rate increase.¹¹⁴ Staff, using the Non-Unanimous Stipulation and Agreement as its current position statement, recommends amortizing rate case expense over three years.¹¹⁵ Normalizing takes an ongoing expense and builds it into cost of service, whereas amortizing takes a lump sum amount and spreads it over a select number of years to allow full recovery.¹¹⁶

5. Silverleaf supports a five year recovery period for rate case expense and notes that any amounts included in base rates will continue to be recovered until new rates are implemented in a future rate case.¹¹⁷

Conclusions of Law and Decision:

Liberty Utilities, in its brief, has requested to recover rate case expenses through at least September 11, 2018, when reply briefs are due. Staff witness Paul Harrison also affirmed September 11, 2018, as a period of time in which rate case expenses could continue to accrue.¹¹⁸ Counsel for Liberty noted that the revenue requirement to

¹¹² Exhibit No. 1, Schwartz Direct, Page 7.

¹¹³ Exhibit No. 1, Schwartz Direct, Page 8.

¹¹⁴ Exhibit No. 106, Harrison Rebuttal, Page 3.

¹¹⁵ Transcript, Pages 142-143.

¹¹⁶ Transcript, Pages 145-146

¹¹⁷ Exhibit No. 303, Stannard Surrebuttal, Pages 2-3.

¹¹⁸ Transcript, Page 149.

cover rate case expense is unknown at the time because rate case expense was still accruing.¹¹⁹ The Commission understands that Commission allowed rate case expenses will be an addition to the revenue requirement determined in this report and order. There are incentives for Liberty Utilities to file another rate case in the next few years due to potential acquisitions. However, the company has not filed a rate case for any of its water or sewer systems within the last five years, and the Commission is not in this order setting a time in which Liberty Utilities must file another rate case.

The Commission concludes that the company should be allowed to recover in rates prudently incurred rate case expense through September 11, 2018. Rate case expenses are to be amortized over a five year period with any over or under recovery to be placed in a regulatory asset or regulatory liability account to be considered in Liberty Utilities' next rate case.

B. Rate Design.

1. Customer Charge

- ***What is the appropriate customer charge for Liberty Utilities service areas?***
- ***What is the appropriate commodity charge for Liberty Utilities service areas?***
- ***Should any of Liberty Utilities' water systems be consolidated?***

The Commission will determine the appropriate rates to charge Liberty Utilities customers by service area. The Commission will determine whether any of Liberty Utilities' systems should be consolidated. Because rate case expense has not been calculated yet, any rate calculated is subject to change based upon the final allowable rate case expense.

¹¹⁹ Transcript, Page 41.

Findings of Fact:

1. The rate structure consists of a fixed monthly customer charge and a commodity (usage) charge. The customer charge is developed by comparing certain costs that are generally considered fixed. Commodity charges are generally developed by comparing the remaining costs and the usage characteristics of each system.¹²⁰

2. Most of the Liberty Utilities' water and sewer tariffs specify a monthly minimum base rate and a usage charge per 1,000 gallons of usage for each additional 1,000 gallons of usage thereafter. In addition, some of Liberty Utilities' customers' water and sewer rates are unmetered and are charged a flat monthly rate.¹²¹

3. Liberty is made up of 11 water and three sewer systems that compose nine water tariff districts and two sewer tariff districts. Liberty acquired these systems by purchasing KMB's water and sewer operations, Silverleaf's water and sewer operations, and Noel's water operations.¹²²

4. Silverleaf proposes applying the overall percentage increase in rate revenues needed for each system to each charge equally for water and sewer.¹²³

5. Silverleaf is opposed to Staff's rate design placing much of the increase in rates within the fixed customer charge. Silverleaf's witness testified that this method shifts much of the cost of the increase onto low volume users, impeding their ability to control their monthly bill.¹²⁴

¹²⁰ Exhibit No. 100, Barnes Direct, Page 3.

¹²¹ Exhibit No. 105, Harrison Direct, Schedule PRH-d2, Page 1.

¹²² Exhibit No. 100, Barnes Direct, Page 2.

¹²³ Exhibit No. 302, Stannard Refiled Rebuttal, Pages 22-23.

¹²⁴ Exhibit No. 302, Stannard Refiled Rebuttal, Pages 24-25.

6. Staff witness Matthew Barnes found that Silverleaf analyzed data from roughly 7,000 monthly bills. Two accountholders account for over 3,000 of those monthly bills. Of those two accountholders, 1,300 monthly bills have zero usage, but those same two accountholders also have the highest number (2,100) of monthly bills. Those accountholders put a tremendous strain on the system. The system has to be built to meet peak demand, and the users who are causing the highest stress on the system should be the ones paying for that system. Even if a substantial amount of the accountholders' monthly bills are for zero usage, the system has to be built to support the one or two months when usage is maxed. This means that the fixed costs for having a properly sized system should be collected from those customers every month through the customer charge.¹²⁵

7. Staff calculated the following customer charge amounts: \$23.88 for a 5/8" meter at the Noel water system, \$30.04 for a 5/8" meter at the consolidated KMB water system, and \$26.65 for the smallest meters (both 5/8" and 3/4") at the Silverleaf water systems.¹²⁶

8. The appropriate amounts for the sewer system customer charges are \$45.67 for the Cape Rock Village sewer system and \$37.07 for the Timber Creek and Ozark Mountain sewer system.¹²⁷

9. The appropriate amount for commodity charge, per thousand gallons, is \$3.04 for the Noel water service system, \$6.65 for the KMB water service system, and \$6.73 for the Silverleaf water service system. The appropriate amount for the

¹²⁵ Exhibit No. 102, Barnes Surrebuttal, Pages 2-3.

¹²⁶ Commission Exhibit No. 1, Attachment A.

¹²⁷ Commission Exhibit No. 1, Attachment A.

commodity charge is \$26.97 for the Timber Creek and Ozark Mountain sewer system.¹²⁸

10. Staff notes that because rate case expense has not been calculated yet, the proposed rates will change. Staff asks the Commission to approve the methodology used to reach the rates.¹²⁹

11. On January 13, 2018, Liberty Utilities formally requested that Staff and OPC consider the consolidation of customer rates, charges and fees, and rules and regulations.¹³⁰

12. Liberty Utilities agreed to consolidate rules and regulations for all of its water systems in the Partial Disposition Agreement. Liberty is requesting that the Commission approve consolidation of customer rates for its KMB and Noel water customers and KMB sewer customers.¹³¹

13. Liberty Utilities acquired the KMB water systems in 2010 and did not keep books and records separate for each of the seven different KMB properties. Liberty consolidated all the rate base and expenses for the KMB properties but kept the rates charged for each property separate according to the appropriate tariffs.¹³²

14. Liberty cites a joint publication by the United States Environmental Protection Agency and National Association of Regulatory Utility Commissioners titled Consolidated Water Rates: Issues and Practices in Single-Tariff Pricing in support of its

¹²⁸ Commission Exhibit No. 1, Attachment A.

¹²⁹ EFIS No. 133, Staff's Initial Brief, Page 25.

¹³⁰ Exhibit No. 105, Harrison Direct, Schedule PRH-d2, Page 4.

¹³¹ Exhibit No. 1, Schwartz Direct, Page 8.

¹³² Exhibit No. 105, Harrison Direct, Schedule PRH-d2, Page 3.

position for consolidation and lists the following reasons from that publication for consolidating its system rates:¹³³

- a. Mitigation of the impact of large rate increases
- b. Lower administrative costs to utilities and regulatory commissions
- c. Addresses small-system viability issues
- d. Improves service affordability for customers
- e. Facilitates compliance with drinking water standards
- f. Encourages investment in water supply infrastructure
- g. Promotes regional economic development

15. Staff proposed two rate design plans for Liberty Utilities. One plan involved district specific pricing where each currently tariffed service area would maintain its own rate structure based on its particular cost of service.¹³⁴ The Commission's Staff also proposed an alternative plan to consolidate the KMB service areas into one tariffed area.¹³⁵

16. Liberty is agreeable to the alternative rate design proposal that consolidates seven sets of rates for the KMB water system.¹³⁶

Conclusions of Law and Decision:

Rate design is how Liberty Utilities collects its revenue requirement. The Commission is keeping the current rate design in regard to each service area having a fixed customer charge regardless of usage and a commodity charge based upon usage.

¹³³ Exhibit No. 1, Schwartz Direct, Page 9, citing Consolidated Water Rates: Issues and Practices in Single-Tariff Pricing, by Jancie A. Beecher Ph.D., September 1999.

¹³⁴ Exhibit No. 100, Barnes Direct, Page 5.

¹³⁵ Exhibit No. 100, Barnes Direct, Page 7.

¹³⁶ Exhibit No. 2, Schwartz Rebuttal, Page 6.

The Commission finds that this creates just and reasonable rates by charging customers not only for the amount of water actually used, but also for use of the system, to assist in maintaining system integrity and readiness. The Commission rejects the notion that merely distributing any increase equally across all systems will result in just rates in this case. As Staff witness Barnes notes, when a low number of account holders have the highest and lowest usage, the stress on the system is severe. Placing a portion of the increase in the fixed charge helps balance seasonal and non-seasonal usage. The Commission is therefore adopting Staff's proposed rate methodology, with adjustments in the final amount to accommodate approved rate case expenses.

Liberty has proposed consolidating its rates for the KMB and Noel systems into one single-tariff rate. The Commission's Staff has proposed maintaining district specific pricing, or, in the alternative, just consolidating KMB properties. There are advantages to each. With district specific pricing, those who cause an expense bear the cost of that expense, while single-tariff pricing can mitigate large capital expenditures made in a particular district.¹³⁷ No party proposed consolidating the Silverleaf service at this time, and no party opposed consolidating the KMB properties.

The Commission concludes that the KMB system should be consolidated, but not the Noel system, which is a much larger system with 665 customers, most of which are permanent residents.¹³⁸

¹³⁷ Exhibit No. 100, Barnes Direct, Page 4.

¹³⁸ Exhibit No. 101, Barnes Rebuttal, Page 4.

2. Phase-in Rates

- ***Should rates for Holiday Hills, Ozark Mountain, and Timber Creek be phased-in over a period of five years?***
- ***Should carrying costs be allowed to be recovered if rates are phased-in?***

Silverleaf is requesting that the Commission order phase-in rates to mitigate the size of any increase on the Silverleaf system customers. The Commission will determine whether to order phase-in rates for Silverleaf or any other Liberty Utilities system.

Findings of Fact:

1. A phase-in rate design is an approach to rate design that allows for rates to be increased on an incremental basis to reach the ultimate Commission approved revenue requirement.¹³⁹

2. Staff does not generally oppose the use of phased-in rates when the magnitude of the rate increase when compared to existing rates makes a slower approach to increasing rates a better option for the customers.¹⁴⁰ Staff is opposed to phase-in rates in this case.¹⁴¹

3. Silverleaf proposes using phase-in rates for customers in the Silverleaf water and sewer systems as a way of mitigating rate shock.¹⁴² The phase-in approach would “stair step” any increase in rates such that only 1/4 of the increase is felt in year 1 and customers have time to adjust their budgets to take into account this new, unavoidable expense.”¹⁴³

¹³⁹ Exhibit No. 103, Busch Surrebuttal, Page 3.

¹⁴⁰ Exhibit No. 103, Busch Surrebuttal, Pages 3-4.

¹⁴¹ Transcript, Page 56.

¹⁴² Exhibit No. 302 – Stannard Refiled Rebuttal, Pages 25-27.

¹⁴³ Exhibit No. 302, Stannard Refiled Rebuttal, Page 28.

4. Rate shock is the financial harm caused to customers from a sudden, significant increase in customer utility bills caused by an increase in utility rates.¹⁴⁴

5. Silverleaf considers Liberty Utilities' time lapse between rate cases a management decision and the cause of any resulting harm done to customers from rate shock.¹⁴⁵ Its witness said: "The decision to wait nine years before filing a rate case did not lie with those customers. It was the choice of Liberty Utilities. These customers should not be penalized for Liberty Utilities' failure to file for timely rate adjustments over the years."¹⁴⁶

6. Silverleaf's phase-in proposal is that rates be phased in over a period of four years with the company earning its authorized rate in year five.¹⁴⁷

7. Silverleaf's proposed phase-in rates would have Liberty Utilities under-recovering in years one and two, and over-recovering in years three and four¹⁴⁸ with, "an adjustment to reflect the under-recovery during the phase-in period."¹⁴⁹

8. Staff is not familiar with a phase-in approach that does not compensate a utility for receiving its Commission approved revenue requirement, or that would result in recovery above the revenue requirement.

9. The plan proposed by Silverleaf does not promote rate stability. "Ultimately, under Mr. Stannards's plan, rates in years three and four will have to be

¹⁴⁴ Exhibit No. 302, Stannard Refiled Rebuttal, Page 16.

¹⁴⁵ Transcript, Page 66.

¹⁴⁶ Exhibit No. 302, Stannard Refiled Rebuttal, Page 25.

¹⁴⁷ Exhibit No. 302, Stannard Refiled Rebuttal, Page 26.

¹⁴⁸ Exhibit No. 302, Stannard Refiled Rebuttal, Page 26-27, Tables 14 and 15.

¹⁴⁹ Exhibit No. 302, Stannard Refiled Rebuttal, Page 26.

higher than they would have been if the entire revenue requirement was put into the initial rates under a normal rate design.”¹⁵⁰

10. Carrying costs are the interest the utility could have earned on the revenue it received; if the utility received its full Commission approved rate rather than a lesser amount. Carry costs occur when, during the phase-in, the utility’s rates are not designed to collect the Commission approved revenue requirement during the initial years of the phase-in.¹⁵¹

11. Silverleaf is not supportive of allowing carrying costs for Liberty Utilities, as its witness said: “The purpose of the phase-in is to mitigate the impact of a large rate increase, the magnitude of which is principally driven by Liberty Utilities failure to file for periodic rate adjustments... Accordingly, the carrying cost of a phase-in should be borne by Liberty Utilities.”¹⁵²

12. Customers are not being penalized by the utility waiting nine years to file a rate case. The Commission agrees with Staff’s witness that, “although the rate increase being proposed is high, the customers did have the advantage of paying lower rates over the past few years rather than paying the higher rates sooner... Customers are advantaged by paying a lower rate between actual rate cases than they otherwise would have paid if Liberty had received a rate increase prior to this rate case.”¹⁵³

13. Phasing-in rates for just the Silverleaf service areas would result in an undue and unreasonable preference.

¹⁵⁰ Exhibit No. 103, Busch Surrebuttal, Page 5.

¹⁵¹ Exhibit No. 103, Busch Surrebuttal, Page 5.

¹⁵² Exhibit No. 302, Stannard Refiled Rebuttal, Page 27.

¹⁵³ Exhibit No. 103, Busch Surrebuttal, Page 8.

Conclusions of Law and Decision:

Silverleaf proposes that the Commission require Liberty Utilities to phase-in its new rates for the Silverleaf service area.¹⁵⁴ It is unclear from William Stannard's testimony whether he is proposing phase-in rates for Silverleaf's service area only or for all of Liberty Utilities service areas. Phase-in rates should not be applied in this rate case under either proposition.

The rate increase for Liberty Utilities' service areas is significant compared to what its customers had previously been paying. The Commission's last approved rate increases for Liberty Utilities' water and sewer systems was in 2011 for the KMB properties, 2007 for the Silverleaf properties, and 2009 for the Noel properties.¹⁵⁵ The Commission does not agree that Liberty Utilities' decision to not come to the Commission for a rate increase earlier was merely a management decision devoid of other factors. Liberty Utilities has invested \$1,952,614 for water and \$621,830 for sewer improvements to meet Department of Natural Resource standards and improve the quality of service.¹⁵⁶ Additionally, because Liberty Utilities has not come to the Commission for a rate case in several years, its customers have benefited from having low, stable rates for a significant time. Silverleaf's argument that Liberty Utilities' customers are being "punished" for the "management decision" of not applying for a rate case sooner is unpersuasive.

Phase-in rates for Liberty Utilities' service areas are not appropriate. Silverleaf's proposed phase-in rate plan is not a gradual increase in rates toward earning a

¹⁵⁴ Exhibit No. 302, Stannard Refiled Rebuttal, Page 25.

¹⁵⁵ Exhibit No. 105, Harrison Direct, Page 5.

¹⁵⁶ Exhibit No. 105, Harrison Direct, Pages 5-6.

Commission approved revenue requirement, but a period of under-earning followed by a period of over-earning, followed by a reduction to a Commission approved revenue requirement. This does not conform to predictability or stability of rates for customers; customer rates would go up every year for four years before going down to a Commission approved revenue requirement. Under the proposed phase-in, if Liberty Utilities were to have a rate case within the next six years, customers would not see the same rates yearly for more than half a decade.

If Silverleaf is proposing that the phase-in rates apply only to Silverleaf service areas, then the Commission would be treating one group of Liberty Utilities' customers different than others without a compelling reason. The result would be inequitable for rate payers, with some service areas paying their full cost of service while the Silverleaf service area does not during the first two years of the phase-in. This shortfall of revenue from the phase-in service area could result in a detriment across the whole system due to less money being available for customer service or maintenance.¹⁵⁷

Likewise, not allowing carrying costs from the revenue shortfall places an undue burden on the utility. Silverleaf suggests that carrying costs should be disallowed because of the time lapse in Liberty Utilities filing a rate case. As stated earlier, customers benefited from low rates for a longer period of time due to the company not requesting a rate increase. Not allowing carrying costs would punish the company without wrongdoing and potentially incentivize more frequent rate case filings and rate case expense, some of which would ultimately be borne by the rate payers.

¹⁵⁷ Exhibit No. 103, Busch Surrebuttal, Page 7.

The Commission concludes that any change in rates for Liberty Utilities should be applied at one time and not phased-in over time. Carrying cost treatment does not need to be determined as the Commission is not applying any phase-in of rates.

C. Future Rate Case Exemption

- ***Should Silverleaf service areas be exempt from consideration in a subsequent rate case?***

Silverleaf has requested that they be exempted from consideration in any future rate case based upon a system acquisition by Liberty Utilities. The Commission will determine whether to exempt Silverleaf from any future Liberty Utilities rate cases.

Findings of Fact:

1. Silverleaf has proposed that the Silverleaf systems should not be included in any future rate cases solely related to Liberty Utilities acquisition of another system.¹⁵⁸

2. The water and sewer systems that serve Silverleaf are separate and detached from Liberty Utilities' other systems.¹⁵⁹

3. Liberty Utilities was approved to acquire seven additional water systems (including Ozark International, Inc.) in Case No. WM-2018-0023, potentially adding 900 customers to its system.¹⁶⁰

4. The Commission's Staff recommends that a utility come in for a rate case or rate review recommendation within 18-24 months after completing acquisition of a new system if there are anticipated major capital improvements, material changes in the

¹⁵⁸ Exhibit No. 302, Stannard Refiled Rebuttal, Page 6.

¹⁵⁹ Exhibit No. 302, Stannard Refiled Rebuttal, Page 7.

¹⁶⁰ Exhibit No. 105, Harrison Direct, Page 8.

composition of the acquiring utility customer base, or if the operational characteristics of the acquiring utility may change.¹⁶¹

5. The Commission's Staff has recommended that Liberty Utilities file another rate case within two years.¹⁶²

6. Another reason the Commission's Staff recommends that Liberty Utilities file a rate case within the next two years is that the company's books and records were not being kept in accordance with Commission rules. A review in 18-24 months will ensure books are being kept appropriately and rates set accordingly.¹⁶³

7. Silverleaf is concerned that it is unfair for Silverleaf systems to be punished by additional rate case costs and other "substantial burdens" based upon Liberty Utilities acquisition of an unrelated system.¹⁶⁴

8. Liberty Utilities expects to file a rate case within the next few years, due to its recent acquisition of a number of additional water systems from Ozark International, Inc., and its desire to address, among other things, the issues of overhead allocations and shared services and, also, to pursue tariff and rate consolidations.¹⁶⁵

9. While Liberty Utilities has received approval to acquire the Ozark International, Inc. systems, closing on the sale and transfer has not yet occurred.¹⁶⁶

10. Liberty Utilities' acquisition of additional systems has the potential to benefit Silverleaf customers.¹⁶⁷

¹⁶¹ Exhibit No. 103, Busch Surrebuttal, Page 9.

¹⁶² Exhibit No. 105, Gateley Direct, Page 5.

¹⁶³ Exhibit No. 103, Busch Surrebuttal, Page 9.

¹⁶⁴ Exhibit No. 302, Stannard Refiled Rebuttal, Page 5.

¹⁶⁵ Exhibit No. 1, Schwartz Direct, Page 8.

¹⁶⁶ Exhibit No. 103, Busch Surrebuttal, Page 9.

¹⁶⁷ Exhibit No. 103, Busch Surrebuttal, Pages 10-11.

11. Liberty Utilities has three full time employees that work out of its Noel office.¹⁶⁸ According to the company, all employees providing services to Liberty Utilities are employed by Liberty Utilities Service Corp.¹⁶⁹ The Company uses outside contractors to perform water and wastewater operator functions, meter reading, maintenance, and operations for all of Liberty Utilities systems except for Noel.¹⁷⁰

12. One of the Commission's Staff's recommendations to Liberty Utilities is that it perform a cost benefit analysis prior to any future rate case to determine if use of in-house employees would be more cost effective than paying outside contractors.¹⁷¹

13. Although Silverleaf is currently served by a separate rate schedule, it is part of Liberty Utilities. In order for the Company to achieve fair and reasonable rates for all of its customers, all of its revenues, expenses and investments need to be reviewed as part of a rate case. This is particularly important to ensure the proper allocation of the costs of shared services and corporate overhead allocations.¹⁷²

Conclusions of Law and Decision:

Silverleaf's proposition that the Silverleaf system be excluded from a future rate proceeding is premised on two assertions: 1) Systems acquired by Liberty Utilities are unrelated to Silverleaf's cost of service, and 2) Systems acquired by Liberty Utilities will negatively impact the rates of the Silverleaf system.

The first assertion is incorrect because while Silverleaf is a separate system from the other Liberty Utilities systems, and while it is not being consolidated like the KMB

¹⁶⁸ Exhibit No. 105, Harrison Direct, Schedule PRH-d2, Page 8.

¹⁶⁹ Exhibit NO. 1, Schwartz Direct, Page 3.

¹⁷⁰ Exhibit No. 105, Harrison Direct, Page 7.

¹⁷¹ Exhibit No. 105, Harrison Direct, Page 8.

¹⁷² Exhibit No. 3, Schwartz Surrebuttal, Page 3.

system, it still shares the same management and corporate structure. Any change in that management or corporate structure will necessarily change the cost of service for the Silverleaf system. Additionally Liberty Utilities currently uses outside contractors to service and maintain the Silverleaf and some other Liberty Utilities systems. Should that change, it would also impact Silverleaf's cost of service.

The second assertion is incorrect because the effect of any change to corporate structure or management is speculative and not necessarily negative. Many of the suggestions the Commission's Staff has made, such as cost analysis of contractors and using continuous chlorine monitoring equipment in the KMB system,¹⁷³ have the potential to reduce cost of service. The acquisition of the Ozark International, Inc. system and 900 additional customers has not closed yet, and the impact of such an addition is speculative as to overall rates. However, as Staff witness James Busch points out, an addition of 37 percent more customers will likely lower Silverleaf's cost of service through depreciation alone. Also, adding customers under shared corporate management, coupled with other shared services, is likely to positively affect Silverleaf's cost of service in subsequent rate proceeding.

Section 393.130.2, RSMo addresses preferential treatment:

No ... water corporation or sewer corporation ... shall directly or indirectly by any special rate, rebate, drawback or other device or method, charge, demand collect or receive from any person or corporation a greater or less compensation for ... water, sewer [service] ..., except as authorized in this chapter, than it charges, demands, collects or receives from any other person or corporation for doing a like and contemporaneous service with respect thereto under the same or substantially similar circumstances or conditions.

Subsection 3 adds:

¹⁷³ Exhibit No. 105, Gateley Direct, Pages 2-3.

No ... water corporation or sewer corporation shall make or grant any undue or unreasonable preference or advantage to any person, corporation or locality, or to any particular description of service in any respect whatsoever, or subject any particular person, corporation or locality or any particular description of service to any undue or unreasonable prejudice or disadvantage in any respect whatsoever.

The statute says that utilities cannot give any “undue or unreasonable” preference or disadvantage to any particular customer, or class of customers, or locality.

As stated above regarding phase-in rates, separating out one system for exclusion from a future rate case creates both an undue and unreasonable preference and an advantage to the Silverleaf system over other systems. An increase in rates that does not apply to one system burdens the other systems with the cost of shared services and management. Likewise, if some customers are excluded from review, those customers in the excluded service area will not be recognized in rates, and the utility could collect revenues above those authorized. An effective rate case requires that all relevant factors are reviewed in order to set just and reasonable rates.¹⁷⁴

The Commission concludes that the Silverleaf systems should not be exempted from any future rate case. The Commission is not ordering that Liberty Utilities file a rate case within two years.

D. Customer Service

- ***Has Liberty Utilities adequately responded to customer service issues?***
- ***Does the Commission wish to take any action regarding customer service issues?***

OMCA intervened in this rate case because of concerns it had about what it considered inadequate service by Liberty Utilities in providing water service. The

¹⁷⁴ Exhibit No. 103, Busch Surrebuttal, Page 12.

Commission will determine what, if any, service issues exist, and decide if any action needs to be taken to resolve or improve service.

Findings of Fact:

1. OMCA's concerns in this case are specifically whether the service provided by Liberty Utilities is safe and adequate, and whether the rates the company proposes are just if service is not consistently safe and adequate.¹⁷⁵

2. Don Allsbury, the property manager employed by OMCA testified as to water and sewer issues he recorded between 2009 and 2018 at the condominiums in Ozark Mountain Resort.¹⁷⁶ The issues recorded by Don Allsbury are summarized as follows:

- a. 2009 – Five water main breaks
- b. 2010 – Several water main freezes
- c. 2011 – One valve malfunction
- d. 2012 – One loss of water pressure
- e. 2015 – Several frozen water meters
- f. 2015 – Over 42 days of high, low, and no water pressure
- g. 2018 – Two frozen water meters¹⁷⁷

3. In April 2018, Liberty Utilities terminated its contract with outside contractor R K Water Operations LLC after experiencing several issues involving quality of service provided. Before that time, the Ozark Mountain system was primarily

¹⁷⁵ Transcript, Page 71.

¹⁷⁶ Exhibit No. 401, Allsbury Direct, Pages 1-2.

¹⁷⁷ Exhibit No. 112, Roos Rebuttal, Page 2.

operated by R K Water Operations LLC.¹⁷⁸ Ozark Mountain was purchased from Silverleaf Resorts Inc. in 2005 and is part of the Silverleaf system.¹⁷⁹

4. Liberty Utilities is planning to remedy the issues and concerns raised by OMCA. Its witness explained:

“[T]he fact that the issues identified and included in Mr. Allsbury’s direct testimony do not extend beyond January 2018, that the Company has already made significant improvements in the quality of service provided and is preparing a list and plan to remedy the issues and concerns raised by OMCA. Specifically, Mr. Allsbury identified multiple issues and reports of water pressure issues. As a result, the Company is currently installing generators in Ozark Mountain’s pressurized water system so that customers will continue to have water during power outages. The Company anticipates that the installation of these generators will be complete by the end of August 2018.”¹⁸⁰

5. Staff met with Paul Carson, Liberty Utilities’ Operations Manager, on February 9, 2018. From that meeting Staff determined that the water pressure problems in 2015 were a combination of equipment failure and operator error. Staff determined that the incidents recounted in Don Allsbury’s testimony have been resolved. According to Staff’s witness, “The water system has been repaired and is currently a reliable source of water. Staff is not aware of any current operational issues with the Ozark Mountain Resort’s water system.”¹⁸¹

6. Liberty has agreed to make changes to bring it into compliance with Commission Rule 4 CSR 240-13.040 as part of the Partial Disposition Agreement adopted by the Commission in this case. Staff’s witness testified, “Liberty has stated it is modifying contract procedures, and referring all customer inquiries to its call center so

¹⁷⁸ Exhibit No. 2, Schwartz Rebuttal, Page 3.

¹⁷⁹ Exhibit No. 302, Stannard Refiled Rebuttal, Page 3.

¹⁸⁰ Exhibit No. 2, Schwartz Rebuttal, Pages 7-8.

¹⁸¹ Exhibit No. 112, Roos Rebuttal Pages 2-3.

that all customer inquiries are logged and properly responded to in a timely manner. In Staff's opinion, replacement of the PRV [pressure release valve], the new contract operator, and Liberty's recent customer service changes have led to more reliable service."¹⁸²

7. Some service issues have not been resolved. Rotting meter boxes reported to Liberty Utilities in 2015¹⁸³ have still not been repaired.¹⁸⁴ Don Allsbury described multiple occasions where calling Liberty to report customer service problems failed to produce satisfactory results because either the company offices were closed, or the company would not act without information unavailable to Allsbury.¹⁸⁵

Conclusion:

OMCA intervened in this case largely because it was concerned that Liberty Utilities was requesting, and would receive, a rate increase for the Ozark Mountain service area without addressing what it felt were numerous instances of inadequate service. While this is not a formal complaint case, the Commission has the responsibility to examine all relevant factors when determining rates.¹⁸⁶ During the hearing, the Commission inquired of OMCA as to what it would like the Commission to do when it comes to customer service.¹⁸⁷ OMCA answered simply, "Better customer service, use of in-house employees, prompter reporting not a month later[.]"¹⁸⁸

¹⁸² Exhibit No. 112, Roos Rebuttal, Pages 3-4.

¹⁸³ Exhibit No. 401, Allsbury Direct, Page 4.

¹⁸⁴ Exhibit No. 401, Allsbury Direct, Page 8.

¹⁸⁵ Exhibit No. 401, Allsbury Direct, Pages 175, 178.

¹⁸⁶ *State ex rel. Util. Consumers' Council of Missouri, Inc. v. Pub. Serv. Comm'n*, 585 S.W.2d 41, 56 (Mo. banc 1979).

¹⁸⁷ Transcript, Pages 75, 77.

¹⁸⁸ Transcript, Page 77.

The Commission recognizes that Liberty Utilities has already made some changes such as terminating its contract with unsatisfactory third party contractors. Liberty Utilities has also agreed to other changes related to customer service that are contained in the Partial Disposition Agreement. OMCA in its brief asked the Commission to order Liberty Utilities to do six things:

- 1) Record all customer inquiries *and service-related complaints* received by Company personnel, as well as all customer inquiries and service-related complaints received and reported by the Company's contractors, in the customer's account records in the customer information system.
- 2) Require Liberty to require all its contractors to report all customer inquiries and service-related complaints to Company personnel, at or near the time the inquiry is received, but no later than one business day thereafter.
- 3) Require Liberty to use local employees for normal, day to day operations.
- 4) Require Liberty to use local employees or local contractors to provide all on-site water system repairs, and where local contractors are utilized, require a local employee to either provide direct, on-site supervision while the work is performed, or to inspect and document the contractor's work no later than one business day after the work is performed.
- 5) Require Liberty's operations manager to make an on-site visit at the Silverleaf water system with Mr. Allsbury within 30 days of issuance of the Commission's Report and Order in this Rate Case, and to document all issues of concern reported to him by Mr. Allsbury.
- 6) Require Liberty to include with specificity, in its 5-year capital improvements plan, how it will resolve issues of concern at the Silverleaf water system reported by Mr. Allsbury, and to specify firm deadlines by which it resolve them.

OMCA also asks that the Commission take into consideration Liberty Utilities' customer service history in determining what rate increase would be just and reasonable to both Liberty Utilities and its customers.¹⁸⁹

¹⁸⁹ EFIS No. 135, Ozark Mountain Condominium Association, Inc.'s Post Hearing Brief.

Decision:

The Commission concludes that based upon the evidence offered in relation to customer service issues, and in consideration of progress made in addressing customer service issues, Liberty Utilities shall do the following:

- 1) Record all service-related complaints received by Company personnel, and service-related complaints received and reported by the Company's contractors, in the customer's account records in the customer information system.
- 2) Require all its contractors to report all service-related complaints to Company personnel, at or near the time the inquiry is received, but no later than one business day thereafter.
- 3) Require Liberty's operations manager to make an on-site visit at the Silverleaf (Ozark Mountain is in the Silverleaf system) water system with Mr. Allsbury within 90 days of issuance of the Commission's Report and Order in this Rate Case, and to document all issues of concern reported to him by Mr. Allsbury.
- 4) Include with specificity, in its 5-year capital improvements plan, how it will resolve issues of concern at the Silverleaf water system (Ozark Mountain is in the Silverleaf system) reported by Mr. Allsbury, and to specify firm deadlines by which it will resolve them.

The Commission is not changing or reducing the rates it is authorizing due to any customer service issues.

THE COMMISSION ORDERS THAT:

1. Liberty Utilities' motion to strike OPC's response to *Notice of no Objections to Non-unanimous Stipulation and Agreement, Request to Modify Hearing Schedule, and Motion for Expedited Treatment* is denied.
2. Silverleaf's motion to strike the testimony of Keith Magee is denied.

3. No party timely objected to the *Non-Unanimous Stipulation and Agreement*. The Commission is treating the *Non-Unanimous Stipulation and Agreement* as non-unanimous. The Commission is not adopting the *Non-Unanimous Stipulation and Agreement*.

4. The Commission adopts the provisions, other than those issues disputed at the evidentiary hearing, of the *Partial Disposition Agreement and Request for Evidentiary Hearing* filed on May 24, 2018, including attachments. The signatories are ordered to comply with the terms of these partial disposition agreements, which are attached hereto as Attachment A and incorporated herein by reference as if fully set forth.

5. Liberty Utilities is authorized to file tariff sheets sufficient to recover revenues approved in compliance with this order. Liberty Utilities shall file its compliance tariff sheets no later than November 5, 2018.

6. Liberty Utilities shall file the information required by Section 393.275.1, RSMo 2016, and Commission Rule 4 CSR 240-10.060 no later than November 8, 2018.

7. The Staff of the Missouri Public Service Commission shall file its recommendation concerning approval of Liberty Utilities' compliance tariff sheets no later than November 8, 2018.

8. Any other party wishing to respond or comment regarding Liberty Utilities' compliance tariff sheets shall file its response or comment no later than November 8, 2018.

9. This Report and Order shall become effective on November 3, 2018.

BY THE COMMISSION



Morris L Woodruff

Morris L. Woodruff
Secretary

Silvey, Chm., Kenney, Hall, Rupp, and
Coleman, CC., concur.

Clark, Regulatory Law Judge