MISSOURI PUBLIC SERVICE COMMISSION

STAFF REPORT

REVENUE REQUIREMENT
COST OF SERVICE

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LIBERTY UTILITIES (MIDSTATES NATURAL GAS) CORP.
d/b/a LIBERTY UTILITIES

CASE NO. GR-2014-0152

Jefferson City, Missouri
June 6, 2014

** Denotes Highly Confidential Information **

* Denotes Propriety Information *

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LIBERTY UTILITIES (MIDSTATES NATURAL GAS) CORP. d/b/a LIBERTY UTILITIES

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I. Executive Summary

A. Staff's Revenue Requirement Recommendation

Staff of the Missouri Public Service Commission ("Staff") has conducted a review of all cost of service components (capital structure and return on rate base, rate base, depreciation expense and operating revenues and expenses) which comprise the Liberty Utilities (Midstates Natural Gas) Corp. d/b/a Liberty Utilities ("Liberty Utilities" or "Liberty Midstates") revenue requirement. This audit was in response to the Liberty Utilities' February 6, 2014 filing seeking to increase rates to recover approximately an additional $7.6 million (including $1.3 million of currently in effect Infrastructure System Replacement Surcharge (ISRS) rates) annually. The test year for this case is the twelve months ending September 30, 2013. The test year update period for this case is the six months ending March 31, 2014. Staff's recommended revenue requirement for Liberty Utilities, based upon updated results through March 31, 2014, is approximately -$3,856,734 at the Staff's recommended midpoint rate of return.

B. Impact of Staff's Revenue Requirement on Retail Rate Revenue

Staff's recommended revenue requirement of -$3,856,734 million would represent a decrease in Liberty Utilities' total natural gas revenues based on existing rates. The decrease relates only to Liberty Utilities' margin revenues and does not include Liberty Utilities' gas cost revenues. While Staff's revenue requirement supports a rate decrease, Staff is not filing a complaint case at this time given that Staff understands that the data provided to Staff to date, requires additional data and clarification by Liberty Utilities, especially in the areas of revenues and rate base. Staff will continue to work with Liberty Utilities regarding this data and will make any necessary adjustments based upon additional information received.

It should be noted that Liberty Utilities has either just provided or has yet to provide clarification of certain customer count and usage data requested by Staff related to the revenues calculation and additional data related to Plant In Service and Accumulated Depreciation Reserve balances. Until recently, Staff expected that it would have all necessary information to perform its analysis and therefore anticipated filing Supplemental Direct Testimony on June 18, 2014. However, Staff has not yet received all information necessary to perform its traditional review and analysis of the revenues in this case. Therefore, as discussed more fully in Staff witnesses Lisa K. Hanneken and Thomas M. Imhoff's direct testimonies which are being filed concurrently with this report, Staff utilized an alternative method for calculation of revenues for purposes of its direct testimony filing pertaining to the revenue requirement in this case. In addition, Staff will likely not be able to file supplemental direct testimony for revenues based on the lack of information necessary to do so.

The impact of the Staff's recommended revenue requirement on each of Liberty Utilities' rate classes will be discussed in the Staff's rate design and class cost of service report that is to be filed on June 26, 2014. It is also important to note that a portion of the Staff's general rate increase recommendation has already been passed on to Liberty Utilities' customers through periodic ISRS rate filings made previously by Liberty Utilities and its predecessor, Atmos Energy Corporation ("Atmos" or "Atmos Energy"). Effective August 1, 2012, Liberty Utilities acquired certain Atmos assets as part of Acquisition Case No. GM-2012-0037, these assets included Liberty Utilities Missouri gas operations. Since the time of Atmos' last general rate increase in 2010 and at the time of Liberty Utilities' direct testimony filing in February 2014, ISRS rate increases totaling $1,332,023 annually had been approved by the Missouri Public Service Commission ("Commission" or "MoPSC"). Those rate increases were charged to Liberty Utilities' customers through the ISRS rate mechanism. Once rates ordered by the Commission in this proceeding become effective, the current ISRS rate surcharge will be reset to zero and the amounts formerly collected through the ISRS surcharge will then be part of Liberty Utilities' general retail rates.

II. Background of Rate Case

On February 6, 2014, Liberty Utilities filed tariffs for a total company proposed increase of \$6,347,569, representing a 31.37% percent increase. Liberty Utilities' case reflects a 10.5% return on equity (ROE) based upon a proposed range of 10.00% to 10.50% with a capital structure of 41.66 percent long-term debt and 58.34 percent common equity.

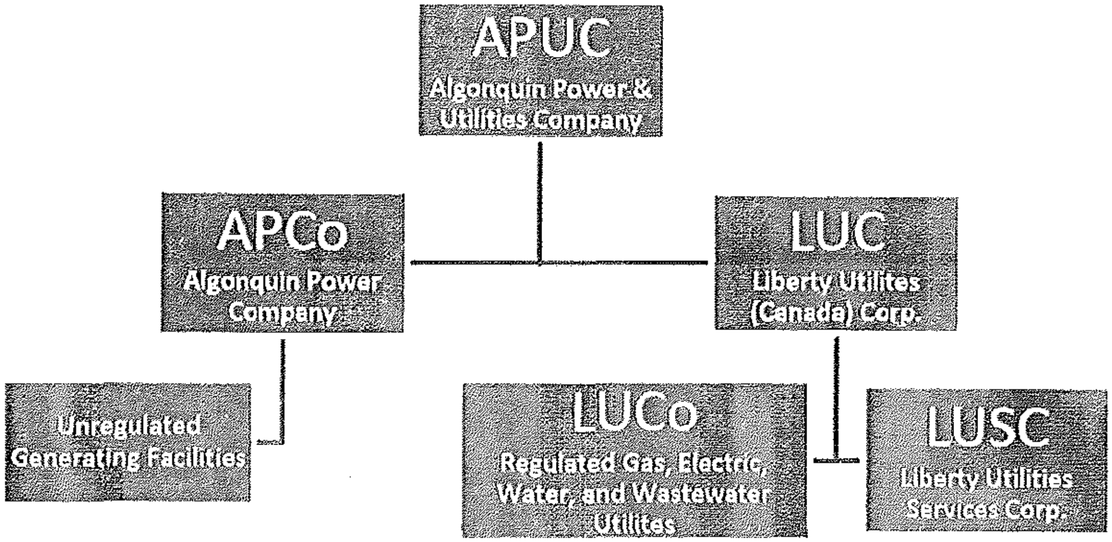
III. Background of Liberty Utilities

Liberty Midstates' ultimate parent company, Algonquin Power & Utilities Corporation ("APUC") is a Canadian corporation whose stock is traded on the Toronto Stock Exchange. APUC has two business units:

> Algonquin Power Company ("APCo"), which owns or has interests in unregulated power generation facilities; and
>
> Liberty Utilities (Canada) Corp. ("LUC") which owns 100% interest in LUCo, which owns and operates thirty regulated utilities located in ten states within the United States that provide retail water, sewer, electric and natural gas service.

Liberty Midstates falls under Liberty Utilities Company (LUCo). Liberty Midstates is comprised of Missouri, Iowa and Illinois utilities. In addition, Liberty Utilities Services Corp. (LUSC) is a service Company that has been recently formed. Below is a simplified organizational chart showing the current structure of APUC and its affiliated companies:

continued on next page



The Missouri gas operations are part of Liberty Midstates, whose head office is in Jackson, Missouri. The Missouri gas operations of Liberty Utilities provide gas service to approximately 55,000 customers, spread throughout three separate rate districts in Northeast ("NEMO"), Southeast ("SEMO"), and Western ("WEMO") Missouri. As discussed in Staff witness Hanneken's direct testimony, Staff will present three separate sets of accounting schedules and revenue requirements for each of these districts as well as a total Missouri set. Liberty Utilities' Missouri operations receive a variety of corporate, administrative and support services from its affiliates and parent corporation, for which the costs are charged to Missouri operations. This process is discussed more fully in the allocation section of this report.

The Commission last authorized a general rate increase for Atmos, in an August 18, 2010 Report and Order in Case No. GR-2010-0192. New rates became effective on September 1, 2010. In that case the Commission approved a stipulation and agreement granting an annual rate increase of $5,650,000.

IV. Issues Regarding Appropriate Record Keeping

As will be discussed more fully in Staff witnesses Hanneken and Imhoff's direct testimonies as well as other sections of this report, Staff discovered several significant issues regarding the adequacy of Liberty Utilities' recordkeeping during its audit of the Liberty Utilities' books and records in this case.

As previously mentioned in Section I above, the revenue data provided by Liberty Utilities originally lacked five months of test year detail as well as being in some instances inconsistent with historical data and otherwise showing signs of being flawed.

In addition to the revenue data, Staff found that Liberty Utilities' plant records are not being kept in a manner consistent with the typical recordkeeping practices of regulated utilities. Staff discovered that during the test year the plant software system was not booking the Construction Work In Progress (CWIP) amounts to the Plant In Service accounts once the projects were completed and placed in service. Rather, the system was holding such items in CWIP. However, subsequent to the test year, in October 2013, the problem was corrected and all plant that had been actually placed in service during test year was finally booked to Plant In Service, along with the associated reserve amounts. It was also discovered that some of the plant retirements had been incorrectly booked; Staff is awaiting additional information to allow it to make adjustments to correct the retirement amounts.

Staff has also encountered various other booking issues which Staff has been able to account for through adjustments in different areas, each of which are discussed more fully in the sections of this report.

In addition, as discussed in Staff witness Zephania Marevangepo's Rate of Return and Capital Structure section, there were difficulties in performing the cost of capital analysis.

V. Major Issues

Liberty Utilities' filed its case based upon a test year ending September 30, 2013. The Staff updated the major components of Liberty Utilities' revenue requirement through March 31, 2014. The major differences between the Staff and Liberty Utilities, as reflected in their respective direct testimony filings, include the following issues along with their approximate dollar value:

Rate of Return – Issue Value – ($724,325) The Company's case reflects a 10.5% ROE based upon a proposed range of 10.00% to 10.50%, while the Staff is recommending an ROE range from 8.20% to 9.20%, with an 8.70% midpoint ROE.

Pension and OPEBs Expense – Issue Value ($747,647) In its direct filing, Liberty Utilities made an overall adjustment to all items it considered employee benefits, such as healthcare costs, pensions, Other Post-Employment Benefits (OPEBs), incentive compensation, and others. The adjustment was based on the amount of increase to payroll calculated by Liberty Utilities witness James Fallert, and then factoring up the test year amount of all benefits by that percentage (calculated as test year benefits over total payroll). In contrast, Staff's adjustment is reliant upon values only related to Pensions and OPEBs and takes into account the most recent levels of actual cash contributions to external trust funds for each item.

Revenues - Issue Value ($2.5 million) As discussed previously, Staff was unable to make all traditional adjustments related to revenues, particularly for weather normalization, customer growth/loss, and seasonality. This had led to significant differences in Staff's revenue numbers compared to Liberty Utilities' revenues amount.

Contractual Customer Revenues - Issue Value ($2.8 million) Staff made adjustments to test year revenues to reflect Staff's calculation of the revenues for certain contractual customers based on information related to each customer. Liberty Utilities did not propose any change to the level of revenues related to its contractual customers.

Staff Expert/Witness: (Section I, II, III, IV and V) Lisa K. Hanneken

VI. Rate of Return and Capital Structure

A. Introduction

An essential ingredient of the cost-of-service ratemaking formula provided above is the rate of return (ROR), which is designed to provide a utility with a return of the costs required to secure debt and equity financing. This ROR is usually premised on the utility's weighted average cost of capital ("WACC"), which is calculated by multiplying each component ratio of the appropriate capital structure by its cost and then summing the results. In this case, Staff is recommending the use of LUCo's capital structure based on its capital structure analyses, which Staff will discuss later in this testimony. While the proportion and cost of most components of the capital structure are a matter of record, the cost of common equity must be determined through expert analysis.

Staff's expert financial analyst, Zephania Marevangepo, has determined Liberty Midstates cost of common equity by applying a well-respected and widely-used methodology[1] to data derived from a carefully-assembled group of comparable companies. Staff then used that cost of common equity, together with other capital component information as of the test year date, September 30, 2013, to calculate Liberty Midstates' fair rate of return as follows:

TABLE ONE: Liberty Midstates' Rate of Return:

			Weighted Cost of Capital Using Common Equity Return of:	
Capital Component	Percentage of Capital	Embedded Cost	**8.20%**	**8.70%**
Common Stock Equity	* *	* ---- *	* *	* *
Long-Term Debt	* *	* *	* *	* *
	100.00%		**6.34%**	**6.57%**

As contained in Table One, Staff recommends, based on its expert analysis, a ROE range of 8.20 percent - 9.20 percent and an overall ROR range of 6.34 percent – 6.80 percent, with mid-point estimates of 8.70 percent ROE and 6.57 percent overall ROR. Staff's recommended ROE incorporates a * * -basis point credit-rating differential adjustment, which is the spread between the average credit-rating ('A') of Staff's proxy group and LUCo's' credit rating * *

Staff established that (1) APUC is the direct parent company of LUCo, (2) LUCo is the direct parent company of Liberty Midstates and (3) APUC is the ultimate parent company

[1] Staff relied primarily on its Discounted Cash Flow ("DCF") analysis of a group of comparable utilities, checking the reasonableness of its result with a Capital Asset Pricing Model ("CAPM") analysis as well as by other corroborating data.

[2] * *

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of both LUCo and Liberty Midstates.[3] *

* Consequently, Staff used DBRS' credit rating on LUCo as the basis for the credit rating differential adjustment to its Liberty Midstates' cost of equity recommendation. Further details of Staff's analysis and recommendations are presented in Appendix 2, Schedules 1-13, attached to this report.

Staff's cost-of-equity estimate is primarily based on the constant-growth Discounted Cash Flow ("DCF") model results. The major assumption made when the constant-growth DCF model is applied to mature companies, such as natural gas distribution companies, is that mature companies experience constant growth into perpetuity. The constant growth (perpetual growth) used in Staff's constant-growth DCF model is premised on Staff's assumption that Staff's set of comparable natural gas distribution companies (proxy group)[5] should not experience a compound annual perpetual growth rate much, if any, higher than those actually achieved for the natural gas distribution industry over a prolonged time period. As Staff explains in detail later in this Section of the Cost of Service Report, the constant-growth rate should not be any higher than 5 percent based on actual experience.

B. Analytical Parameters

The determination of a fair rate of return is guided by principles of economic and financial theory; and by certain minimum constitutional standards. Investor-owned public utilities such as Liberty Midstates are private property that the state may not confiscate without appropriate compensation. The United States Constitution requires, therefore, that utility rates set by the government must allow a reasonable opportunity for the shareholders to earn a fair return on their investments. The United States Supreme Court has described the minimum characteristics of a Constitutionally-acceptable rate of return in two frequently-cited cases. In ***Bluefield Water Works & Improvement Co. v. Public Service Commission of West Virginia,*** the Court stated:[6]

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[3] File No. GM-2012-0037: Notice of Corporate Reorganization, page 2-paragraph 3 and page 3-paragraph 5.

[4] *

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[5] Schedule 7-2.

[6] 262 U.S. 679, 692-93, 43 S.Ct. 675, 679, 67 L.Ed. 1176, 1182-83 (1923).

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

Similarly, in the later of the two cases, ***Federal Power Commission v. Hope Natural Gas Co.***, the Court stated:[7]

> '[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.

From these two decisions, Staff derives and applies the following principles to guide it in recommending a fair and reasonable rate of return ("ROR"):

1. A return consistent with returns of investments of comparable risk;
2. A return sufficient to assure confidence in the utility's financial integrity; and
3. A return that allows the utility to attract capital.

Embodied in these three principles is the economic theory of the opportunity cost of an investment. The opportunity cost of an investment is the return that investors forego in order

[7] 320 U.S. 591, 603, 64 S.Ct. 281, 288, 88 L.Ed. 333, 345 (1943).

to invest in similar risk investment opportunities, which will vary depending on market and business conditions.

The methodologies of financial analysis have advanced greatly since the ***Bluefield*** and ***Hope*** decisions. Additionally, today's utilities compete for capital in a global market rather than a local market.[8] Nonetheless, the parameters defined in those cases are readily met using current methods and theory. The principle of the commensurate return is based on the concept of risk. Financial theory holds that the return an investor may expect is reflective of the degree of risk inherent in the investment, risk being a measure of the likelihood that an investment will not perform as expected by that investor. Any line of business carries with it its own peculiar risks and it follows, therefore, that the return Liberty Midstates may expect is equal to that required for comparable-risk utility companies.

Financial theory holds that the results of a company-specific DCF method satisfies the constitutional principles inherent in estimating a return consistent with those of companies of comparable risk;[9] however, Staff recognizes that there is also merit in analyzing a comparable group of companies as this approach allows for consideration of industry-wide data. Because Staff believes the cost of equity can be reliably estimated using a comparable group of companies and the Commission has expressed a preference for this approach, Staff relies primarily on its analysis of a comparable group of companies to estimate the cost of equity for Liberty Midstates.

In this case, Staff has applied the comparable company approach through the use of both the DCF method and the Capital Asset Pricing Model ("CAPM"). Properly used and applied in appropriate circumstances, both the DCF and the CAPM methodologies can provide accurate estimates of a utility's cost of equity. Because it is well-accepted economic theory that a company that earns its cost of capital will be able to attract capital and maintain its financial integrity, Staff believes that authorizing an *allowed* return on common equity no lower than the *cost* of common equity is consistent with the principles set forth in ***Hope*** and ***Bluefield***.

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[8] Neither the DCF nor the CAPM methods were in use when those decisions were issued.

[9] Because the DCF method uses stock prices to estimate the cost of equity, this theory not only compares the utility investment to other utilities, but it compares the utility investment to all available assets. Consequently, setting the allowed ROE based on a market-determined cost of equity is necessarily consistent with the principles of ***Hope*** and ***Bluefield***.

C. Current Economic and Capital Market Conditions

Determining whether a cost of capital estimate is fair and reasonable requires a good understanding of the current economic and capital market conditions, with the former having a significant impact on the latter. With this in mind, Staff emphasizes that an estimate of a utility's cost of equity should pass the "common sense" test when considering the broader current economic and capital market conditions.

1. Economic Conditions

For the 2013 calendar year, the U.S. economy expanded in all four quarters. Real GDP increased 1.1 percent in the first quarter, 2.5 percent in the second quarter, 4.1 percent in the third quarter and 2.6 percent in the fourth quarter.[10] The Bureau of Economic Analysis attributes the deceleration in real GDP growth from the third quarter to the fourth quarter to a downturn in inventory investment, a larger decrease in federal government spending, and a downturn in housing investment. As of March 19, 2014, the Federal Reserve Bank ("Fed") projected the economy would grow between 2.8 percent and 3.0 percent this year and between 3.0 percent and 3.2 percent next year. Assuming the projected economic growth does not cause inflation rates to rise above the Fed's target inflation rate of 2 percent and the unemployment rate continues to trend toward 6.5 percent, the Fed's actions should be consistent with what it has communicated to markets.

Information released from the recently-held Federal Open Market Committee ("FOMC") meeting held on March 19, 2014, share the FOMC's view that the data received since the last meeting in January indicate that growth in economic activity decelerated. Labor market indicators showed further improvement, but the unemployment rate remains elevated. The FOMC reduced its overall bond purchase program by another $10 billion per month beginning April 2014; and also indicated that it will continue to taper the bond purchase program if the incoming information and financial developments exhibit substantial improvement.

The FOMC updated its forward guidance based on the unemployment rate now nearing 6.5 percent. The following excerpt reflects the FOMC's current stance:

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[10] Bureau of Economic Analysis, GDP Growth Slows in Fourth Quarter, March 27, 2014 and National Income and Product Accounts Gross Domestic Product, 4th quarter and annual 2013 (third estimate); Corporate Profits, 4th quarter and annual 2013.

> To support continued progress toward maximum employment and price stability, the Committee today reaffirmed its view that a highly accommodative stance of monetary policy remains appropriate. In determining how long to maintain the current 0 to ¼ percent target range for the federal funds rate, the Committee will assess progress–both realized and expected—toward its objectives of maximum employment and 2 percent inflation. This assessment will take into account a wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial developments. The Committee continues to anticipate, based on its assessment of these factors, that it likely will be appropriate to maintain the current target range for the federal funds rate for a considerable time after the asset purchase program ends, especially if projected inflation continues to run below the Committee's 2 percent longer-run goal, and provided that longer-term inflation expectations remain well anchored.
>
> When the Committee decides to begin to remove policy accommodation, it will take a balanced approach consistent with its longer-run goals of maximum employment and inflation of 2 percent. The Committee currently anticipates that, even after employment and inflation are near mandate-consistent levels, economic conditions may, for some time, warrant keeping the target federal funds rate below levels the Committee views as normal in the longer run.[11]

Some of Staff's proxy group companies issuances of long-term debt offer evidence of the existence of the still-low long-term debt cost environment. On August 13, 2013, Laclede Gas Company issued $450 million of first mortgage bonds 3.34 percent (average) debt series ($100 million 5-year term 2.00 percent series debt, $250 million 10-year term 3.40 percent series debt and $100 million 30-year term 4.625 percent series debt) compared with Laclede Gas Company's 6.5 percent $25 million first mortgage bonds paid at maturity on October 15, 2012. On August 19, 2013, Northwest Natural Gas Company issued 3.542 percent $50 million first mortgage bonds with a 10-year maturity. Another example is AGL Resources, which issued $500 million in 30-year senior notes with a fixed interest rate of 4.4 percent on May 16, 2013.

[11] Federal Reserve Press Release March 19, 2014.

2. Capital Market Conditions

a. Utility Debt Markets

Utility debt markets clearly indicate a lower cost-of-capital environment. If one were to assume that the risk premium[12] required for investing in utility stocks rather than utility bonds were constant, then the currently low utility debt yields clearly translate into a lower required return on equity. In other words, lower cost of debt is indicative of lower cost of capital, all else being equal.

Although long-term interest rates – as measured by 30-year Treasury Bonds "T-Bonds" and utility bond yields – increased during the 2013 calendar year, they have decreased slightly during the first three months of 2014 and are still low when compared to long-term interest rates experienced prior to and immediately after the end of the most recent recession in June 2009 (*see* Schedules 4-2 and 4-3, and Schedules 4-1 and 4-3 respectively). As of March 2014, the average spread between 30-year T-bonds (3.62 percent) and average utility bond yields (4.74 percent)[13] was 112 basis points, which is 42 basis points below the average of such yields displayed in the period since 1980 (*see* Schedule 4-4). Utility bond yields over the last couple of years continue to remain at levels not experienced since the 1960s.[14]

b. Utility Equity Markets

Investors view regulated utility company stock investments as a close alternative to bond investments. Therefore, similar to bond investments, typically when long-term interest rates fall, regulated utility company stock prices rise. This is what largely triggered utility company stocks, specifically natural gas utility stocks, to outperform the broader markets until approximately May 2013. During the next few months, interest rates started to increase out of fear that the Fed would start tightening monetary policy in the near future, which caused returns on utility stocks to lag that of the S&P 500 by a fairly wide margin for

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[12] Risk Premium in this context is the excess required return to invest in a company's equity rather than its debt.

[13] The 4.74 percent yields is based on an average from data obtained from BondsOnline.com For utility bond yields Staff provides prior to September 2010, Staff used Mergent Bond Record. Staff has canceled its subscription to Mergent Bond Record and will rely on data it receives from BondsOnline pursuant to a subscription agreement.

[14] Because Staff does not have utility bond yield data dating back to the 1960s, this is based on Staff's review of general corporate bond yields that were available from the St. Louis Federal Reserve website. This data showed that the general level of bond yields was much lower in the 1960s.

the rest of the 2013 calendar year. The total return on the S&P 500 for 2013 was 32.39 percent compared to a total return of 21.08 percent for Staff's natural gas utility proxy group.

The broader markets have moderated a bit during the first quarter of 2014. This appears to be largely due to concerns about valuation levels of growth stocks as compared to the prospects for future growth. This appears to have caused some movement back to utility stocks. During the first quarter of 2014, the S&P 500 had total return of 1.81 percent as compared to the total return on Staff's natural gas utility proxy group of 3.96 percent. For the twelve months ended March 31, 2014, the total return on the S&P 500 was 22.40 percent as compared to the total return on Staff's natural gas utility proxy group of 13.61 percent.

Because regulated utilities had been trading at a premium to the S&P 500 before the rally in the broader markets during the latter half of 2013, it appeared that investors were fairly risk averse and seeking yield through investment in utility stocks and other defensive sectors. However, investors became more willing to increase their risk exposure in the broader markets during the latter half of 2013. But this trend has not continued during the first quarter of 2014. Investors have shown that they continue to value dividend-paying stocks as compared to growth stocks. In a recent Wall Street Journal article, investors' favor of dividend stocks for the first part of 2014 was discussed:

> The shift from last year, when so-called growth stocks were in favor, reflects rising concern that corporate earnings are running out of gas and the economic recovery will be stuck in low gear. Few investors expect the market to deliver the gains seen last year, when the S&P 500 returned 32% including dividends...
>
> ...An unexpected drop in interest rates this year has increased the appeal of dividend-paying stocks. Despite the Federal Reserve's staggered withdrawal of its rate-lowering stimulus measures, the yield on 10-year Treasury notes stands at 2.726%, down from 3% at the start of this year.[15]

It appears that investors have pulled back from growth stocks because of reduced expectations for growth in earnings for the broader markets. The appeal of some dividend-paying stocks,

[15] Dan Strumpf, "Dividend Stocks Bear Fruit: *As Shares Get Pricey, More Investors Pick Steady Payouts Over Rapid Growth*," April 7, 2014, P. C1, Wall Street Journal.

such as Staff's natural gas distribution proxy group, is that they offer dividend yields that are higher than yields on Treasury Bonds, and they offer a fairly predictable growth rate in the dividends assuming the natural gas distribution company does not expose itself to unpredictable non-regulated operations.

However, it is important to understand that while Staff's natural gas proxy group lagged behind the S&P 500 for the twelve months ended March 31, 2014, the returns were still well above what can be explained by expected earnings growth. Because the valuation levels of the stocks of Staff's natural gas utility proxy group have increased since Staff last sponsored testimony in the Kansas City Power & Light Company ("KCPL"), Ameren Missouri and Empire rate cases, this supports Staff's position that investors are still not requiring a very high return to invest in gas utility companies. In fact, some investment analysts believe at current valuation levels utility stocks won't experience any capital appreciation in 2014.[16]

D. Liberty Midstates' Operations

The excerpt below is from paragraph two (2) of Liberty Midstates' notice of intended case filing (GR-2014-0152), dated November 20, 2013. The excerpt provides information about how Liberty Midstates became the owner of its Missouri gas distribution assets:

> By its Order Approving Unanimous Stipulation And Agreement issued March 14, 2012 in File No. GM-2012-0037, the Commission approved the Unanimous Stipulation and Agreement ("Stipulation") entered in that proceeding and authorized Atmos to sell, and Liberty Utilities to purchase, substantially all of the assets of Atmos used to provide natural gas and transportation services in Missouri. The Commission further issued new certificates of service and necessity to Liberty Utilities for the service areas formerly served by Atmos.

Company witness David Swain's, direct testimony, page 4, lines 11-14, indicates the following about Liberty Midstates' operations:

> The Company is engaged in the business of distributing and selling natural gas in the States of Missouri, Illinois and Iowa, serving approximately 85,000 customers. The majority of

[16] Shahriar (Shah) Pourreza, Sophie K Karp, Ryan Levine and Mark Rudovic, "FY 2014 utility Sector Sneak Peak: Stock Pickers Market – Select Winners and Losers Exist in '14," January 2, 2014, Citi Research.

those customers, approximately 55,000, are located in Missouri.

E. Liberty Utilities (Midstates Natural Gas) Co.'s Credit Ratings

Liberty Midstates is not rated by any credit rating agency. Liberty Midstates' direct and indirect parent companies (LUCo and APUC) are rated by S&P and DBRS – a Canadian-based rating agency. *

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F. Cost of Capital

In order to arrive at Staff's recommended ROR, Staff specifically performed (1) capital structure analyses, (2) an embedded cost of debt analysis, and (3) a cost of common equity analysis.

1 <u>Capital Structure Analyses</u>

Staff considered and examined (i) the capital structure that was considered for purposes of setting customer rates in Atmos Energy last rate case, (ii) Liberty Midstates' consolidated capital structure, (iii) LUC' consolidated capital structure, and (iv) APUC's consolidated capital structure. The last three capital structures were as of this case's test year date –September 30, 2013.

(i) <u>Capital structure for Atmos Energy Corporation's Missouri Operations</u>

Before delving into its various capital structure considerations, Staff believes it is informative to summarize the basis for the capital structure that Staff recommended for purposes of setting customer rates for the same Missouri distribution assets under the ownership of Atmos Energy in Case no. GR-2010-0192. For all practical purposes, the allowed rate of return should not change drastically due to a mere change in ownership. It's the required return for the gas distribution assets based on a fair and reasonable balance of debt and equity that should be determinative of a fair and reasonable allowed rate of return. These Missouri assets, *now owned by Liberty Midstates*, were once a part of Atmos Energy's Kentucky/ Mid-Sates Division and Colorado-Kansas Division.

Staff and Robert J. Smith ("Mr. Smith"), Assistant Treasurer of Atmos Energy at the time, recommended Atmos Energy's consolidated capital structure. Staff's capital structure recommendation comprised 50.97 percent equity, 47.50 percent long-term debt and 1.53 percent short-term debt. The ratios were based on Atmos Energy's February 28, 2010, consolidated financial statements. Mr. Smith's capital structure comprised 49.38 percent equity and 50.62 percent long-term debt. These ratios were based on Mr. Smith's computation

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of Atmos Energy's thirteen month average of long-term debt and equity components ending with the June 30, 2009, capital structure.[21,22]

Mr. Smith recommended Atmos Energy's consolidated capital structure and noted, on page 3 and 4 of his direct testimony, that the two divisions that served the Missouri Operations (1) were not separate legal entities but simply unincorporated divisions of Atmos Energy, (2) did not issue their own debt and equity, and (3) they all relied on Atmos Energy for all debt and equity funding needed for their operations. Staff shared and still shares the same sentiments with regards to transactions and structural organizations of this nature.

(ii) ***<u>Liberty Midstates Capital Structure</u>***

Liberty Midstates' parent company uses its internal finance department to manage and determine Liberty Midstates' capital structure. The ratemaking capital structure for Liberty Midstates filed in this case comprises * * percent equity and * * percent long-term debt, of which the long-term debt ratio is representative of the dollar amount * * of debt capital that was used to finance the acquisition of Liberty Midstates. The equity ratio is representative of the dollar amount * * of Liberty Midstates' internal tracking of capital it classifies as equity as of the test year date – September 30, 2013.

<u>Staff's position/ concerns with the approach:</u>

As already noted in this testimony, Liberty Midstates (1) is not a rated entity, (2) does not issue its own debt but relies on LUCo for capital assignments, and (3) does not issue its own equity but relies on its ultimate parent company (APUC), through its immediate parent company (LUCo), for equity contributions.

The above reasoning is consistent with Staff's longstanding approach and with that recommended by Atmos Energy's witness in the last rate case before Liberty Midstates assumed the Atmos Missouri Operations *(see section **F(1)(i)** of this testimony).*

Besides, Staff understands that cash is fungible, and that alone makes it difficult for Staff to verify whether the funds that are ultimately pushed down from APUC, through LUCo, to Liberty Midstates are true equity infusions or simply debt capital invested as equity.

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[21] Case No. GR-2010-0037: Robert J. Smith direct testimony: page 4- lines 13 through 16.

[22] Case No. GR-2010-0037: Robert J. Smith direct testimony: page 5-lines 3 through 5: "*I excluded from this calculation any impact from short-term debt because the Company's use of short-term debt is seasonal in nature and is intended to be used to finance additions to utility plant.*"

Staff, therefore, does not consider Liberty Midstates' capital structure to be a legitimate ratemaking capital structure because it is of no consequence to investors. Although Staff understands that APUC and LUCo may attempt to assign capital to subsidiaries for its own internal reporting and management needs, it is not proper to use this subjective process for purposes of setting a fair and reasonable allowed ROR.

<u>Staff's recommendation:</u>

Consequently, Staff does not recommend the Commission use this approach for setting rates for Liberty Midstates' Missouri gas distribution assets.

(iii) ***<u>LUCo's capital structure</u>***

Staff also reviewed LUCo's capital structure as of the test year date – September 30, 2013. Based on the financial statements provided by the Company in response to Staff's Data Request No. 0183, Staff derived a capital structure consisting of approximately * * percent equity and * * percent long-term debt for LUCo.

<u>Staff's position/ concerns with the approach:</u>

Staff understands that LUCo is the parent company of all of APUC's regulated operations in the United States. As was discussed earlier, LUCo is rated by S&P and by DBRS, a Canadian-based rating agency. S&P assigned LUC a * * credit rating and DBRS assigned LUCo a * * credit rating.

LUCo uses a centralized approach for raising debt capital for its regulated utility operations. Consequently, Liberty Midstates does not issue any of its own debt. LUCo issues debt through a financing subsidiary, Liberty Utilities Finance. However, the ratings assigned to the debt issued by Liberty Utilities Finance are based on the rating agencies view of the risk associated with LUCo's operations because this debt (secured and unsecured) is guaranteed by LUCo.[23] To the extent LUCo needs additional equity other than retained earnings, it relies on equity infusions from its parent company (APUC).

Assuming APUC is not issuing debt to make these equity infusions, a situation generally referred to as double leveraging, then the common equity ratio reflected at LUCo can be directly applied to the recommended ROE. Additionally, to the extent that debt

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[23] Liberty Utilities' corporate financing strategy is similar to how American Water issues debt for its water utility subsidiaries, including Missouri-American Water Company. American Water Capital Corporation (AWCC) is a direct subsidiary of American Water that exists solely for purposes of issuing debt for American Water's subsidiaries. Rating agencies rate the debt issued by AWCC based on the risk profile of American Water because American Water guarantees the debt of the financing subsidiary.

investors in LUCo rely on this common equity ratio for purposes of determining the required return on their debt investment, such capital structure can be considered as market-tested. Although Liberty Midstates has been assigned debt and equity, its capital structure is not market tested and is not relied on by investors in determining a required return because there are no direct investments, debt or equity, in Liberty Midstates.

Staff did not audit all of the equity infusions APUC made into LUCo to determine whether these funds were raised through debt or equity capital issuances by APUC. If APUC's capital structure was more leveraged than LUCo's capital structure, then Staff would have been much more concerned about potential manipulation of LUCo's capital structure for ratemaking purposes. Because APUC actually has a less leveraged capital structure than LUCo, Staff does not have this concern in this case.

Staff's recommendation:

Consequently, Staff recommends that LUCo's capital structure be used for purposes of setting customer rates.

(iv) ***APUC's capital structure***

Staff also reviewed APUC's capital structure as of the test year date –September 30, 2013. Based on APU's 2013 consolidated annual report,[24] APUC's capital structure was 57 percent equity and 43 percent long-term debt. This is a capital structure that represents the financial position of APUC's combined regulated and unregulated operations.

*

*

Staff's position/ concerns with the approach:

While APUC is (1) the ultimate parent Company of Liberty Midstates and LUCo, (2) the primary basis for the rating that S&P assigns to LUCo, and (3) publicly–traded and market tested, Staff notes that APUC is a Canadian corporation with largely diverse non-regulated operations primarily in Canada.

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[24] http://investors.algonquinpower.com/Cache/1001182084.PDF?Y=&O=PDF&D=&fid=1001182084&T=&iid=4142273

[25] *

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At the time of the credit rating upgrade of APUC and its subsidiaries by S&P (October 11, 2013), more than * * of APUC's consolidated cash flows were from non-regulated operations. For the nine months ended September 30, 2013, LUCo's operating income was approximately * * of APU's consolidated operating income,[26] which is less than the 65 percent threshold Staff used to select a proxy group of companies that have a consolidated risk profile that is consistent with regulated distribution companies.

Staff's recommendation:

Staff dismissed APUC's capital structure and does not believe APUC's capital structure is reasonable for purposes of determining Liberty Midstates' customer rates.

2. Embedded Cost of Debt

Staff understands that the debt and debt cost reported on Liberty Midstates' books are products of the debt allocation process performed by LUCo for all its United States operations. Consequently, this debt cost does not capture the dynamic nature associated with LUCo's centralized management of its capital structure and its corresponding debt costs. In order to be logically consistent with the Staff's capital structure recommendation above, Staff recommends LUCo's consolidated embedded cost of debt of * * percent be matched with LUCo's consolidated capital structure for purposes of setting an allowed rate of return for Liberty Midstates' Missouri gas distribution assets.

Basis for the debt cost due to pending discovery matters:

Staff estimated its cost of debt recommendation in this case based on consolidated debt and stated interest rates Staff could identify in LUCo's and APUC's Notes to Financial Statements as of September 30, 2013. Staff normally relies on company data request responses (in most rate cases involving other Missouri utilities) for its embedded cost of debt estimate. But due to the Company's different interpretation of/ confusion about the information Staff requested in Staff Data Request No. 0177, Staff has not yet received a complete response providing all of the debt cost information for LUCo on a consolidated basis. Until Staff receives this information, its recommendation will be based on the stated

[26] Data Request Response No. 0183: Liberty Utilities Interim Consolidated Financial Statements (Cash Flow Statement) & Algonquin Power and Utilities Corp 2013 Third Quarter Report: Interim Consolidated Financial Statements (Cash Flow Statement).

interest rates on LUCo's consolidated debt, which results in a lower cost of debt estimate due to lack of consideration of issuance expenses on this debt.

3. Cost of Common Equity

Staff's expert financial analyst, Zephania Marevangepo, estimated Liberty Midstates' cost of common equity through a comparable company cost-of-equity analysis of a proxy group of eight companies using the DCF methodology. Additionally, Staff used a CAPM analysis and a survey of other indicators as a check of the reasonableness of its recommendations.

a. The Proxy Group

First, Staff formed a group of comparable companies for the commensurate return analysis. Staff started with 20 market-traded natural gas utilities, as classified by SNL Financial (*see* Schedule 7-1). Staff decided to start using SNL Financial for purposes of selecting its proxy group and estimating the cost of common equity because it is widely used by investors, utilities, industry associations and public service commissions throughout the country. In fact, SNL acquired Regulatory Research Associates, a publication cited in almost every major rate case in Missouri. To the extent SNL Financial does not provide the same data Staff relied on from Value Line to estimate the cost of equity, Staff has replicated the same or similar data by extracting it from the SNL database. Additionally, the source of the companies' financial data can be verified by direct links to the companies' SEC financial statements. Lastly, SNL Financial provides more detail on equity analysts' projections as tracked by FactSet,[27] which is the type of information many rate-of-return witnesses claim is influential in understanding how investors determine the price they are willing to pay for stocks.

Staff applied a number of criteria to develop a proxy group comparable in risk to Liberty Midstates:

1. Stock publicly traded (1 company eliminated, 19 remaining);
2. At least 65% Operating Income from Distribution (8 companies eliminated, 11 remaining);

[27] FactSet - The Company provides global financial and economic information, including fundamental financial data on tens of thousands of companies worldwide: Screening for Winners by Rex Moore, The Motley Fool, December 8, 2003.

3. At least 65% of Assets are Distribution Assets (0 companies eliminated, 11 remaining);

4. Two analysts for long term projected EPS growth available within the last 90 days, with at least one estimate available within last 30 days (3 companies eliminated, 8 remaining);

5. Positive historical 5-year compound annual growth rate in dividends per share through most recent 5 years (0 companies eliminated, 8 remaining); and

6. At least investment grade credit rating (0 companies eliminated, 8 remaining).

This resulted in a group of eight publicly-traded natural gas utility companies ("the comparables" or "proxy group") that could be used as a proxy for estimating Liberty Midstates' cost of common equity. The comparables are listed on Schedule 7-2.

b. The Constant-growth DCF

Next, Staff estimated Liberty Midstates' cost of common equity applying values derived from the proxy group to the constant-growth DCF model. The constant-growth DCF model is widely used by investors to evaluate stable-growth investment opportunities, such as regulated utility companies. The constant-growth version of the model is usually considered appropriate for mature industries such as the regulated utility industry.[28,29] It may be expressed algebraically as follows:

$$k = D_1/P_0 + g$$

Where: k is the cost of equity;

D_1 is the expected next 12 months dividend;

P_0 is the current price of the stock; and

g is the dividend growth rate.

The term D_1/P_0, the expected next 12 months' dividend divided by the current share price, is the dividend yield. Staff calculated the dividend yield for each of the comparable

[28] Aswath Damodaran, *Investment Valuation: Tools and techniques for determining the value of any asset*, University Edition, John Wiley & Sons, Inc., 1996, p. 195-196.

[29] John D. Stowe, Thomas R. Robinson, Jerald E. Pinto and Dennis W. McLeavey, *Analysis of Equity Investments: Valuation*, Association for Investment Management and Research, 2002, p. 64.

companies by dividing the weighted average of equity analysts' projected dividends per share ("DPS") for the 2014 fiscal year and 2015 fiscal year, as reported by FactSet, by the monthly high/low average stock price for the three months ending April 30, 2014 (*see* Schedule 11).[30] Staff weighted the DPS projections in this manner in order to reflect the approximate amount of time remaining in the 2014 fiscal year for each comparable company. Staff used the above-described stock price because it reflects current market expectations. The projected average dividend yield for the eight comparable companies is approximately 3.78 percent, unadjusted for quarterly compounding.

c. The Inputs

In the DCF method, the cost of equity is the sum of the dividend yield and a perpetual growth rate ("g") that is intended to replicate the projected capital appreciation of the stock. In estimating a growth rate, Staff analyzed both actual and projected DPS, earnings per share ("EPS") and book value per share ("BVPS") for each of the comparable companies (*see* Schedules 8-1 through 8-3). Staff also reviewed equity analysts' consensus estimates for long-term compound annual growth rates as reported by FactSet and provided by SNL Financial. The average consensus long-term EPS growth rates for the proxy group is currently 3.96 percent. (*see* Schedule 8-4).

In Staff's experience, historical and projected growth rates for natural gas distribution utilities had been fairly consistent. Based on the shorter-term data shown on Schedule 8-5, it would appear that a growth rate range of 4.0 to 5.0 percent would be reasonable for an estimate of the cost of equity using the constant-growth DCF, but this does not give consideration to empirical and logical information that suggest that utility companies should grow at a rate less than that of the overall economy due to the mere fact that investors invest in utility companies for yield and not growth. In fact, considering that companies in the S&P 500 (a proxy for the U.S. capital markets) in recent years have retained approximately 65 percent to 70 percent of their earnings for reinvestment,[31] while natural gas distribution utilities' retention ratio has been approximately half that of the S&P 500,[32] it makes logical

[30] The monthly high/low averaging technique minimizes the effects of short-term stock market volatility on the calculation of dividend yield. P_0 is calculated by averaging the highest and the lowest price for each month during the selected period.
[31] Table B-95 and B-96 attached to the 2013 Economic Report of the President.
[32] "Natural Gas Industry Summary," December 31, 2013, Edward Jones.

sense that utilities will grow at a rate less than that of nominal gross domestic product ("GDP") growth. Consequently, a projected long-term, steady-state nominal GDP growth rate should be considered as an upper constraint when testing the reasonableness of growth rates used to estimate the cost of equity for a regulated gas utility.

Because the constant growth rate is assumed to last in perpetuity, the projected economic growth rates that are most pertinent for evaluating the sustainability of a growth rate for a given industry are those that are based on a steady-state economic environment for the country in which that industry operates. In the case of natural gas distribution utilities, it is important to project reasonable long-term sustainable growth rates that are consistent with the projected lower growth of the United States' developed domestic economy. Although some analysts try to infer potential future economic growth in the U.S. from historical growth rates, it is clear that most economic experts believe that the U.S. economy has developed to the extent that the growth rates of the past won't be realized again in the future, hence the current low interest rate environment. This is clear from long-term economic forecasts provided in Table 8, on page 92 of the U.S. Energy Information Administration's 2013 Annual Energy Outlook. The following table is reproduced for convenience:

Table 8. Comparisons of average annual economic growth projections, 2011-2040

Average annual percentage growth rates

Projection	2011-2015	2011-2025	2025-2040	2011-2040
AEO2013 (Reference case)	2.5	2.6	2.4	2.5
AEO2012 (Reference case)[a]	2.7	2.6	2.5	2.6
IHS Global Insight (August 2012)	2.5	2.6	2.5	2.5
OMB (January 2013)[a]	2.2	2.8	--	--
CBO (February 2013)[a]	2.6	2.7	--	--
INFORUM (November 2012)	2.6	2.6	2.4	2.5
Social Security Administration (August 2012)	2.9	2.7	2.2	2.4
IEA (2012)[b]	2.5	2.6	--	2.4
Blue Chip Consensus (October 2012)[a]	2.4	2.5	--	--
ExxonMobil	--	2.5	2.2	2.4
ICF International	--	--	--	2.6
Oxford Economics Group (January 2013)	2.7	2.7	2.6	2.6

-- = not reported or not applicable

[a]OMB, CBO, and Blue Chip forecasts end in 2022, and growth rates cited are for 2011-2022. *AEO2012* projections end in 2035, and growth rates cited are for 2011-2035

[b]IEA publishes U.S. growth rates for certain intervals: 2010-2015 growth is 2.5 percent, 2010-2020 growth is 2.6 percent, and 2010-2035 growth is 2.4 percent.

Staff has used the Energy Information Administration, the Congressional Budget Office and the Blue Chip Consensus forecasts for purposes of evaluating projected long-term GDP growth in past rate cases. This table summarizes not only these sources, but several other sources that are widely used in evaluating potential GDP growth. For example, the Federal Energy Regulatory Commission ("FERC") uses IHS Global Insight for purposes of evaluating GDP growth in gas pipeline rate cases. As can be seen in the above table, these sources provide not only a near-term projected annual compound economic growth rate, but also a projected annual compound growth rate over a very long period, which is of most relevance to a constant-growth DCF growth rate. In fact, some of these sources provide projected annual compound growth rates for the period 2025 through 2040, which provides insight as to the growth rate economists believe are sustainable given the fundamentals of the United States' developed economy. Such "trend" growth rates should be given the most weight to test the reasonableness of long-term growth rates for a mature industry, such as the regulated natural gas distribution industry. Although not included in this table, most economists expect a long-term trend growth rate in the GDP price deflator of approximately 2.0 percent. After multiplying this 2.0 percent inflation rate by a real GDP growth rate of 2.5 percent, this results in a compound growth rate of 4.55 percent for a sustainable, trend growth rate in the U.S. economy. Although some projections may be slightly higher or lower than a 4.55 percent growth rate in GDP, Staff believes this is a reasonable estimate based on the various sources it reviewed.

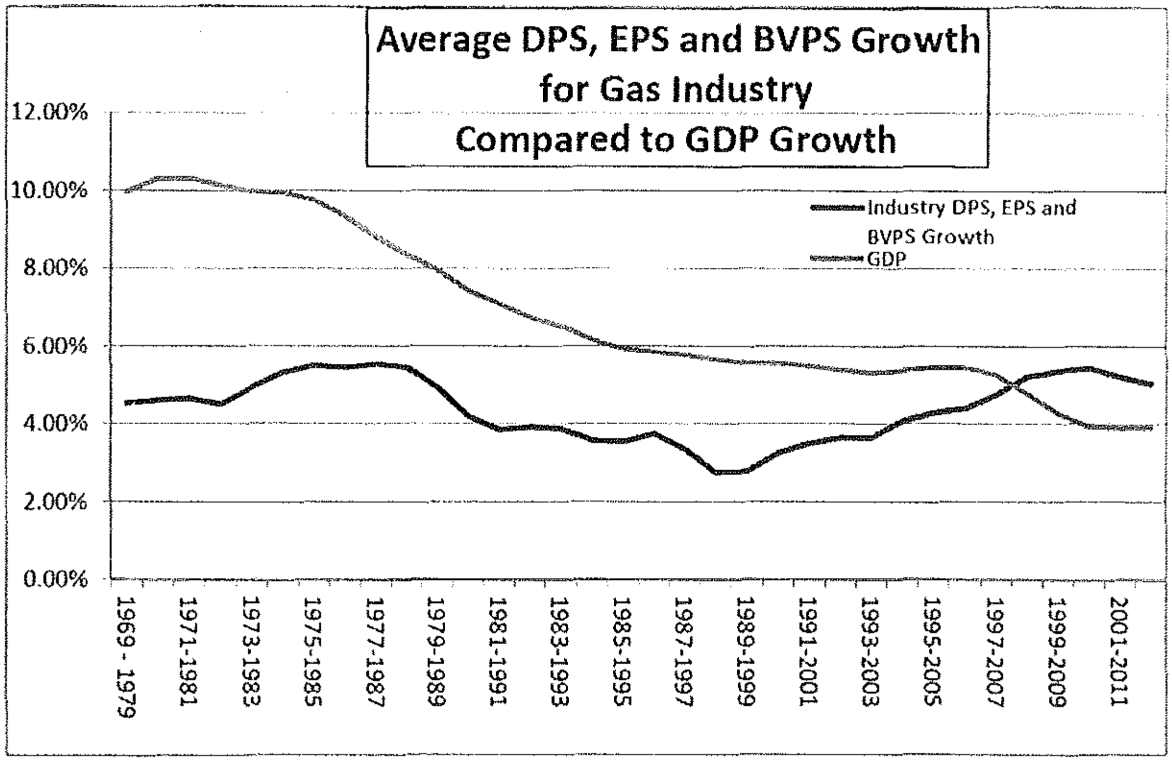
Although the fundamentals of the natural gas distribution industry do not support a growth rate higher than that of the overall economy, Staff decided it would be prudent to compare historical growth rate patterns for the natural gas distribution industry to that of GDP growth to better understand the relationship between gas industry growth and GDP growth.

In order to evaluate the gas industry's growth compared to GDP growth, Staff had to select a group of natural gas distribution companies that could be considered a good proxy for the natural gas distribution industry for a long, continuous period. Staff started with the entire set of companies that Edward Jones classified as natural gas distribution companies in its September 30, 2013, quarterly publication on the natural gas industry. Staff then researched its library of Value Line Ratings & Reports to determine which of these companies had continuous historical financial data for at least 20 years. The following companies had at least 20 years of continuous financial data: AGL Resources, Atmos Energy, Laclede Group, New Jersey Resources, Northwest Natural Gas, Piedmont Natural Gas, South Jersey Industries and WGL Holdings.[33] Actually, all of these companies, with the exception of Atmos Energy, had continuous financial data in the Staff's library going back until at least the early 1970s, with most companies having information covering the entire historical period (back to 1968) in which Staff has information available in its library. Staff still included Atmos in its long-term proxy group, but Staff also analyzed trends without Atmos.

Staff's analysis of the proxy group's financial data since 1968 revealed that the actual realized growth of the natural gas distribution industry has averaged in the low 4 percent range, or about 75 percent of average GDP growth of around 7 percent over the same period. Although the natural gas distribution industry grew at a slower rate than GDP, Staff believes it is also important to consider that the growth in the natural gas distribution industry was not highly correlated with GDP growth over this period. Below is a graph of the natural gas distribution industries' average 10-year compound growth rates as they compare to GDP growth for the period 1968 through 2013 (this graph and the supporting data are also contained in Schedules 8-5 through 8-7):

continued on next page

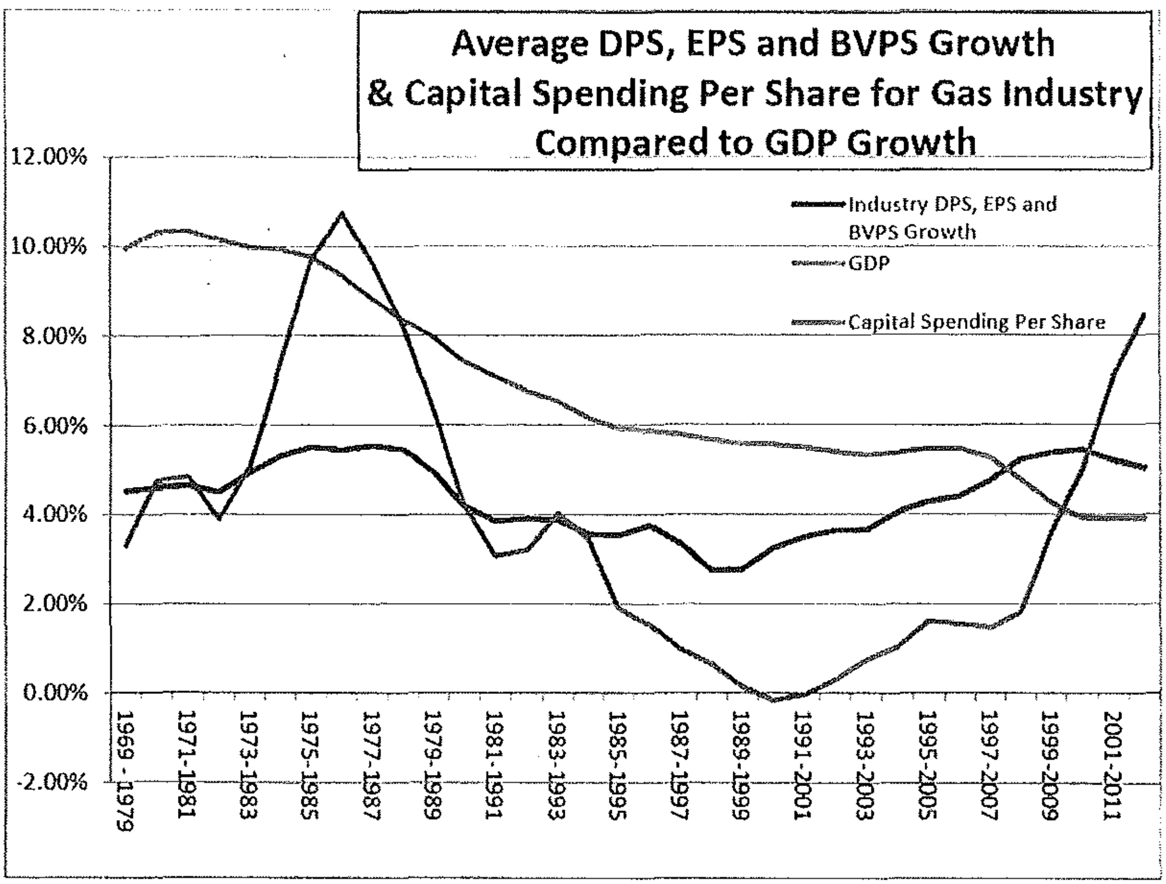
[33] Edward Jones does not classify Southwest Gas Company as a natural gas distribution company. Staff's selection criteria in this case caused it to include Southwest Gas Company in Staff's natural gas proxy group. However, based on Southwest Gas' historical financials, it appears the Company was exposed to volatility not consistent with the other natural gas distribution utilities. Consequently, Staff excluded Southwest Gas from its long-term proxy group.



As can be seen in the above graph, the growth for the natural gas distribution industry moved inversely to that of GDP for the 10-year periods from 1970-1980 through 1975-1985 and 1988-1998 through 2001-2011. Consequently, empirical evidence shows that natural gas distribution utility growth has had very little correlation to that of GDP. If this is the case, then a key question for purposes of understanding the reasonableness of constant growth rates used in a DCF analysis is how one should incorporate GDP into evaluating the reasonableness of gas industry growth rates and what are the major factor(s) that will determine the sustainability of gas industry growth rates going forward?

As Staff has already explained, even though natural gas distribution industry growth has not been highly correlated to GDP in terms of growth patterns, it has on average been less than GDP growth. Therefore, long-term GDP growth is at the very least a constraint on the maximum long-term growth potential for the industry even though they don't always move together during shorter intervals. Therefore, considering the fact that average GDP growth is projected to be much lower than it had been over the past 40 years, then it is only logical to expect the long-term compound annual growth rates to be lower for the natural gas distribution industry over the same 40-year period. This supports a long-term constant growth rate of less than 4.55 percent.

The other factors that often determine potential growth for the regulated gas distribution industry are investment and demand/customer growth. Because most regulated natural gas distribution companies have moved to largely decoupled rate designs in which the recovery of the revenue requirement is not a function of usage, but of number of customers, the other major factor should be limited to expansion of the system to serve additional customers. Staff's understanding of the history of the natural gas distribution industry, at least that of the proxy group Staff analyzed, is that customer growth was a key driver of capital investment in the 1980s. In order to understand the relative magnitude of the capital investment that natural gas distribution companies made in the 1980s, Staff also analyzed the changes in capital spending per share from the period 1968 through the present. Staff then compared the industry's capital spending to the average growth in DPS, EPS and BVPS and found a fairly high correlation between the two.



As can be seen, there is a higher correlation between capital spending and industry growth then there is between GDP and industry growth. One would expect capital expenditures to be fairly highly correlated to GDP growth, but that is not the case for the gas distribution industry. The current rise in capital expenditures is not driven by expected growth in the economy, but in the perceived need to accelerate capital expenditures for infrastructure replacement.

Consequently, growth for existing systems should primarily be a function of investment growth. Staff's understanding of the investment growth in the natural gas distribution industry is that many companies have been and continue to pursue replacement of existing infrastructure in accordance with various infrastructure replacement programs and favorable rate treatment associated with these programs.[34] To the extent there is limited customer growth, this will be the primary driver of growth for the gas distribution industry in general.

Because investors are well aware of the limitations on potential growth for the industry as compared to its historical growth, as Staff discussed above, Staff believes it is important to consider the natural gas distribution industry's actual experienced growth over the long term, when evaluating whether investment analysts' 5-year EPS growth rates are sustainable. Staff's Schedule 8-4 indicates investment analysts believe the EPS growth over the next 5-years could be around 4 percent. Based on actual historical growth over the long term, it would appear that this growth rate would be appropriate as a proxy for constant growth.

[34] Atlanta Gas Light currently has a Strategic Infrastructure Development and Enhancement ("STRIDE") program, which was approved by the Georgia Public Service Commission ("GPSC"). STRIDE is a continuing 10-year infrastructure plan that is updated every three years for review and approval by the GPSC (SNL Energy Financial Focus, February 15, 2013); approximately 60% of Atmos' 2013 capital expenditures are for infrastructure replacement projects related to safety and compliance with 90% of total capital expenditures targeted for jurisdictions that have some form of alternative ratemaking, e.g. infrastructure riders and charges (SNL Energy Financial Focus, March 28, 2013); Northwest Natural Gas plans to replace all of its bare steel pipeline in Washington by the end of 2014 and will be allowed to recover costs annually rather than waiting for a formal rate proceeding (SNL Press Release, November 11, 2013); in a December 17, 2013, Order the North Carolina Utilities Commission ("NCUC") authorized Piedmont Natural Gas the use of an integrity management rider ("IMR"), which allows the company to track and recover future capital expenditures it expects to incur to comply with federal pipeline safety and integrity requirements (Regulatory Research Associates, Regulatory Focus, December 31, 2013); Maryland and Virginia have approved five-year surcharge mechanisms to allow Washington Gas recovery of accelerated infrastructure replacement programs.

Schedule 8-5 shows the rolling average 10-year compound growth rates for EPS, DPS and BVPS for the eight natural gas distribution companies Staff analyzed. Staff calculated the historical compound growth rates consistent with Value Line's methodology, which uses a 3-year average for the beginning period and a 3-year average for the ending period. For example, even though the data Staff analyzed dates back to 1968, the 10-year compound growth rate is based on the 3-year average of per share data for the period 1968-1970 and 1978-1980. The average rolling 10-year compound growth rates for the period Staff analyzed was 4.44 percent for EPS; the rolling 10-year compound DPS growth rate was 4.24 percent; the rolling 10-year compound BVPS growth rate was 4.53 percent; and the overall average for DPS, EPS and BVPS was 4.40 percent. If Atmos is excluded from these averages, then the results are as follows: 4.22 percent for DPS; 4.51 percent for EPS; 4.48 percent for BVPS; and an overall average of 4.40 percent (see Schedule 8-6).

Because the gas distribution industry only achieved growth in the low 4 percent range during a period of high capital investment and higher economic growth (see Schedule 8-8), Staff believes investors are likely using constant-growth rates closer to 4 percent. However, because some of the more recent growth rates are closer to 5 percent, Staff will use an overall range of 4 percent to 5 percent. This results in a natural gas distribution industry cost of equity estimate of 7.80 percent to 8.80 percent before the credit rating differential adjustment. While Staff believes this is a reliable estimate of the cost of equity for natural gas distribution companies, Staff understands that this is below recent allowed returns for gas distribution companies around the country.

Although Staff's absolute cost of equity estimate in this case is fairly similar to the cost of equity Staff estimated in the recent Ameren Missouri and KCPL rate cases, there is a general perception in the investment community that natural gas distribution company stocks deserve a higher valuation level due to lower risks. Wells Fargo analysts stated the following in a June 4, 2013, equity research report on The Laclede Group when comparing the valuation levels of the regulated electric industry to that of the natural gas distribution industry: "The gas LDC median multiples reflect premiums ranging from 5 percent to 10 percent on 2013-15 estimated EPS, which we believe relates to the **generally lower business risk of gas LDCs versus electric utilities"** (emphasis added).[35]

[35] *See* Wells Fargo June 4, 2013 equity research report on The Laclede Group.

G. Tests of Reasonableness

Staff has tested the reasonableness of its DCF results, both by use of a CAPM analysis and by consideration of other evidence.

1. The Capital Asset Pricing Model

The CAPM is built on the premise that the variance in returns is the appropriate measure of risk, but only the non-diversifiable variance (systematic risk) is rewarded. Systematic risks, also called market risks, are unanticipated events that affect almost all assets to some degree because the effects are economy wide. Systematic risk in an asset, relative to the average, is measured by the Beta of that asset. Unsystematic risks, also called asset-specific risks, are unanticipated events that affect single assets or small groups of assets. Because unsystematic risks can be freely eliminated by diversification, the reward for bearing risk depends on the level of systematic risk. The CAPM shows that the expected return for a particular asset depends on the pure time value of money (measured by the risk free rate), the reward for bearing systematic risk (measured by the market risk premium), and the amount of systematic risk (measured by Beta). The general form of the CAPM is as follows:

$$k = Rf + \beta\,(Rm - Rf)$$

Where:	k	is the expected return on equity for a security;
	Rf	is the risk-free rate;
	β	is beta; and
	Rm - Rf	is the market risk premium.

Staff's CAPM is presented on Schedule 12. For inputs, Staff relied on historical capital market return information through the end of 2013. For the risk-free rate (Rf), Staff used the average yield on 30-year U.S. Treasury bonds for the three-month period ending April 31, 2014 – 3.63 percent. For beta (β), Staff relied on estimates directly calculated through an Excel spreadsheet designed specifically to be used with the SNL database of market and financial information. Although Staff is no longer using Value Line's published betas for purposes of its CAPM analysis in its direct testimony, because Value Line is used by many retail investors, Staff still believes Value Line's beta calculation methodology should be considered when performing a CAPM analysis. Because estimating beta is a matter of having access to financial data and performing statistical calculations, unless a financial services provider has a proprietary adjustment they make to their beta calculation, understanding the methodology used by a financial provider allows an analyst to approximately replicate betas of that provider. Fortunately, this is the case for Value Line's beta calculation methodology. Consistent with Value Line's approach to calculating beta, Staff used 5 years of historical weekly returns of the subject company and the NYSE index. The covariance of the weekly returns on the NYSE index and the weekly returns on the subject company is divided by the variance of the weekly returns on the NYSE index to determine raw beta (unadjusted beta). Staff then adjusted the raw beta using the Blume adjustment formula as used by Value Line: Adjusted Beta= (.35 + .67(Unadjusted Beta)) (*see* Schedule 12).

The average beta for the proxy group was .80. For the market risk premium (Rm – Rf) estimates, Staff relied on the historical difference between earned returns on stocks and earned returns on bonds.[36] The first risk premium was based on the long-term arithmetic average of historical return differences from 1926-2013 – 6.20 percent. The second risk premium was based on the long-term geometric average of historical return differences from 1926 to 2013 – 4.64 percent. The results using the long-term arithmetic average risk premium and the long-term geometric risk premium are 8.55 and 7.31 percent, respectively.

These cost-of-common-equity results support the reasonableness of Staff's cost-of-equity estimates derived from its DCF analysis. Staff again notes that both U.S. Treasury yields and utility bond yields are quite low (at levels last experienced in the early 1960s) and the spread between them is presently below their long-term average. It is not improbable that investors are only requiring returns on common equity in the 7 to 8 percent range for natural gas utility stocks. In fact, as Staff will explain in its other tests of reasonableness, these cost-of-equity estimates are consistent with common sense tests.

[36] From Duff & Phelps *2014 Valuation Handbook: A Guide to the Cost of Capital.*

2. Other Tests

a. The "Rule of Thumb"

A "rule of thumb" method allows estimation of the cost of equity by adding a risk premium to the yield-to-maturity ("YTM") of the subject company's long-term debt. Based on experience in the U.S. markets, the typical risk premium is in the 3 to 4 percent range.[37]

Considering this is based on general U.S. capital market experience and regulated utilities are on the low end of the risk spectrum of the general U.S. market, a risk premium closer to 3 percent seems logical. This is especially true considering that regulated utility stocks behave like bonds. For the months of February, March and April 2014, "A" rated 30-year utility bonds and "Baa" rated 30-year utility bonds had average yields of 4.51 percent and 5.28 percent respectively.[38] Adding a 3 percent risk premium, the "rule of thumb" predicts a cost of common equity between 7.51 percent and 8.28 percent. Adding a 4 percent risk premium, the "rule of thumb" predicts a cost of common equity between 8.51 percent and 9.28 percent.

b. Average Authorized Returns

In the past, the Commission has applied a test of reasonableness using average authorized returns published by Regulatory Research Associates ("RRA") to test the reasonableness of its allowed ROE. Because the Commission recently made allowed ROE determinations in the KCPL and Ameren Missouri cases, Staff believes the Commission should utilize the RRA data to test the reasonableness of an allowed ROE for Liberty Midstates as it compares to KCPL and Ameren Missouri.

According to RRA, the average authorized return on equity in the first quarter of 2014 for natural gas and electric utility companies were 9.54 percent (based on six decisions) and 10.23 percent (based on eight decisions), respectively, which is a difference of 69 basis points. The data does not include a February 20, 2014, New York Public Service Commission steam rate decision for Consolidated Edison Co. of New York that adopted a 9.30 percent ROE. The simple average authorized return on common equity for natural gas

[37] John D. Stowe, Thomas R. Robinson, Jerald E. Pinto and Dennis W. McLeavey, *Analysis of Equity Investments: Valuation*, Association for Investment Management and Research, 2002, p. 54.
[38] BondsOnline.com pursuant to a subscription agreement Staff has with BondsOnline.

and electric utility companies for the four quarters of 2013 was 9.68 percent (based on twenty-one decisions) and 10.02 percent (based on fifty decisions), respectively, a difference of 34 basis points. Although these differences seem to imply that regulators have recognized the lower risk of natural gas utility companies as they compare to electric utility companies, there is a significant difference in the amount of decisions for gas cases compared to electric cases. As a result, Staff reviewed the difference between the annual average authorized ROEs for years prior to 2013.

Staff discovered that beginning in 2007, allowed ROEs for gas utility companies began to consistently be below those of electric utility companies. In 2007, it was only approximately 10 basis points lower, but the difference gradually increased and leveled off at approximately 30 basis points. It actually narrowed to approximately 20 basis points in 2012, but as already noted, it then widened again to 34 basis points in 2013. The difference increased to 69 basis points in the first quarter of 2014. However, there were only 6 natural gas case decisions and 8 electric utility case decisions in the first quarter of 2014.

Staff does not know if this trend will be sustained, but as can be seen in the report published April 9, 2014, allowed ROEs for gas and electric were usually about the same before 2007. The only explanation Staff can readily give for the recent difference is the fact that gas utility stocks have recently been trading at a premium to electric utility stocks. This can be due to many factors, including favorable regulatory ratemaking treatment, levelized capital expenditures, lower elasticity to economic conditions, consistently earning allowed ROE, lower natural gas prices, etc.

H. Conclusion

Using widely-accepted methods of financial analysis, Staff has developed a weighted average cost of capital for Liberty Midstates in the range of 6.34 percent to 6.80 percent (*see* Schedule 13). This rate was calculated by applying an embedded cost of long-term debt of * * percent and a cost of common equity range of 8.20 percent to 9.20 percent to a capital structure consisting of * * percent common equity and * * percent long-term debt. Staff urges the Commission to accept its recommendation and allow Liberty Midstates to earn a fair return on its net rate base of 6.34 percent to 6.80 percent.

Staff Expert/Witness: Zephania Marevangepo

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VII. Rate Base

A. Plant in Service and Depreciation Reserve

1. Plant in Service

Accounting Schedule 3, Staff's Plant In Service schedule, reflects by account Staff's value of Liberty Utilities' Plant In Service for Missouri operations through September 30, 2013, as updated through March 31, 2014. In addition, Staff has separately reflected balances associated with Plant In Service allocated to the Missouri operations from Liberty Utilities. This corporate plant includes items such as customer billing software, furniture, etc. Staff's adjustments to the September 30, 2013 test year balances to update each account to March 31, 2014 balances are reflected in Staff's Accounting Schedule 4, Adjustments to Plant.

During Staff's review of this issue, Staff discovered several areas of concern while analyzing the Plant In Service data provided through Liberty Utilities' general ledger and various Staff data requests. These include unusually long lags in booking plant, reserve and retirement amounts, incorrectly calculated retirement entries, and the inability by Staff to verify the total amounts of the plant and reserve balances provided by Liberty Utilities. Therefore, Staff has been unable to perform its normal verification or reconciliation activities to determine if the total amounts of Plant In Service and Accumulated Depreciation Reserve presented to Staff through the update period ending March 31, 2014 are accurate. Also, Staff has not been provided with the necessary information to date in order to make adjustments to correct the erroneous retirement entries.

Staff has discovered that several continuous months of the test year reflected no additions to Plant In Service. Given that Staff was provided data in the recent ISRS Case No. GO-2014-0006, which indicates that additions did take place during this time frame and the fact that it is highly unlikely for a utility of this size not to have any additions during most of the test year, Staff believes that the Plant In Service records provided were erroneous. Upon discussion with Liberty Utilities, Staff was made aware that the utility's fixed asset management software was not functioning correctly during the test year and therefore did not properly transfer the completed CWIP amounts to Plant In Service at the time that the plant actually became in service. Rather, when the problem was discovered, the utility made 'catch up' entries subsequent to the test year, in October 2013. Liberty Utilities has stated that the Accumulated Depreciation Reserve associated with these entries was properly calculated as if the plant were accumulating reserve for the entire period it was in service. However, to date, Staff has been unable to verify this. In addition, while the utility seems to have corrected its books for the software issue during the test year, a review of the data provided indicates that the practice of skipping months and then making 'catch up' entries continued subsequent to October 2013 through the end of the update period.

At this time, Liberty Utilities has provided Staff with limited data as verification of test year plant. While Staff has asked for supporting documentation for the value of Plant In Service additions and retirements during the test year, to date, Liberty Utilities has only provided an explanation of the four largest items placed into service during the test year, but which were not booked until later. The value of these four items range from approximately $54,000 to $1 million, and were listed as being placed into the NEMO and WEMO districts. While Staff understands that many of the additions being placed in service may fall below these amounts, in aggregate, Staff would expect the amount of additions during the test year to be substantially more. In addition, the listing provided does not provide any data related to the SEMO district; again, perhaps the individual additions were below the utility's threshold for provision to Staff. However, Staff is aware there should be, in aggregate, a large amount of additions for SEMO based on the utility's ISRS filing and the fact that the SEMO district is, in general, the largest district. Without more detailed information for all the districts and plant additions, Staff is unable to verify that the overall March 31, 2014 balances which include the 'catch up' entries are correct.

Staff is also aware that some retirement entries were incorrectly calculated, in that the value of the retired assets was significantly overstated by Liberty Utilities. Therefore, Plant In Service is understated. For example, if a new asset was placed in service, and it had replaced an asset that had been in service since 1950, instead of removing the original booked 1950 asset cost, which would likely be far less than the new amount, Liberty Utilities removed the same amount as the new plant cost (or an amount close to it) as the retirement amount. At this time, Liberty Utilities is attempting to gather data regarding this problem to provide to Staff for its review and calculation of any necessary adjustments.

While Staff has been unable to verify individual detailed Plant In Service and Accumulated Depreciation Reserve account balances, Staff has determined that the total balances appear to be reasonably accurate. Therefore, Staff is utilizing in its rate base the actual Plant In Service and Accumulated Depreciation Reserve balances as recorded on Liberty Utilities' books as of March 31, 2014. Staff will review any additional information provided by Liberty Utilities in order to perform a more thorough review of these balances. Should Staff find any discrepancies based on this data, Staff will make any necessary adjustments at that time.

Staff Expert/Witness: Sarah Sharpe

2. Accumulated Depreciation Reserve

Staff's Accounting Schedule 6, Accumulated Depreciation Reserve, reflects by account Staff's value of Liberty Utilities' accumulated depreciation reserve through September 30, 2013, as updated through March 31, 2014. Staff's adjustments to the September 30, 2013 test year balances are reflected in Accounting Schedule 7, Adjustments to Depreciation Reserve.

Given that accumulated depreciation reserve is directly linked to Plant In Service, the issues discussed in the Plant In Service section regarding Staff's concerns will have a direct impact on the reserve, and ultimately could change Staff's calculations.

Staff Expert/Witness: Sarah Sharpe

B. Cash Working Capital

Cash working capital (CWC) represents the amount of cash required for day-to-day expenses incurred in providing service to ratepayers. In some instances, payments for goods and services are paid shortly after, or even before, the goods are received/utilized or the services are performed. In other instances, the payment for a good or service received occurs long after the good or service is received. If, on average, the payment for goods or services utilized in the provision of utility service is made before receipt of related customer revenues, the utility will have a relatively constant investment in cash working capital (i.e., a constant investment in the prepayment of cash expenses made in advance of the receipt of related service revenue). In this instance, the utility's shareholders are compensated for the funds they provided by inclusion of these funds in rate base. By so doing, the shareholders earn a return on the funds they have invested. Conversely, if on average, the payment for goods or services utilized in the provision of utility service is made after receipt of related customer revenues, the utility will enjoy a relatively constant source of cost free funds supplied by ratepayers (i.e., ratepayers provide cost free capital to the utility in the form of payment for utility service prior to the time that the utility is required to pay "cash" for goods and services consumed in providing the utility service). Ratepayers under this circumstance are compensated for the funds they provided by reducing rate base by the amount of the customer-provided cash working capital.

To determine the amount of cash working capital provided by both the ratepayers and shareholders, Staff performs a lead/lag study. The lead/lag study involves the analysis of the timing of when expenses are paid to suppliers, employees, etc. and when the utility receives revenues from customers for the services it provides. A positive cash working capital requirement indicates that, in the aggregate, the shareholders provided the working capital for the test year. This means, on average, the utility paid the expenses incurred to provide the gas service to the ratepayers before the ratepayers paid for the service. A negative cash working capital requirement indicates that, in aggregate, the ratepayers provided the working capital during the test year. This means, on average, the ratepayers paid for their gas service before the utility paid the expenses incurred to provide that service.

Liberty Utilities has indicated that it does not have a full test year of billing and collection data for these properties under its ownership in order to conduct a complete cash working capital analysis. In view of the lack of Liberty Utilities' own data, Staff reviewed the lead/lag analysis that was utilized in the last Atmos Energy Corporation's Case No. GR-2010-0192, and has adopted the same lead and lag factors for this rate case. Staff believes those lead and lag factors are reasonable as they relate to the same service territory. Liberty Utilities is the successor owner to Atmos Energy Corporation of these properties. Staff utilized those lead/lag calculations and applied them to the adjusted test year amounts determined in this rate case to calculate the cash working capital requirement for each of Liberty's rate divisions. Staff's overall study resulted in a negative cash working capital requirement. This means that the ratepayers have provided the working capital, in the aggregate, during the test year. Therefore, the ratepayer will be compensated for the working capital, through a reduction to rate base. Finally, Staff recommends that Liberty Utilities submit a lead/lad study as part of its next rate case, as discussed in Liberty Utilities witness James Fallert's direct testimony.

Staff Expert/Witness: Kofi A. Boateng

C. Gas Stored Inventory

Natural gas inventory is cyclical in nature, in that gas inventory volumes increase throughout the summer as gas is injected into storage, then decrease throughout the winter as gas is withdrawn or consumed. This natural gas inventory stored underground represents an investment by Liberty Utilities. Therefore, it is included in rate base which allows Liberty Utilities an opportunity to earn a return on its investment. Liberty Utilities did not acquire any propane facilities as part of the recent purchase of utility properties in Missouri and other states as a result of acquiring Atmos' assets in Case No. GM-2012-0037, and does not sell nor store any propane.

A 13-month average of month ending total costs is used to account for the fluctuation in inventory levels over time. Therefore, Staff included as an addition to rate base a 13-month average of the combined inventory quantities and corresponding prices for gas storage inventory levels using the month-ending balances during March 2013 through March 2014.

Staff Expert/Witness: Sarah Sharpe

D. Prepayments

During Staff's review of test year recorded prepayment amounts, it was discovered that adjustments should be made to the monthly prepayment balances shown in the utility's books and records in order to correctly state Staff's rate base. Staff corrected a prepayment balance that had not been properly expensed on a monthly basis. Staff included a level of prepayments in rate base that reflects a 13-month average ending March 31, 2014. Staff then allocated the amount of Liberty Utilities' prepayments to each division: WEMO, SEMO, and NEMO.

Staff Expert/Witness: Sarah Sharpe

E. Customer Deposits

Staff's inclusion for customer deposits in rate base reflects a 13-month average ending March 31, 2014. Customer deposits are funds received from the utility company's customers as security against potential loss arising from the customer's failure to pay for utility service. Until refunded, customer deposits represent a source of funds available to the company, and are included as an offset to the rate base investment. Generally, interest is calculated on customer deposits and paid to customers for the use of their money. See the discussion in Section IX.B.1., Expenses-Interest on Customer Deposits Expense.

Staff Expert/Witness: Sarah Sharpe

F. Customer Advances

Customer advances are funds provided to the company by individual customers to reimburse in part the cost of providing their individual service. Since these funds represent interest-free money to the company, it is appropriate to include these funds as a reduction, or offset to rate base. Unlike customer deposits, no interest is paid to customers for the use of this money. The amount of customer advances used by Staff as an offset to rate base reflects a 13-month average ending March 31, 2014.

Staff Expert/Witness: Sarah Sharpe

G. Accumulated Deferred Income Taxes (ADIT)

A company's deferred income tax balance represents, in effect, a prepayment of income taxes by a company's customers prior to payment to the taxing authority by the company. As an example, because a company is allowed to deduct depreciation expense on an accelerated basis for income tax purposes, depreciation expense used for income taxes paid by the company is considerably higher than depreciation expense used for rate making purposes. This results in what is referred to as a "book-tax timing difference," and creates a deferral of income taxes to some point in the future. A net credit balance in the deferred tax reserve represents a source of cost-free funds to a company. Therefore, the company's rate base is reduced by the deferred tax reserve balance to avoid having customers pay a return on funds that are provided cost-free to the company.

In the case of Liberty Utilities, there is no ADIT currently on the Liberty Utilities' books related to any timing difference. While most companies book these amounts as they go, Liberty Utilities only books ADIT on an annual basis once its tax return has been filed and the amount of ADIT has been determined. Currently, Liberty Utilities' 2013 tax return has not yet reached the point to which ADIT has been booked; consequently there are no balances readily available to Staff to determine the actual amount to include in Staff's cost of service calculation. Given this situation, Staff has made a calculation based on actual plant balances at March 31, 2014, of what it believes to be an appropriate level of ADIT for inclusion in its cost of service. Should actual amounts be provided after this direct filing, Staff will take those amounts into consideration for subsequent filings.

Staff Expert/Witness: Lisa K. Hanneken

H. Rate Base Offset

As part of the Stipulation and Agreement in Liberty Utilities Acquisition Case No. GM-2012-0037, Liberty Utilities agreed to a rate base offset to credit customers on Atmos' books at the time of close of the transaction, which otherwise would have been lost. The stipulation stated that a total of $16.34 million was to be amortized over ten years, commencing on the date of close. Therefore, Staff has included an amount of $13.6 million in its rate base calculation to account for this offset.

Staff Expert/Witness: Lisa K. Hanneken

I. Energy Efficiency Amortization

Liberty Utilities agreed, as part of the Stipulation and Agreement in the Liberty Utilities Acquisition Case, No. GM-2012-0037, to continue certain ratemaking agreements previously stipulated to by Atmos Energy Corporation in its prior general rate case, No. GR-2010-0192. One of the agreed-upon items relates to energy efficiency costs. Liberty Utilities (through Atmos' agreement) agreed that $150,000 would be included in base rates related to energy efficiency costs, and that any additional program costs incurred above this level would be placed in a regulatory asset account. This regulatory asset amount, in turn, would be included in rate base in Liberty's future rate case and amortized over a period of six years. Staff has therefore included an amount of $51,911 in its rate base calculation related to the energy efficiency regulatory asset. In addition, Staff included an associated amount of amortization expense, calculated over a six-year period; see Section IX.C.5. related to this adjustment.

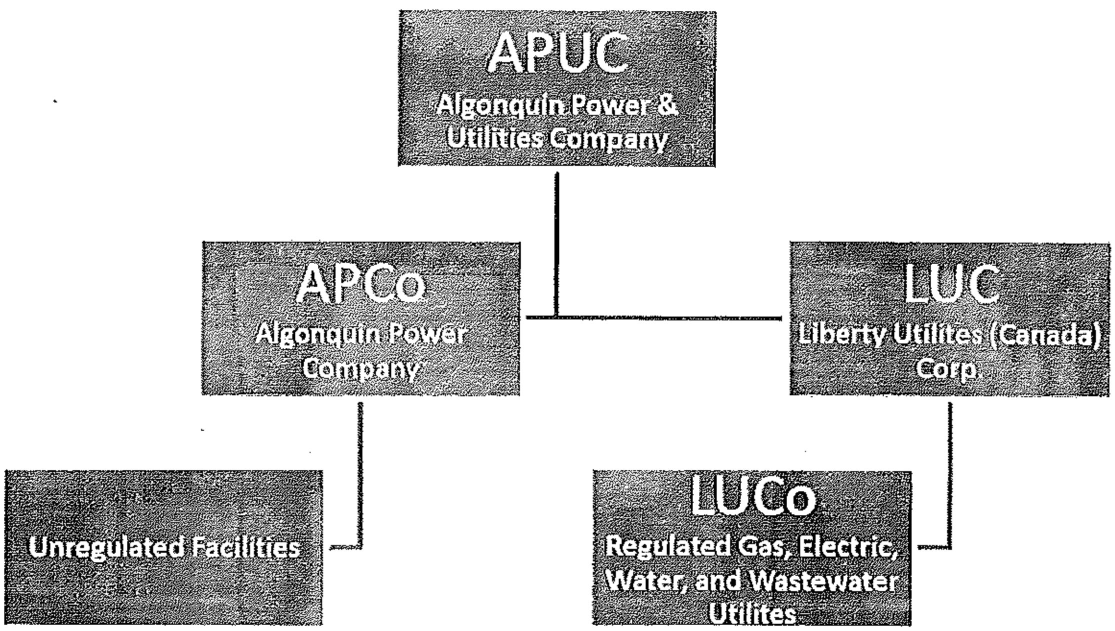
Staff Expert/Witness: Lisa K. Hanneken

VIII. Allocations

A. Allocations / Cost Allocation Manual

Liberty Utilities' Missouri operations receive a variety of corporate, administrative and support services from its affiliates and parent corporation. The cost of these services are charged to the Missouri operations through allocations, either directly or indirectly.

During the test year, the allocations were received from APUC, Liberty Utilities (Canada) Corp. ("LUC"), and LUC's service companies (the "Service Companies"), as well as the Liberty Midstates, based on the percentages applied monthly as provided for in the Cost Allocation Manual (CAM). The following organization chart describes the test year relationships in a simplified form:



Per the CAM in effect during the test year:

> APUC: APUC is the ultimate corporate parent and affiliate that provides financial, strategic management, corporate governance, administrative and support services to LUC and its subsidiaries as well as to the numerous unregulated utility assets held by APCo. The services provided by APUC are necessary for LUC and its subsidiaries to have access to capital markets for capital projects and operations, and are necessary in providing a high level of shared services at the

lowest cost. These services are expensed at APUC and are performed for the benefit of APCo and LUC and their respective businesses.

APUC used the Three Factors Methodology to during the test to allocate costs not directly attributable to a specific entity. This methodology is similar to other such allocation methodologies, where the costs are spread based on certain aspects of the entities which will receive the allocated costs. In APUC's case, the three factors in the Three Factors Methodology are revenue, expenses, and plant-in-service. Therefore, APUC determines the amount of each of these items for each of the entities. Then each of the three factors are given equal weight, or 33.3%. The resulting percentages are then utilized to spread the costs to each entity. Notwithstanding the above, if a charge is related either solely to the regulated utility business, i.e., LUC, or to the power generation business, i.e., APCo, then all of those costs will be allocated to the business segment for which they are incurred. Furthermore, costs directly attributable to a specific region ("Regional Costs") are identified as such and allocated by LUC to the utilities in that region using the Utility Four Factor Methodology, as defined in Section IV. Lastly, if a cost can be directly attributable to a specific entity, it will be directly charged to that entity.

LUC: LUC provides its regulated utilities with the following services: accounting, corporate finance, human resources, information technology, rates and regulatory affairs, environment, health and safety, and security, customer service, procurement, and utility planning. The following are examples of those services: (i) budgeting, forecasting, and financial reporting services including preparation of reports and preservation of records, cash management (including electronic fund transfers, cash receipts processing, managing short-term borrowings and investments with third parties); (ii) development of customer service policies and procedures; (iii) development of human resource policies and procedures; (iv) selection of information systems and equipment for accounting, engineering, administration, customer service, emergency restoration and other functions and implementation thereof; (v) development, placement and administration of insurance coverages and employee benefit programs, including group insurance and retirement annuities, property inspections and valuations for insurance; (vi) purchasing services including preparation and analysis of product specifications, requests for proposals and similar solicitations; and vendor and vendor-product evaluations; (vii) energy procurement oversight and load forecasting; and (viii) development of regulatory strategy.

In addition, LUC provides information technology and some human resource services to APCo and APUC. These costs are directly charged to APCo and APUC.

Unless a charge can be directly attributable to a specific utility, LUC allocates its direct labor and direct non-labor costs, including capital costs, to its regulated utilities using a Utility Four Factor Methodology. LUC uses the Utility Four Factor Methodology to allocate Regional Costs to the utilities in that region and to allocate costs incurred for the benefit of all of its regulated assets ("System-Wide Costs") to all of its utilities.

The "Four Factor Utility Methodology" allocates costs by relative size of the utilities. The methodology used by LUC involves (1) Utility Plant, (2) Total Customers, (3) Non-Labor Expenses, and (4) Labor as allocating factors, with each factor assigned a specific weight. LUC uses the following weights under this Four Factor Utility Methodology:

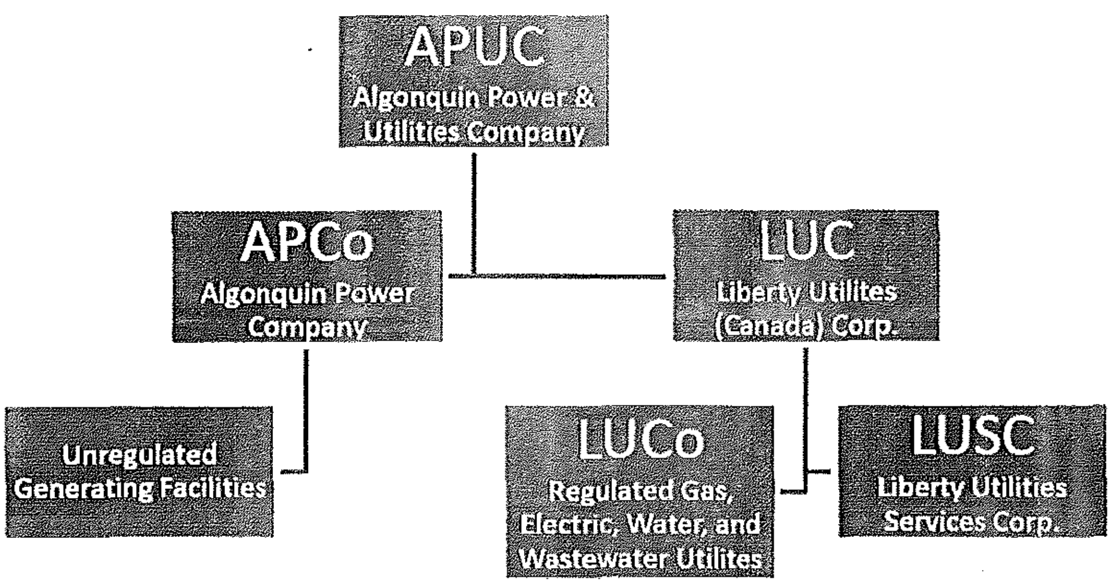
Factor	**Weight**
Utility Plant	50%
Customer Count	40%
Non-Labor Expenses	5%
Labor	5%
Total	**100%**

Services Company: Some of LUC's regulated utilities may receive services such as: billing and customer service; operations and engineering; environment, health and safety, and security; finance; information technology; regulatory; legal; and administrative services, e.g., rent, insurance, and office services, from a Service Company.

Unless a charge can be directly attributable to a specific utility, billing and customer service costs are allocated on customer count. For an example of how this allocation works please see Appendix 4 [of CAM]. Operations and engineering costs are directly charged based on timesheets to the relevant regulated utility. Unless a charge can be directly attributable to a specific utility, both labor and non-labor (including capital), environment, health and safety, and security, finance, information technology, regulatory, legal, and administrative costs are allocated using the Utility Four Factor Methodology.

Gas Procurement: LUC's natural gas utilities receive gas procurement services from a shared group that is housed out of New Hampshire. The group's non-labor costs are directly charged to specific assets. The gas procurement employees directly charge their time to specific assets as well. Any shared services that are provided, such as development of an overall hedging strategy, are allocated based on natural gas volumes.

The CAM allocation percentages are generally in force for the entire calendar year, unless events take place which would impact the factors, and then new percentages may be calculated during the course of the year. Such was the case during the test year when the factors were updated during the year based on various changes. Staff's review of the test year allocation amounts revealed that due to the recent acquisition (as well as other factors), Missouri's operations at first received sporadic allocations which eventually became more regular and measured. However, even though the allocation methods and percentages leveled out towards the end of the test year, Staff believes that the test year is not representative of an ongoing level of allocated costs. In addition to the variances experienced in the test year, a new CAM has been produced for 2014, which changes the methodologies and factors. However, the new CAM has minimum impact on the overall allocation factors, when comparing the ending test year factors versus the 2014 factors. The following organization chart describes the relationships for the new 2014 CAM, in a simplified form:



While the overall hierarchy has not changed, except for the formation of a services corporation, some of the methodologies have changed. For example, instead of a 3-factor methodology at the APUC level, the costs are now more appropriately allocated based upon the factors which drive the costs. Also, certain costs, which are incurred for the benefit of APUC's businesses, are no longer allocated to any subsidiary. These include costs such as donations, certain corporate travel, and certain overheads.

Within the new CAM, the LUC costs that cannot be directly attributed to a specific utility, such as indirect labor and indirect non-labor costs, including capital costs, are allocated to its regulated utilities using a Utility Four Factor Methodology. LUC also uses the Utility Four Factor Methodology to allocate to its regulated utilities the system-wide indirect labor and indirect non-labor costs allocated to LUC from APUC. The new four-factor method is similar to the previous four-factor method; however, the weighting has been changed to:

Factor	**Weight**
Utility Plant	25%
Customer Count	25%
Non-Labor Expenses	25%
Labor	25%
Total	**100%**

In addition, LUC provides certain services that benefit the entire company, i.e., APCo and the utilities. These indirect costs are allocated using methodologies which are designed to closely align the costs with the driver of the activity.

Different from the prior CAM is the formation of LUSC. Previously the employee costs for a specific utility, such as Missouri, were incurred on the books of the specific utility. However, now all utility employees in the United States are employed by LUSC. All employees' costs, such as salaries, benefits, insurances, etc., are paid by LUSC and direct charged to the extent possible. Services provided from LUSC to each regulated utility are done on a time sheet basis to the extent possible. In instances where time sheeting of labor charges may not be possible, the allocation factors are based on the drivers for which the costs were incurred. Even though this is a change from the prior CAM, in general the costs should not vary greatly from those previously experienced (i.e., a NEMO meter reader's time will still be ultimately direct charged to NEMO).

Comparing the allocation factors in use at the end of the test year (i.e. September 2013) and those currently being utilized (i.e. 2014 factors), Staff finds little overall change. The below table shows the comparison of factors:

Allocated From	Effective Percentage Received by Missouri – September 2013	Effective Percentage Received by Missouri – 2014
APUC	** _____ **	** _____ **
LUC	** _____ **	** _____ **
Midstates	** _____ **	** __ **

While these factors are important, and were a part of Staff's analysis of allocations, Staff is more concerned with the amount of allocations actually experienced by Missouri operations during the test year when the factors and methodologies were in flux. For example, there were some months where no allocations were expensed to Missouri, and in some months 'catch up' allocations were made to capture various changes to the factors and amounts.

Given what Staff finds to be unrepresentative and, in some cases, erroneous allocation amounts during the beginning of the test year, Staff has made an adjustment to utilize the amount of allocations experienced during the update period, the 12-months ending March 31, 2014, and then updated those amounts based on the current 2014 factors. By making this adjustment, the variances seen early in the test year are eliminated and the level of current ongoing factors can be taken into account. It should be noted that Staff's adjustment takes into account the fact that various Staff witnesses made adjustments to allocated items through their analysis of specific issues (e.g., disallowance of promotional items that were allocated to Missouri). Those adjustments are discussed more fully in the individual sections of this report.

As part of this case, the new 2014 APUC CAM has been presented to Staff for review and approval. While Staff believes the CAM allocation methodologies presented to be an acceptable approach, Staff suggests that a meeting be held with all parties to further discuss the CAM and its impact to Missouri ratepayers. Specifically, Staff seeks the opportunity to

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discuss with Liberty Utilities its procedures for accounting for the allocated costs on its books in order to facilitate a more efficient review of such allocations in the future.

In addition, Staff would like to discuss the possibility of additional materials being provided in the context of an annual CAM filing which would allow for a more productive review of the allocated costs in the future.

Staff Expert/Witness: Lisa K. Hanneken

IX. Income Statement

A. Missouri Jurisdictional Rate Revenues

1. Introduction

In order to calculate Liberty Utilities' Missouri retail jurisdictional revenue deficiency (or excess), it is necessary to determine and sum all annualized and normalized Missouri jurisdictional operations and maintenance expenses, all income tax and other tax expenses, as well as annualized depreciation expense. Additionally, a return requirement is determined by multiplying a recommended weighted overall cost of capital by Liberty Utilities' Missouri retail jurisdictional investment in plant, working capital and various other investment components (i.e., rate base). The sum of all Missouri retail jurisdictional expenses and the Missouri retail jurisdictional return requirement are then compared to normalized and annualized "revenues at existing rates" to determine the Missouri retail jurisdictional base rate revenue deficiency (or excess).

Staff Expert/Witness: Kofi A. Boateng

2. Character of Liberty Utilities' Missouri Retail Sales

All three of Liberty Utilities' Missouri Rate Divisions serve primarily small cities or towns in rural areas. Further, the vast majority of all three Rate Divisions' sales are made to residential, small general service (SGS), and medium general service (MGS) customers whose loads are affected by weather (i.e., heating degree days). Liberty Utilities also experiences seasonal fluctuations in the number of Missouri retail customers it serves. A number of customers disconnect service during the non-heating season, only to reconnect once the heating season begins again. Another characteristic of Liberty Utilities' Missouri Rate Divisions is that, at least for several years, these service territories have experienced slight, but continuous, declines in the total number of customers served, particularly for the residential customer class.

Staff Expert/Witness: Kofi A. Boateng

3. Annualization of Base Tariff Revenues and Interaction of Staff's Base Tariff Proposal with Currently Approved Infrastructure System Replacement Surcharges

Staff calculated revenues, utilizing customer counts and volume of usage for the twelve month ending March 2014, and also by considering existing base tariff rates. When arriving at revenues at existing permanent/base rates, Staff did not calculate the annualized impact of the Infrastructure System Replacement Surcharge (ISRS) that was in effect during the test year, nor did it calculate the annualized impact of the ISRS tariff change that became effective on October 30, 2013, as a result of File No. GO-2014-0006. When base rates are designed within this proceeding, the ISRS that went into effect on October 30, 2013 will be rolled into base rates and the ISRS will be reset to "zero." Liberty Utilities chose to reflect annualized ISRS revenues in its presentation of total test year revenues based upon the ISRS that was in effect at the time of its original direct filing. The portion of ISRS revenues included in the Company's test year total revenues is approximately $1.3 million. Staff has removed the ISRS revenues from Liberty Utilities' filed test year in order to reflect the current ongoing level of base rate revenues. Staff does not perceive that there is any issue between itself and Liberty Utilities regarding ISRS revenues or the design of base rates as they relate to ISRS in this proceeding. The difference is merely in the presentation of the calculated revenue deficiency by each party within this proceeding.

Staff Expert/Witness: Kofi A. Boateng

4. Calculation of Rate Revenue in this Case

Based on the update to the test year ending September 30, 2013 for changes in major cost of service components occurring through March 31, 2014, it is usually appropriate to annualize base tariff revenues considering "normalized" billing determinants associated with the number of customers taking service through the end of September 2013. Typically, it is important to normalize sales for average weather conditions. The intent of normalization and annualization of billing determinants and weather conditions adjustments to test year revenue sales and rate revenues is to determine the level of revenue that Liberty Utilities would have collected on an annual normal-weather basis, based on information at the end of the update period.

During its review of Liberty Utilities billing data, Staff observed disparities in the data maintained by Atmos Energy Corporation versus that generated by Liberty Utilities. These disparities go to support the evolving nature of Liberty Utilities' billing records as articulated by witness James Fallert in his direct testimony. From August 1, 2012 through March 1, 2013, Liberty Utilities' billing data was maintained by Atmos Energy Corporation under a continuous service agreement. This means that the test year billing data was billed under two different billing systems with Atmos Energy Corporation maintaining the billing records from October 2012 through March 1, 2013, while Liberty Utilities handled the rest of the billed data for the test year through the update period of March 31, 2014. Also, Staff identified unusual spikes in the residential customer levels for each of the rate divisions for the month of March 2014, compared to the historical billed data maintained by Atmos Energy Corporation. Because of a number of deficiencies identified in Liberty Utilities' billing data since it assumed ownership of the Missouri properties, as discussed by Staff witness Lisa K. Hanneken, Staff was unable to normalize base tariff customer level or volumetric energy usage to reflect "normal" weather. Therefore, Staff calculated annualized revenues, utilizing update period customer level and the volume of gas sold or distributed for the twelve ending March 31, 2014, and by applying the existing base tariff rates for each of Liberty Utilities' rate classes.

Staff Expert/Witness: Kofi A. Boateng

5. Removal of Purchased Gas Cost

Liberty Utilities' gas costs are currently recovered through a Purchase Gas Adjustment (PGA) clause, as a pass-through cost collected from the Company's customers. Liberty Utilities has not included the revenue or the expense piece associated with its purchased gas transactions in its filed cost of service nor is it seeking a rate recovery of purchased gas amounts in this proceeding; therefore, no adjustment is required on Staff's part at this time.

As part of its review, Staff did make an adjustment to account for gas costs that were erroneously booked to transmission expense by Liberty Utilities. During 2012, Liberty Utilities incorrectly charged certain gas costs to transmission expense, but subsequently made a correcting entry in December 2012 to remove all 2012 entries in the transmission account. Given that only some of the 2012 erroneous entries are recorded during the test year and that the correcting entry, related to all the 2012 entries, was also recorded in the test year, the amount of expense on the books for the test year for the transmission account is misstated. In order to reflect this timing difference and the fact that the account did not have any actual expenses booked to it during the test year, Staff made an adjustment to set the account to zero.

Staff Expert/Witness: Kofi A. Boateng

6. Revenue – Weather Normalization

Since the primary use of natural gas in Missouri is for the purpose of space heating, natural gas sales are dependent upon weather conditions. As natural gas rates are based on usage, it is important that abnormal weather influences are removed from the test year.

Staff was unable to conduct this analysis for the test year because Liberty Utilities was unable to provide the full and complete amount of data requested and needed by Staff to conduct a conclusive weather normalization analysis. Staff filed a motion to compel to ensure that Liberty Utilities provides the necessary information to conduct this complete analysis. Liberty Utilities has assured Staff that it will provide this information. If Staff receives the requested information from Liberty Utilities, Staff will conduct its analysis.

Staff Expert/Witness: Joel McNutt

7. Revenues - Industrial and Transportation Customers

The typical adjustments to the Industrial and Transportation customers' test year usage and revenues include adjustments to (1) reflect customers coming on, or leaving Liberty Utilities' system during the test year; (2) annualize customer accounts that take service on more than one rate class during the test year; and (3) normalize the usage for weather sensitive customers to reflect what usage would have been under normal weather conditions. Staff has not been able to perform its analysis due to the lack/untimeliness of data provided by Liberty Utilities. Staff has used actual revenues, twelve months ending March 2014 with the exception of proposing ** ______________________________ ** for the Direct filing of this case.

Staff Expert/Witness: Kim Cox

NP

8. Contractual Customers

a. Special Contract Customers

Tariff – Special Contract Customers

Liberty Utilities has historically entered into 2 special contracts with customers on its system. Existing tariffs do not have a reference to this type of service. Missouri Gas Energy (MGE), the utility that serves the Kansas City area, has an example of a special contract provision in its tariffs. Ameren Missouri also has an example. Staff is recommending using the MGE and Ameren tariffs as a starting point for a new provision in Liberty Utilities' tariffs that addresses special contracts, because without a tariff provision which allows special contracts and which provides criteria for entering into special contracts, such contracts are discriminatory since they provide special treatment for some customers. The Staff recommends the MGE special contract language with changes to reflect a required EFIS submission for informational purposes and a requirement that the terms and conditions of any special contract be consistent with the terms and conditions of the Liberty Utilities' tariffs.

Example language:

> *CONTRACT RATES: Company may, in instances where it faces competition from alternative suppliers of natural gas, enter into special transportation rate contracts with industrial customers or other large consumers on such terms and conditions as may be agreed upon by the parties and which, in the Company's sole discretion, are deemed necessary to retain services to an existing customer or to reestablish service to a previous customer or to acquire new customers. Such terms and conditions shall not be inconsistent with the Company's tariffs. The rates agreed upon by Company and customer shall not exceed the maximum transportation charges nor be less than 10 cents per Mcf. All such contracts, amendments, and contract renewals shall be filed in EFIS under Non-Case Related submissions and shall be subject to the Commission's jurisdiction. Ratemaking treatment of any flexed Transportation Charges will be reviewed and considered by the Commission in subsequent rate proceedings.*

Staff Expert/Witness: David M. Sommerer

Adjustments – Special Contract Customers

In Case No. GR-2010-0192, *In the Matter of Atmos Energy Corporation's Tariff Revision Designed to Implement a General Rate Increase for Natural Gas Service in the Missouri Service Area of the Company*, a Unanimous Stipulation and Agreement

("Stipulation") was approved by the Commission. On Page 3 of the Stipulation, Paragraph 7 Special Contracts, it states:

> The Signatories agree that revenues associated with special contracts shall not be imputed in this case. The Signatories agree that Atmos shall offer to extend the special contracts of Noranda and General Mills to expire on the effective date of rates approved in Atmos' next general rate case. The rates for such extended period shall be those in effect at the end of the respective contract's original term. This paragraph shall not be construed to limit the ability of Atmos and Special Contracts customers: i) to accept alternative mutually agreeable contract provisions, or ii) to enter into alternative mutually agreeable contracts for service.

Staff has reviewed the contract with Noranda Aluminum, Inc. ("Noranda") that became effective ** **

Staff also reviewed the contract with General Mills ('GM"). The contract became effective ** **

Staff Expert/Witness: Kim Cox

NP

b. SourceGas Contract

Staff recommends ** ____ **, rather than the ** __________ **

Liberty Utilities provides transportation service over its SEMO distribution lines pursuant to a FERC Order. (*See* FERC Order in Docket No. CP12-42 issued on March 30, 2012.) This service primarily relates to transportation required by SourceGas, an Arkansas Local Distribution Company (LDC), that serves Blytheville, Arkansas, and other areas in Northeast Arkansas.

Natural gas flows from North to South and is measured near the border between Southeast Missouri and Northeast Arkansas. From a ratemaking perspective there are two general approaches for addressing the costs and expenses associated with this service. One alternative would be to analyze the plant and related expenses associated with providing this service and allocate the costs away from Liberty Utilities' SEMO jurisdiction. Another method would be to credit the available revenues to the SEMO cost of service in recognition that some of the plant and related expenses are used to provide service to SourceGas. Liberty Utilities has not calculated a separate cost of providing this transportation service to SourceGas.

Liberty Utilities has chosen to provide SourceGas firm transportation service at a ** ____ ** (This maximum rate is based upon Liberty Utilities' MoPSC regulated tariff rate, which is one of the alternatives considered by FERC.) In addition, Liberty Utilities' ** ____ **

In an effort to determine whether ** ____

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** To date, Liberty's main ** **

The current Liberty Utilities agreement with SourceGas has a designated ** **

Therefore the Staff is ** **

Staff Expert/Witness: David M. Sommerer

9. Other Revenue Adjustments

Liberty Utilities' other revenues consist of forfeited discounts, rents from property, late fees, etc. Staff's analysis included a review of these revenue levels over an eighteen-month period including the test year through the update period. Based upon Staff's review, the other revenue levels at the update period, the twelve-month period ending March 31, 2014, appear reasonable for each of the respective Missouri divisions. Therefore, Staff will adopt this update period level as an annualized level of other revenue.

Staff Expert/Witness: Kofi A. Boateng

10. Payroll and Benefits

a. Payroll, Payroll Taxes, 401(k) and Other Employee Benefit Costs

Staff's annualized payroll was based upon the test year ending September 30, 2013, actual Missouri-direct gas-related payroll expense. Staff removed a percentage of payroll

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allocated to construction and adjusted for the following: a) all known increases in employee levels and union wage increases that have occurred through the update period of March 31, 2014; b) a 3.0% merit increase as of January 1, 2014 for non-union employees; and c) another 2.5% wage increase based upon the most current union contract terms that will occur June 1, 2014. Staff did not believe a change in the level of allocated payroll that Liberty Utilities' incurs from APUC and LUC was necessary. Staff's adjustment for payroll expense was distributed by account based on the actual payroll distribution experienced by the utility during the test year ending September 30, 2013, in order to restate test year payroll expense to an annualized level.

It is important to note that Liberty Utilities accrues future salary increases throughout the year prior to the salary increase actually going into effect. Staff recommends that only actual payroll amounts be recorded until such time as any salary increase is actually in effect.

Staff's annualization for payroll taxes reflects an overall increase from test year levels of Federal Insurance Contributions Act (FICA), Old Age Survivors and Disability Insurance (OASDI), and Federal Unemployment Tax Act (FUTA). Staff did not include State Unemployment Tax Act (SUTA) payroll taxes as these taxes are not currently incurred by the utility. These increases reflect the addition of employees to the Liberty Utilities' workforce as well as the wage increase for both the union and non-union employees.

Currently employees are offered medical, dental, vision, life insurance, long-term disability, short-term disability, 401(k) benefits, and an employee stock purchase program.

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*

In addition, Liberty Utilities has several retired employees previously from Atmos that are receiving partially paid medical benefits, but are using Consolidated Omnibus Budget Reconciliation Act (COBRA) for their dental and vision coverage. The medical benefits are partially funded by the Company at a much lower percentage than active employees. Staff has reflected an annualized level of employee benefits in its cost of service calculation. Staff's annualized level utilizes the last known level of benefits adjusted to remove benefit costs associated with employees that are no longer with the utility, as well as to include benefits costs related to new employees hired during the update period that have met eligibility requirements.

Staff Expert/Witness: Lisa M. Ferguson

b. Incentive Compensation and Bonuses

Liberty Utilities has three forms of incentive compensation. The first type is the long-term incentive plan (LTIP) ** ______________________________ **. The second type is the short-term incentive plan (STIP) * * The third type of incentive compensation is the shared bonus pool (SBP) * *

c. Long-Term Incentive Plan (LTIP)

** ______________________________

**

d. Short-Term Incentive Plan (STIP)

*

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*

e. **Shared Bonus Pool (SBP)**

*

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Incentive Compensation is labor related; and all labor related costs include an expense amount as well as an amount that is capitalized. For all amounts mentioned above that are being removed by Staff, an adjustment will be made to expense accounts, but there will also be a proportionate amount removed from plant and depreciation reserve.

Staff Expert/Witness: Lisa M. Ferguson

f. Pensions

Liberty Utilities maintains a qualified defined benefit pension plan, which Liberty Utilities characterizes as a "cash balance plan", for all of its employees that meet the basic eligibility requirements of the plan. Liberty Utilities has established a pension trust fund with an independent third-party trust and funds the trust in accordance with the requirements of the Employment Retirement Income Security Act (ERISA) of 1974, and the Pension Protection Act of 2006 (PPA). Liberty Utilities' pension costs are calculated on an accrual basis, by the Company's actuary, in accordance with the Financial Accounting Standards Board's (FASB) ASC 715 (formerly *FAS 87, Employers' Accounting for Pensions*). The current practice of Staff is to recommend rate recovery of pension expense in an amount equal to current or recent cash contributions by the utility to its pension trust fund. Staff reviewed the most recent Liberty Utilities' actuarial report for the fiscal year ending December 31, 2013, and the amount of accruals and payments through the update period ending March 31, 2014. ** ____________________

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Staff Expert/Witness: Kofi A. Boateng

g. <u>Other Post-Employment Benefits (OPEBs)</u>

The costs associated with Liberty Utilities providing certain post-retirement benefits such as healthcare and life insurance benefits to eligible employees after they have retired from active employment from Liberty Utilities are considered Other Post-Employment Benefits or OPEBs. Liberty's OPEB plan is similar to its pension plan. As with pension expense, Liberty Utilities' OPEB costs are calculated by its actuary in accordance with the FASB's ASC 715 (formerly FAS 106, *Employers' Accounting for Postretirement Benefits Other than Pensions*). The actuarial assumptions used in the calculation of FAS 106 are similar in many respects to the valuation of FAS 87. The current practice of Staff is to recommend rate recovery of OPEBs in an amount equal to its current level of ASC 715/FAS 106 OPEBs expense, as long as that amount is contributed to an external trust fund dedicated to future payment of OPEBs to retired employees. Based upon the review of Liberty Utilities' OPEBs contributions, accruals and actuarial report for the fiscal year ending December 31, 2013, Staff believes that at the present time it is appropriate to only include the actual contribution to Liberty Utilities' OPEBs trust fund made through the twelve months ending March 31, 2014 (the end of the test year update period), in its cost of service computation. ** **

Staff Expert/Witness: Kofi A. Boateng

B. Other Non-Labor Expenses

1. Interest on Customer Deposits Expense

Staff included a level of expense related to the annualized level of interest that Liberty Utilities would be required to pay based upon the balance of customer deposits that existed at March 31, 2014. Staff utilized an interest rate as set forth in Liberty Utilities' current tariff, YG-2014-0157, which states, "Interest on deposits shall be paid on a per annum rate equal to the prime bank lending rate plus one percentage point as published in The Wall Street Journal

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for the last business day of the preceding calendar year...". See the discussion in Section VII.E., Rate Base-Customer Deposits.

Staff Expert/Witness: Sarah Sharpe

2. Environmental Expense

Liberty Utilities purchased Missouri utility assets from Atmos Energy Corporation August 1, 2012, and as part of the Stipulation and Agreement in Case No. GM-2012-0037, Condition II.A.4. states:

> Liberty-Midstates shall not ever seek recovery in rates for any environmental costs related to the clean-up of the Hannibal Manufactured Gas Plant site, unless such costs are related to new claims that were not known to Atmos or Liberty-Midstates at the time of closing of the Transaction.

Liberty Utilities has not incurred any new environmental costs at this time and in fact has yet to accrue a reserve account for any future expenditures. Due to the lack of current environmental expense and no known future expenses, Staff did not make an adjustment for this issue.

Staff Expert/Witness: Lisa M. Ferguson

3. Uncollectibles Expense

Uncollectible expense is the portion of retail revenues that a utility company is unable to collect from retail customers. Generally, after a certain amount of time has passed, delinquent customer accounts are written off and turned over to a third-party collection agency for recovery. Through the collection agency, the utility company may be able to successfully collect some portion of the delinquent amounts owed. "Net write-offs" represent the amount of delinquent accounts recognized by a utility over a period of time, offset by any subsequent recoveries in the same period of amounts earlier written off.

Traditionally, Staff has included a normalized level of uncollectible expense in the cost of service for ratemaking purposes by examining the actual net write-offs (billed revenues that will never be collected) over a period of time. Staff has reflected an adjustment to normalize the test year uncollectible expense based upon the level of net-write offs that was determined in Atmos Energy Corporation's rate Case No. GR-2010-0192. Given the lack of Liberty Utilities' historical data of bad debt write-offs, and that Liberty Utilities current

Missouri customers are essentially the same customers that Atmos had at the time of the last rate case, Staff utilized the prior case's level to represent the ongoing level of expense. Staff recommends that for purposes of future rate cases, Liberty Utilities should address Staff's concern regarding lack of data in this area by initiating a process to capture historical write-off data in a manner which will allow for a complete uncollectible analysis.

Staff Expert/Witness: Kofi A. Boateng

4. Advertising Expense

In forming its recommendation of the allowable level of Liberty Utilities' advertising expense, Staff relied on the principles it has consistently applied when analyzing advertising expense, by adhering to the Commission's decision in: *re: Kansas City Power and Light Company*, Case Nos. EO-85-185, et al., 28 Mo. P.S.C. (N.S.) 228, 269-71 (1986). In that case, the Commission adopted an approach that classifies advertisements into five categories and provides rate treatment of recovery or disallowance based upon a specific rationale. The five categories of advertisements recognized by the Commission are as follows:

a. General: informational advertising that is useful in the provision of adequate service;

b. Safety: advertising which conveys the ways to safely use electricity and to avoid accidents;

c. Promotional: advertising used to encourage or promote the use of electricity;

d. Institutional: advertising used to improve the company's public image; and

e. Political: advertising associated with political issues.

The Commission adopted these categories of advertisements explaining that a utility's revenue requirement should: 1) always include the reasonable and necessary cost of general and safety advertisements; 2) never include the cost of institutional or political advertisements; and 3) include the cost of promotional advertisements only to the extent that the utility can provide cost-justification for the advertisement (Report and Order in KCPL Case Nos. EO-85-185, et al., 28 Mo. P.S.C. (N.S.) 228, 269-271 (April 23, 1986)).

Staff reviewed advertising performed at both the local level (Missouri districts), as well as at all corporate allocated levels (APUC, Liberty Algonquin Business Services (LABS), LUC, and Liberty Utilities) during the test year. Staff found no evidence that any of these levels had engaged in any political advertising and Staff allowed all costs for safety advertising and general advertising. While Staff has not adjusted the cost of service to exclude any advertising costs on the basis of the above classifications, Staff included adjustments to remove items that were not related to Missouri operations, those for which Staff is awaiting ad copies, as well as for advertising related to an organization whose membership costs were already removed by Liberty Utilities. Staff also made adjustments to re-classify advertising costs that were erroneously capitalized to Plant In Service and Accumulated Depreciation Reserve accounts and moved those costs to advertising expense. In addition to these adjustments, Staff witness Lisa K. Hanneken made adjustments to exclude advertising related to transaction costs (*see* Section IX.B.14.-Transaction and Transition Costs).

a. Promotional Giveaways

In its direct filing, Liberty Utilities made an adjustment to remove some promotional items. Staff reviewed those items as part of its analysis of expenses directly incurred at the local Missouri districts as well as allocated corporate costs. Staff has made an adjustment to remove various promotional items such as tumblers, pens, t-shirts, and flash drives, are used for promoting Liberty Utilities' services or image in the community. These items provide no ratepayer benefit; therefore they have been excluded from Staff's cost of service calculation.

Staff Expert/Witness: Sarah Sharpe

5. Membership Dues and Donations

Staff reviewed all membership dues paid and donations made to various organizations during the test year ending September 30, 2013 directly incurred at the local Missouri districts of Liberty Utilities and allocated to the districts from the corporate levels. Staff recommends adjustments to disallow various dues and donations that were incurred by Liberty Utilities during the test year because they were not necessary for the provision of safe and adequate service.

In *Re: Missouri Public Service, a Division of UtiliCorp United, Inc.*, Case Nos. ER-97-394, et al., Report and Order, 7 Mo.P.S.C.3d 178, 212 (1998), the Commission stated:

> The Commission has traditionally disallowed donations such as these. The Commission finds nothing in the record to indicate any discernible ratepayer benefit results from the payment of these donations. The

> Commission agrees with the Staff in that membership in the various organizations involved in this issue is not necessary for the provision of safe and adequate service to the MPS ratepayer.

Staff has asked for further explanation of numerous expense reports and as well as various company credit card items in Staff's Data Request 254 in order to complete Staff's analysis of this issue. Once this data is provided, additional adjustments are possible.

Staff Expert/Witness: Sarah Sharpe

6. Lobbying Activities

Staff performed an analysis related to governmental affairs and lobbying expenses incurred by or allocated to Liberty Utilities. As part of its analysis, Staff determined that some of the dues for certain organizations allocated to Liberty Utilities contained a percentage used to fund government affairs or lobbying activities. Staff has traditionally disallowed the cost of these activities and, therefore, has removed these amounts from Liberty Utilities' Missouri test year expense level. The disallowance of these amounts is consistent with Staff's treatment in other rate cases.

Staff Expert/Witness: Sarah Sharpe

7. Miscellaneous Expenses

During the test year, numerous miscellaneous costs were incurred at various corporate levels and allocated to Missouri, as well as being incurred at the local Missouri district level. After reviewing these expenses, Staff made an adjustment to remove costs for items which provide no ratepayer benefit. These charges include items such as complimentary meals for employees, holiday parties, and flowers. The majority of miscellaneous expense items were in the form of employee expense reports and credit card charges. Staff is currently awaiting more information in response to Staff's Data Request No. 254 to finish its review of these costs, therefore future adjustments are possible.

Staff Expert/Witness: Sarah Sharpe

8. Outside Services

Regulated utilities employ the services of outside vendors to complete a variety of daily business, from use of temporary office workers to cleaning services. During the test year, Liberty Utilities switched customer billing vendors, so Staff is currently awaiting information requested in Staff's Data Request No. 67.1 in order to review the data provided to determine if any adjustment is necessary.

Staff Expert/Witness: Sarah Sharpe

9. Outside Auditor Expenses

During the test year, Liberty Utilities' parent corporation, APUC, switched accounting firms from KPMG to EY for accounting, advising, and auditing services. Staff annualized the Liberty Utilities' test year allocated costs for accounting, advisory, and auditing services and included $76,227 in the cost of service for this item.

Staff Expert/Witness: Sarah Sharpe

10. Legal Expense

As part of its analysis of legal expense, Staff reviewed invoices for actual payments for legal services for which some part of the cost was accrued and allocated to Liberty Utilities' Missouri operations by affiliated companies. As a result of this review, Staff determined that APUC, parent company of Liberty Utilities, received various legal and professional services during the test year and allocated the costs of those services to its subsidiaries. Staff reviewed copies of these invoices for the services APUC received and determined that in some cases, Missouri received allocated costs for legal services rendered to other jurisdictions. These costs should be directly assigned to the jurisdiction that principally benefited from those services. Staff has therefore made an adjustment to the amount of legal expense that was accrued and allocated by APUC to Liberty Utilities, and ultimately to Missouri ratepayers, during the test year.

Staff Expert/Witness: Kofi A. Boateng

11. Rate Case Expense

In this filing, Staff has included the actual incremental rate case costs incurred by Liberty Utilities as of April 15, 2014, and then normalized those costs over a three-year period. Staff will continue to analyze any additional rate case expenses incurred by Liberty Utilities through the duration of this case to establish a reasonable and ongoing normalized level of rate case expense for inclusion in rates.

Staff Expert/Witness: Kofi A. Boateng

12. Injuries and Damages

Liberty Utilities does not record an ongoing reserve accrual to account for unexpected future injuries and damages incurred. Since the acquisition from Atmos, only one incident resulting in a claim for damages was incurred by Missouri operations, which occurred in the SEMO district in August 2012. Because only this instance has occurred, Staff believes it would be appropriate to normalize this cost over three years. This incident was initially capitalized to Plant In Service; however, Staff has made adjustments to remove the amount from Plant In Service, as well as Accumulated Reserve, and properly place it into expense.

Per the FERC Uniform System of Accounts (USOA) for gas utilities as of April 1, 2004, account 925 Injuries and Damages states:

> This account shall include the cost of insurance or reserve accruals to protect the utility against injuries and damages claims of employees or others, losses of such character not covered by insurance, and expenses incurred in settlement of injuries and damages claims. It shall also include the cost of labor and related supplies and expenses incurred in injuries and damage actives.

Staff recommends that if injuries and damages are incurred on a more frequent basis in the future, that consideration should be given to recording this cost on Liberty Utilities' books using an accrual method for accounting for future injuries or damages.

Staff Expert/Witness: Sarah Sharpe

13. New Building Expenses

During the update period ending March 31, 2014, Liberty Utilities completed the construction of a new building for its Midstates Home Office in Jackson, Missouri. This new building takes the place of three rented spaces which had previously housed the Home Office. Staff has included the cost of this building in its rate base calculations and has removed the amount of lease expense related to the old office locations. In addition, Staff has annualized the amount of expense related to utilities for the new building based on currently available data.

Staff Expert/Witness: Lisa K. Hanneken

14. Transaction and Transition Costs

As part of the Stipulation and Agreement in the Liberty Utilities Acquisition Case, Case No. GM-2012-0037, transaction and transition costs were contemplated as being costs that would be incurred by Liberty Utilities as a result of the acquisition.

Transaction costs as defined in the stipulation and agreement are costs relating to gaining regulatory approval, development of transaction documents, investment banking costs, costs related to raising equity incurred prior to closing of the transaction, communication costs regarding the ownership change, and name change costs. As part of the Stipulation and Agreement in the acquisition case, Liberty Utilities agreed that it would not seek recovery of any transaction costs related to the acquisition. Staff reviewed Liberty Utilities' books and records for the test year ending September 30, 2013 and has removed what is defined by the stipulation as transaction costs. These included costs to rename certain assets and the cost of customer notifications related to the change in ownership. As part of Staff's review of these costs, Staff has made an adjustment to remove certain advertising costs related to customer notifications.

In addition, it was agreed that any transition costs could be placed on Liberty Utilities books for consideration in future rate cases. Most transition costs have historically been determined to be non-recurring in nature and therefore are typically removed from the utility's cost of service. Liberty Utilities removed several transition costs as part of the adjustments made to its direct filed case such as expenses related to the Continuing Services Agreement with Atmos to provide services related to the transition of customer billing. Staff has reviewed these costs as part of its analysis of transition costs and included an adjustment to remove costs related to transition items which should not be included in the ongoing cost of service. These included costs such as the expenses related to the Continuing Services Agreement in place for part of the test year with Atmos Energy Corporation to assist with the transition to Liberty Utilities.

Staff Expert/Witness: Lisa K. Hanneken

15. Relocation Expense

Staff has removed various costs related to the relocation of employees that were incurred in relation to Liberty Utilities acquiring assets from Atmos Energy Corporation. These costs include temporary lodging for house hunting, travel expenses, moving of household items, etc. Liberty Utilities has also made a similar adjustment for these items; however, Staff has made additional removals for relocation expenses that were not properly booked and removed in the utility's adjustment. Some of the costs removed by Staff were discovered through the analysis performed on miscellaneous expenses. As discussed in the Miscellaneous Expense Section IX.B.7., Staff is awaiting additional information regarding these expenses. Should this additional information contain relocation items, Staff will make further adjustments to remove these items from its cost of service.

Staff Expert/Witness: Lisa M. Ferguson

16. Regulatory Expenses

The MoPSC Assessment is an amount billed to all regulated utilities operating under the jurisdiction of the Commission. The assessment is used to meet the Commission's operating costs for regulating those utilities. Staff's MoPSC Assessment adjustment represents the difference between MoPSC assessment expense recorded by Liberty Utilities' Missouri districts during the test year and the most recent MoPSC Assessment that was in effect for fiscal year 2014, for the period covering July 1, 2013 to June 30, 2014.

Staff Expert/Witness: Sarah Sharpe

17. Postage Expense

In January 2014, the United States Postal Service (USPS) implemented an increase in postage costs. Staff has annualized the postage costs and reflected the impact of the postage increase in its calculation. Staff's ongoing level of postage expense is consistent with the customer count it has reflected within its revenue calculation.

Staff Expert/Witness: Kofi A. Boateng

18. Rent and Lease Expense

During the test year, Liberty Utilities' Missouri operations incurred lease and rent expense on various buildings and pieces of equipment that it uses in the provision of utility service to its customers. In addition, an amount of allocated lease and rent expense from the Liberty Midstates Home Office was placed on the Liberty Utilities' Missouri books based on the Company's allocation factors. Staff reviewed Liberty Utilities' leases and rent expense during the test year ending September 30, 2013, and also through the update period ending March 31, 2014. As a result of this review Staff annualized this expense to an ongoing level.

As part of the annualization process Staff made adjustments to Liberty Utilities' expense levels in its cost of service calculation to remove any items with costs that are no longer ongoing. For example, the former leased Home Office space in Jackson, MO, was replaced by a building built and owned by Liberty Utilities. In addition, Staff made adjustments to account for any ongoing lease which began during or subsequent to the test year and consequently was not booked at an entire year's worth of cost during the test year. Staff also included an adjustment to reflect the current ongoing level of expense for vehicle leases. Overall, Staff's annualization adjustment increases lease and rent expense for these items to the annual ongoing level.

Staff Expert/Witness: Lisa K. Hanneken

19. Fleet Fuel Expense

Liberty Utilities and the Missouri operations own and lease several vehicles and pieces of machinery in order to perform utility business. There are vehicles such as Jeeps® and company cars for work-related travel, as well as trucks and heavy machinery such as backhoes for work performed in the field. Liberty Utilities incurs expenses for the fuel to run this machinery. Staff has included the test year level of fuel expense for direct filing purposes. However, Staff has requested additional information in order to determine whether an adjustment to annualize fuel expense is appropriate, and may propose to adjust this cost at a later stage in the proceeding.

Staff Expert/Witness: Lisa M. Ferguson

C. Depreciation and Amortization Expense

1. Background

In its Order Approving the Unanimous Stipulation and Agreement in Case No. GM-2012-0037, the Commission ordered Liberty Utilities to adopt the depreciation rates of Atmos.[39] In addition to adopting the depreciation rates, Liberty and Atmos agreed to other record keeping and reporting requirements in section II.A.10 of the Stipulation and Agreement:

[39] Atmos' then-current depreciation rates were ordered in Case No. GR-2006-0387.

10. Depreciation Related-Issues

a. For purposes of accruing depreciation expense, Liberty-Mid-States [*sic*] shall adopt the currently ordered depreciation rates for Atmos approved by the Commission in File No. GR-2006-0387 and attached as Schedule JAR-1 (Appendix 1);

b. Atmos shall transfer all plant and depreciation reserve records to Liberty-Midstates in compliance with the format set forth in Title 18: Conservation of Power and Water Resources, Part 201—Uniform System Of Accounts Prescribed For Natural Gas Companies Subject To The Provisions Of The Natural Gas Act (FERC USOA).

c. Liberty-Midstates shall prepare and maintain its books in accordance with the FERC Uniform System of Accounts (USOA).

d. Staff recognizes the Depreciation Study submitted by Atmos is sufficient for meeting the requirement of 4 CSR 240-3.275. The Signatories acknowledge that this study shall be deemed to meet Liberty-Midstates' requirement to perform a depreciation study within 5 years or 3 years prior to the next rate case.

e. The Signatories recommend the Commission order Atmos to record the entries determined in its Missouri depreciation study submitted on June 1, 2011, prior to the close of the Transaction.

f. Liberty-Midstates shall submit the following information in accordance with 4 CSR 240-3.275 Submission Requirements for Gas Utility Depreciation Studies.

1) FERC USOA requires the following information shall be recorded as part of a Continuing plant inventory record (CPR).

2) FERC USOA CPR Rule 8. *Continuing plant inventory record* means company plant records for retirement units and mass property that provide, as either a single record, or in separate records readily obtainable by references made in a single record, the following information:

A. For each retirement unit:

(1) The name or description of the unit, or both;

(2) The location of the unit;

(3) The date the unit was placed in service;

(4) The cost of the unit as set forth in Plant Instructions 2 and 3 of this part; and

(5) The plant control account to which the cost of the units is charged; and

B. For each category of mass property:

(1) A general description of the property and quantity;

(2) The quantity placed in service by vintage year;

(3) The average cost as set forth in Plant Instructions 2 and 3 of this part; and

(4) The plant control account to which the costs are charged.

2. Staff's Investigation

As part of this case, Staff reviewed the depreciation rates being used by Liberty Utilities. Through discovery, Staff became aware that the accounting and depreciation records transferred from Atmos to Liberty, as part of the sale, were consolidated into 3 divisions from the 7 that had depreciation rates ordered. This consolidation, without an existing order, is inconsistent with the accounting required to use the ordered depreciation rates. Since records do not exist to segregate the consolidated divisions back into the districts for which ordered depreciation rates exist, Staff recommends accepting the consolidation for depreciation purposes. Schedule JAR(DEP)-1 attached in Appendix 3 provides Staff's recommended depreciation rates for the Liberty divisions of WEMO[40], NEMO[41], and SEMO[42].[43] Staff has supplemented the depreciation schedule with corporate allocated plant depreciation rates. These rates reflect currently ordered depreciation rates for the general plant accounts of the Butler and Kirksville districts. Staff recommends that the Commission's Report and Order in this case officially order such depreciation rates for the three divisions and for the corporate allocated plant.

Staff Expert/Witness: John A. Robinett

[40] Formerly Butler and Rich Hill/Hume districts
[41] Formerly Kirksville, United Cities Gas and Palmyra districts
[42] Formerly Southeastern Missouri and Neelyville districts
[43] Staff's recommended depreciation rates for the WEMO, NEMO, and SEMO divisions are the currently-ordered rates for the Butler and Kirksville districts. Staff would also note that the SEMO division's currently-ordered depreciation rates are not significantly different from the Butler and Kirksville districts.

3. Capitalized Depreciation Expense

Liberty Utilities utilizes transportation and power-operated equipment to perform both maintenance and construction activities. Generally, a portion of the depreciation calculated on this equipment is capitalized and charged to the associated capital construction project, and is eventually placed in Plant In Service. However, Staff discovered during its analysis that Liberty Utilities does not make these calculations. Therefore, in order to account for this capitalized depreciation, Staff has calculated the amounts that should have been capitalized since Liberty Utilities' retained ownership of the assets in August 2012 to the end of the update period in March 2014. Staff then restated the Plant In Service and associated Accumulated Depreciation Reserve balances.

In addition, Staff has removed a portion of the annualized depreciation expense related to the transportation and power-operated equipment in order to reflect the portion of this expense that is to be capitalized.

Staff Expert/Witness: Sarah Sharpe

4. Miscellaneous Amortization Expense

During the review of Liberty Utilities' books and records, Staff discovered an amount listed as amortization expense on the books during the test year, 12-months ending September 30, 2013. However, after discussions with Liberty Utilities, it was determined that these amounts were amounts brought over from the Atmos books and were more appropriately recorded as depreciation expense. Staff has removed this amount of amortization expense from its cost of service calculations given that Staff has already annualized all ongoing levels of amortization expense and Staff's methodology to annualize depreciation expense will capture all appropriate levels of depreciation expense on a going forward basis.

Staff Expert/Witness: Lisa K. Hanneken

5. Energy Efficiency Amortization Expense

As discussed in Section VII.I. related to the energy efficiency rate base asset, Staff made an adjustment to include an amount of $8,652 in its expense calculation for the level of amortization expense associated with the asset.

Staff Expert/Witness: Lisa K. Hanneken

D. Taxes Other than Income

1. Property Taxes

For property assessment purposes, each utility company is required to file with its respective taxing authority a valuation of utility property at the beginning of each assessment year, which is January 1st. Several months later, based on information provided by the utility, the taxing authority will send the company "assessed values" for every category of the company's property. The taxing authority will issue the utility company a property tax rate later in the year. Ultimately, the taxing authority issues a property tax bill to the company late in each calendar year with a "due date" of December 31. The billed amount of property taxes is based on the property tax rate applied to the previously determined assessed values of the utility's plant-in-service balances as of January 1 of the same year. Staff developed its property tax amount based on the Company's actual taxes paid as of December 31, 2013, which are paid based on investment as of January 1, 2013. In addition, Staff has included a level of corporate allocated property tax in its annualized amount. However, Staff has not included a property tax amount for Liberty Utilities' new building. The building came into service as of March 2014. Therefore, while the building has been included in Staff's rate base calculations, it has yet to be assessed for real estate/property tax purposes and, consequently, Liberty Utilities will not receive a bill for a known and measurable property tax amount on this new building until the end of 2015.

Staff Expert/Witness: Lisa M. Ferguson

2. Corporate Franchise Tax

Based on Liberty Utilities' response to Staff's Data Request No. 148, Liberty Utilities was incorporated on May 10, 2011, but did not have taxable assets to report to the State of Missouri on its initial 2011 franchise tax return. Therefore, Liberty Utilities' tax liability was zero for 2011. In addition, since this base year tax liability was zero, the future tax liability was capped at zero for all tax years until the tax year ending December 31, 2015. Since Liberty Utilities' corporate franchise tax expense for the test year was already at zero, no adjustment was necessary.

Staff Expert/Witness: Sarah Sharpe

E. Current Income Tax Expense

Staff's calculation of income tax expense is determined by its calculation of net operating income. This calculated amount is adjusted to reflect the different treatment afforded various income and deduction items in determining taxable income on which income taxes are based. To calculate income taxes, Staff applied a consolidated federal and state income tax rate of 38.39% to the taxable income in Staff's cost of service.

Staff Expert/Witness: Lisa K. Hanneken

X. Ratepayer Funded Energy Efficiency and Low-Income Weatherization Programs

A. Energy Efficiency

Staff finds at this time Liberty Utilities has remained dedicated to following and enhancing the programs previously put in place by Atmos and recommend they continue with their current programs. They continue to focus on customer education, encouraging energy efficiency and conservation. Staff recommends Liberty Utilities continue with their Energy Conservation and Efficiency Programs and continue to receive, on annual basis, $150,000 included in base rates, with $105,000 (of the $150,000) for the Residential Low Income Weatherization Assistance Program.

Staff Expert/Witness: Kory Boustead

B. Low-Income Weatherization Assistance Program

Staff recommends Liberty Utilities continue with their involvement in the Low-Income Weatherization Assistance Program where they provide $105,000 to the Environmental Improvement and Energy Resources Authority ("EIERA") for distribution by the EIERA and the Missouri Department of Economic Development, Division of Energy, to the six community action agencies serving their customers. In addition Staff recommends Liberty Utilities change any reference to Atmos within the tariff to Liberty Utilities.

Liberty Utilities' current weatherization program and description are as follows:

Residential Low Income Weatherization Assistance Program

> This program is designed to provide energy education and weatherization assistance to low-income residential customers to assist

customers in reducing their energy consumption and thus reduce their natural gas utility bill. This program component of the Company's Energy Conservation and Efficiency Program shall receive, on annual basis, $105,000 of the $150,000 included in base rates, for assistance to eligible low-income customers of Atmos who use natural gas for space heating. Additional annual funding may be designated for this program in accordance with decisions by the Energy Efficiency Advisory Group.

Staff Expert/Witness: Kory Boustead

XI. Appendices

Appendix 1: Staff Credentials

Appendix 2: Support for Staff Cost of Capital Recommendation – Zephania Marevangepo

Appendix 3: John A. Robinett - Depreciation Rates

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of Liberty Utilities (Midstates Natural Gas) Corp. d/b/a Liberty Utilities' Tariff Revisions Designed To Implement a General Rate Increase for Natural Gas Service in the Missouri Service Areas of the Company	)))))	Case No. GR-2014-0152

AFFIDAVIT OF KOFI A. BOATENG

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Kofi A. Boateng, of lawful age, on his oath states: that he has participated in the preparation of the foregoing Staff Report as identified in the individual sections as identified in the Table of Contents of said Report; that he has knowledge of the matters set forth in such Report; and that such matters are true to the best of his knowledge and belief.

Kofi A. Boateng

Subscribed and sworn to before me this 6th day of June, 2014.

D. SUZIE MANKIN
Notary Public - Notary Seal
State of Missouri
Commissioned for Cole County
My Commission Expires: December 12, 2016
Commission Number: 12412070

D Suzie Mankin
Notary Public

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of Liberty Utilities (Midstates Natural Gas) Corp. d/b/a Liberty Utilities' Tariff Revisions Designed To Implement a General Rate Increase for Natural Gas Service in the Missouri Service Areas of the Company	)))))	Case No. GR-2014-0152

AFFIDAVIT OF KORY BOUSTEAD

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Kory Boustead, of lawful age, on her oath states: that she has participated in the preparation of the foregoing Staff Report as identified in the individual sections as identified in the Table of Contents of said Report; that she has knowledge of the matters set forth in such Report; and that such matters are true to the best of her knowledge and belief.

Kory Boustead

Kory Boustead

Subscribed and sworn to before me this 6th day of June, 2014.

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Notary Public - Notary Seal
State of Missouri
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D Suzie Mankin

Notary Public

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AFFIDAVIT OF KIM COX

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Kim Cox, of lawful age, on her oath states: that she has participated in the preparation of the foregoing Staff Report as identified in the individual sections as identified in the Table of Contents of said Report; that she has knowledge of the matters set forth in such Report; and that such matters are true to the best of her knowledge and belief.

Kim Cox

Kim Cox

Subscribed and sworn to before me this 6th day of June, 2014.

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AFFIDAVIT OF LISA M. FERGUSON

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Lisa M. Ferguson, of lawful age, on her oath states: that she has participated in the preparation of the foregoing Staff Report as identified in the individual sections as identified in the Table of Contents of said Report; that she has knowledge of the matters set forth in such Report; and that such matters are true to the best of her knowledge and belief.

Lisa M. Ferguson

Lisa M. Ferguson

Subscribed and sworn to before me this 6th day of June, 2014.

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AFFIDAVIT OF LISA K. HANNEKEN

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Lisa K. Hanneken, of lawful age, on her oath states: that she has participated in the preparation of the foregoing Staff Report as identified in the individual sections as identified in the Table of Contents of said Report; that she has knowledge of the matters set forth in such Report; and that such matters are true to the best of her knowledge and belief.

Lisa K Hanneken

Lisa K. Hanneken

Subscribed and sworn to before me this 6th day of June, 2014.

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AFFIDAVIT OF ZEHPANIA MAREVANGEPO

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Zephania Marevangepo, of lawful age, on his oath states: that he has participated in the preparation of the foregoing Staff Report as identified in the individual sections as identified in the Table of Contents of said Report; that he has knowledge of the matters set forth in such Report; and that such matters are true to the best of his knowledge and belief.

ZM

Zephania Marevangepo

Subscribed and sworn to before me this 6th day of June, 2014.

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AFFIDAVIT OF JOEL MCNUTT

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Joel McNutt, of lawful age, on his oath states: that he has participated in the preparation of the foregoing Staff Report as identified in the individual sections as identified in the Table of Contents of said Report; that he has knowledge of the matters set forth in such Report; and that such matters are true to the best of his knowledge and belief.

Joel McNutt

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AFFIDAVIT OF JOHN A. ROBINETT

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

John A. Robinett, of lawful age, on his oath states: that he has participated in the preparation of the foregoing Staff Report as identified in the individual sections as identified in the Table of Contents of said Report; that he has knowledge of the matters set forth in such Report; and that such matters are true to the best of his knowledge and belief.

John A. Robinett

John A. Robinett

Subscribed and sworn to before me this 6th day of June, 2014.

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D Suzie Mankin

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AFFIDAVIT OF SARAH B. SHARPE

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Sarah B. Sharpe, of lawful age, on her oath states: that she has participated in the preparation of the foregoing Staff Report as identified in the individual sections as identified in the Table of Contents of said Report; that she has knowledge of the matters set forth in such Report; and that such matters are true to the best of her knowledge and belief.

Sarah B. Sharpe
Sarah B. Sharpe

Subscribed and sworn to before me this 6th day of June, 2014.

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AFFIDAVIT OF DAVID SOMMERER

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

David Sommerer, of lawful age, on his oath states: that he has participated in the preparation of the foregoing Staff Report as identified in the individual sections as identified in the Table of Contents of said Report; that he has knowledge of the matters set forth in such Report; and that such matters are true to the best of his knowledge and belief.

David Sommerer

Subscribed and sworn to before me this 6th day of June, 2014.

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Notary Public