Exhibit No.:
Issue: Various Cost of Service Issues
Witness: James Fallert
Type of Exhibit: Rebuttal Testimony
Sponsoring Party: Liberty Utilities (Midstates Natural Gas) Corp. d/b/a Liberty Utilities
Case No.: GR-2014-0152
Date Testimony Prepared: July 30, 2014

**MISSOURI PUBLIC SERVICE COMMISSION**

**CASE NO.: GR-2014-0152**

# REBUTTAL TESTIMONY

**OF**

**JAMES FALLERT**

**ON BEHALF OF**

**LIBERTY UTILITIES (MIDSTATES NATURAL GAS) CORP.**
**D/B/A LIBERTY UTILITIES**

**July 30, 2014**

*** Denotes Proprietary Information ***



**NP**

**REBUTTAL TESTIMONY**
**OF**
**JAMES FALLERT**

**CASE NO. GR-2014-0152**

**TABLE OF CONTENTS**

**REBUTTAL TESTIMONY**

**OF**

**JAMES FALLERT**

**CASE NO. GR-2014-0152**

## I. POSITION AND QUALIFICATIONS

**Q. PLEASE STATE YOUR NAME, BUSINESS AFFILIATION AND BUSINESS ADDRESS.**

A. My name is James Fallert. I am doing business as James Fallert Consultant LLC and my business address is 3507 Burgundy Way Dr., St. Louis, MO 63129.

**Q. ON WHOSE BEHALF IS YOUR TESTIMONY PRESENTED?**

A. Liberty Utilities (Midstates Natural Gas) Corp. d/b/a Liberty Utilities ("Company" or "Liberty Utilities").

**Q. ARE YOU THE SAME JAMES FALLERT WHO SUBMITTED DIRECT TESTIMONY ON BEHALF OF LIBERTY UTILITIES IN THIS CASE ON FEBRUARY 6, 2014?**

A. Yes.

## II. PURPOSE OF TESTIMONY

**Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY IN THIS CASE?**

A. The purpose of my testimony is to address the direct testimony of various Staff witnesses regarding the issues listed below. I would note that no other parties filed direct testimony regarding these issues.

- Pensions and OPEBs
- Uncollectible Accounts
- Cash Working Capital
- Depreciation Rates
- Depreciation Capitalized
- 401K Expense
- Interest on Customer Deposits
- Direct Labor Expense
- Other Items

**Q. ARE YOU SPONSORING ANY SCHEDULES IN CONNECTION WITH YOUR TESTIMONY?**

A. Yes. I am sponsoring **Schedules JF-R1 and JF-R2** attached to this testimony.

## PENSIONS AND OPEBs

**Q. WHAT AMOUNTS DID LIBERTY INCLUDE IN COST OF SERVICE FOR PENSIONS AND OPEBS IN ITS DIRECT FILING?**

A. The Company calculated an overall level of benefits as a percent of payroll, and applied this percentage to the normalized payroll levels in this case. The resulting normalized

O&M expense as it related to pensions and OPEBs was $138,389 and $422,303, respectively.

**Q. WHAT DO THESE AMOUNTS REPRESENT?**

A. These are the actual amounts for pension and OPEB expense recorded in the test year, with an adjustment for additional costs associated with higher payroll levels included in normalized expense.

**Q. WHAT WAS STAFF'S RECOMMENDATION?**

A. Staff recommended * * in cost of service for these items. Staff based this recommendation on the fact that Liberty * *.

**Q. IS THIS AN APPROPRIATE METHOD FOR SETTING RATES IN THIS CASE?**

A. No. Staff's recommendation is not representative of these plans' costs going forward on either a funding basis or financial reporting basis.

**Q. PLEASE ELABORATE.**

A. Following are the estimated future minimum funding requirements calculated by the Company's actuary in its most recent reports dated January 2014 (and adjusted to include only the portion applicable to Missouri):

| Year | Pension | OPEB |
|---|---|---|
| 2014 | * | * |
| 2015 | * | * |
| 2016 | * | * |
| 2017 | * | * |
| 2018 | * | * |

It is apparent that basing rates on a single year's funding levels is problematic in an environment where changes of the magnitude of those above occur. Rates set at * * today would likely result in the necessity for significant increases in the future, and would not recognize that employees are working and earning these benefits now.

**Q. PLEASE EXPLAIN.**

A. Funding levels at this point in time are not representative of the annual costs being incurred for these plans. The available funding amounts for pensions in 2013 range from * *. While the minimums are currently * *, our actuaries anticipate a significant increase in 2016. OPEB liabilities are not required to be funded until paid, so they are low at this point since we don't yet have many retirees in the plans. Employees are earning benefits under these plans as they work, but Staff's proposed recovery based on * * fails to provide for these costs in current rates. This means that these current costs would be borne in future rates.

**Q. WHAT DO YOU SUGGEST AS AN ALTERNATIVE?**

A. We recommend that rates be set on the basis of expense as determined by our actuaries for financial reporting purposes. These amounts are $153,977 for pensions and $491,286 for OPEBs (these are the amounts allocated to Missouri).

**Q. WHY IS THIS BASIS PREFERABLE TO STAFF'S PROPOSAL TO BASE COST OF SERVICE ON 2013 FUNDING LEVELS?**

A. The 2013 funding level is not representative of ongoing expected levels, and does not represent the true cost of providing these benefits. The financial reporting calculations obviate these problems.

**Q. BUT IF RATES ARE BASED ON THESE FINANCIAL REPORTING LEVELS, WON'T THE COMPANY'S CUSTOMERS BE PROVIDING MORE CASH IN RATES THAN THE COMPANY IS CONTRIBUTING TO ITS PLANS?**

A. That is a concern in the initial years, which is why Liberty is willing to commit to contributing the financial reporting amounts in the future in the event that such amounts are allowed in rates. In the case of the OPEBs, this would be done pursuant to Missouri Statute (Section 386.315.2, RSMo).

**Q. DO YOU HAVE ANY ADDITIONAL PROPOSALS?**

A. Yes. Our goal in proposing the use of financial reporting amounts for both expense and funding purposes is to provide a basis for stability and appropriate rate recovery of pension and OPEB costs. We believe that these goals would be greatly enhanced with the implementation of a pension and OPEB tracking mechanism similar to that currently in place for numerous other Missouri utilities. Attached as **Schedule JF-R1** is a proposed tracking mechanism modeled after others currently utilized in Missouri.

**Q. DO YOU HAVE ANY ADDITIONAL COMMENTS?**

A. Yes. Our goal is to not only provide for appropriate rate recovery for our pension and OPEB plans in this case, but to also establish a methodology that will provide the opportunity for stability in funding, expense, and ratemaking well into the future. We believe that the proposed combination of establishing rates based on financial reporting calculations of our actuary, funding these amounts, and establishing a pension/OPEB tracking mechanism as proposed herein provide the best available method to accomplish these goals.

## UNCOLLECTIBLE ACCOUNTS

**Q. PLEASE DESCRIBE THE ADJUSTMENTS TO UNCOLLECTIBLE ACCOUNTS EXPENSE MADE IN THIS CASE.**

A. Both the Company's and Staff's adjustments based the amount of uncollectible accounts expense included in cost of service on the amount allowed in the prior 2010 Atmos rate case.

**Q. ARE THERE ANY DIFFERENCES BETWEEN STAFF'S CALCULATION OF UNCOLLECTIBLE EXPENSE AND LIBERTY'S?**

A. Yes. We have also included an adjustment to include the impact of the additional revenue requirement requested in this case on write-offs. This adjustment was calculated by first determining a percent of revenues written-off by comparing the normalized write-offs (prior to this adjustment) to revenues. The resulting percentage of 0.98% was then multiplied by the revenue requirement request. Staff did not include this adjustment. We believe that there is a clear relationship of uncollectible accounts to revenues, and therefore that it is appropriate for the commission to increase any revenue requirement increase granted in this case by 0.98% to account for the impact of the increase on uncollectibles. The Company will incur this expense with implementation of rates from this case and so it should be reflected as part of the cost of service.

## CASH WORKING CAPITAL

**Q. PLEASE DESCRIBE YOUR CALCULATION OF CASH WORKING CAPITAL IN THIS CASE.**

A. Liberty's billing and collection practices have been evolving since purchase of the properties in August 2012. Additionally, the test period in this case was billed under two different billing systems since billing was handled by Atmos until March 1, 2013. Under the circumstances, we were concerned that performing the full lead/lag study normally employed in Missouri for determining cash working capital would not provide results that could reasonably be expected to be indicative of normal operations going forward. Staff evidently agreed, since they did not perform a lead/lag study either.

**Q. HOW DID LIBERTY ADDRESS THIS ISSUE IN ITS DIRECT FILING?**

A. We considered adopting the leads and lags determined in the 2010 Atmos case since this is the most recently available data for this service area. However, this data is very unrepresentative of the current situation given differences in billing and collection practices, change-over in systems from Atmos to Liberty, and the passage of time.

**Q. HOW THEN DID YOU ADDRESS THIS ISSUE?**

A. We took a two pronged approach. First, we looked to other jurisdictions for simpler methods that might provide an indication of a reasonable one-time approach for this case.

Second, we looked for a means to verify the reasonableness of the resulting answer using a simplified update of collection lags currently being experienced.

**Q. PLEASE CONTINUE.**

A. First, we found that some jurisdictions use a "1/8 rule" as a proxy to simplify the calculation of a cash working capital adjustment. The "1/8 rule" multiplies the operating expenses (excluding gas costs, depreciation, and taxes) in a case by 1/8 to produce an estimated cash working capital adjustment. The 1/8 multiplier is based on observations that detailed cash working capital studies frequently produce results consistent with its results. The "1/8 rule" resulted in cash working capital of $1,250,226 in our direct filing. Second, we reviewed the results of the previous study used in Atmos' 2010 rate case, and performed a simplified comparison of revenues and accounts receivable balances during the test year in the previous case to this current case. This analysis indicated that collection lags appear to have increased markedly, providing directional support for an increase from 2010. In fact, this analysis indicated that adjusting the collection lags in the 2010 case to these longer levels would have resulted in cash working capital of about $1.6 million.

**Q. WHAT WAS STAFF'S APPROACH TO THIS ISSUE?**

A. Staff simply applied the leads and lags determined in 2010 to the current case, and thus arrived at a result very similar to that case.

**Q. WHY IS STAFF'S APPROACH INAPPROPRIATE?**

A. As discussed earlier, Staff's approach makes no accommodation for the many changes in circumstances that have occurred since the last detailed lead/lag study was performed in the 2010 Atmos case.

**Q. ARE YOU ADVOCATING THAT THE COMMISSION ADOPT THE 1/8 METHOD GOING FORWARD?**

A. No, not at all. We are only advocating its use in this single case due to the unusual circumstances. We recognize the value of a full lead/lag study and plan to perform one for our next case. We also recognize that these unusual circumstances have made it difficult for the Staff and Commission to determine an appropriate approach for this case. Under the circumstances for this issue only we believe that it would be reasonable for the Commission to "split the difference" between Staff's and the Company's positions. This would result in cash working capital of $343,820 in this case (the midpoint between Liberty's level of $1,250,226 and Staff's of negative $562,585). .

## <u>DEPRECIATION RATES</u>

**Q. WHAT IS THE ISSUE IN REGARD TO NORMALIZED DEPRECIATION EXPENSE?**

A. Liberty is in agreement with Staff's proposed depreciation rates, with the exception of rates for corporate hardware and software. This is hardware and software that is used at the Company's corporate office in Jackson, Missouri and allocated to its divisions in Iowa, Illinois and Missouri jurisdictions.

**Q. WHAT RATES IS LIBERTY CURRENTLY USING FOR THESE ITEMS?**

A. These items are being depreciated at a rate of 14.29%, or about 7 years.

**Q. WHAT IS THE SOURCE OF THAT 14.29% RATE?**

A. This rate was adopted consistent with rates used by Atmos although we have been unable to identify an ordered rate for corporate hardware and software. Nevertheless, it is the rate that we believe is consistent with the requirement in the acquisition case that Liberty continue Atmos' then-current depreciation rates. We discovered in the course of this current rate case that while Atmos used the 14.29% rate for its system and network hardware and software, the rate for personal computer hardware and software was actually 18.98%.

**Q. PLEASE EXPLAIN.**

A. The rates of 14.29% for General Office server and network hardware and software and 18.98% for PC hardware and software appear to comport with the Staff's accounting schedules from the 2010 Atmos rate case, providing us reasonable assurance that the aforementioned depreciation rates would keep us in compliance.

**Q. WHAT RATES IS LIBERTY RECOMMENDING IN THIS CASE?**

A. The Company recommends continuation of the 14.29% rate (7 years) for system hardware and software and implementation of the rate of 18.98% (5.3 years) for PC hardware and software. These rates are consistent with rates used by Atmos and provide a realistic useful life for these systems. We believe that it would be reasonable to continue these historical rates inherited from Atmos in this case, but plan on performing a depreciation study of these accounts for our next case, at which time we would support any adjustment to the rates indicated by the study.

**Q. WHAT RATE HAS STAFF RECOMMENDED FOR THESE ITEMS?**

A. Staff applied a rate of 4.75% (21 years) to corporate hardware and software.

**Q. PLEASE COMMENT ON THIS PROPOSED RATE.**

A. In my opinion, 21 years is an unrealistically long life to apply to computer equipment and systems. This would imply that systems and equipment purchased today would, on average, still be in service in the year 2035. In the fast changing world of information systems, this assumption strains credulity.

## DEPRECIATION CAPITALIZATION

**Q. WHAT IS DEPRECIATION CAPITALIZATION?**

A. Depreciation capitalization provides for depreciation expense associated with certain power operated equipment accounts to be transferred to capital accounts, on the theory that this equipment is used in building capital assets and therefore the depreciation associated with its use for this purpose should be capitalized as part of the value of the asset.

**Q. HAS LIBERTY ADOPTED DEPRECIATION CAPITALIZATION ACCOUNTING?**

A. To this point the Company has not implemented this accounting refinement.

**Q. WHAT DID STAFF PROPOSE IN THIS CASE?**

A. Staff recalculated plant balances as if this method had been in effect since the Company's inception in Missouri on August 1, 2012, and made corresponding adjustments in its direct case.

**Q. WHAT IS YOUR RESPONSE?**

A. The Company agrees to adopt depreciation capitalization accounting, with the caveat that the Order in this case should specify that such accounting is to be implemented retroactive to August 1, 2012 with corresponding adjustment of plant balances and depreciation expense. This will insure that all plant added since the Company's inception is accounted for in a consistent manner and that the Company's books match the balances used to determine revenue requirement in this case. **Schedule JF-R2** attached to this testimony provides suggested ordered language to accomplish this objective.

## 401K PLAN

**Q. PLEASE DESCRIBE THE COMPANY'S 401K PLAN.**

A. This plan allows employees to defer a portion of their wages into a tax-deferred retirement plan. The Company matches the employee contributions up to a limit of * * of pay.

**Q. DID LIBERTY INCLUDE AN ADJUSTMENT TO COST OF SERVICE IN THIS CASE FOR THE 401K PLAN?**

A. Yes. Since the 401K match is a percent of payroll, an adjustment should be made to account for the impact of payroll increases on the matching 401K expense. The

Company included this effect as part an adjustment for overall benefits as mentioned earlier in this testimony.

**Q. DID STAFF INCLUDE SUCH AN ADJUSTMENT?**

A. No.

**Q. WHAT DO YOU RECOMMEND AS A REMEDY?**

A. There should be two adjustments to Staff's case. First, any increased payroll included in cost of service should be increased by * * to account for the impact of that increase on the 401K match. Second, Staff's calculation of normalized payroll indicated that 57% of normalized payroll is applicable to operations and maintenance, as opposed to 52% during the test year. Test year 401K expense should be further adjusted to include the effect of this change.

**Q. PLEASE EXPLAIN WHY YOU RECOMMENDED A * * MATCHING PERCENT FOR 401K EXPENSE.**

A. The * * match is available to eligible individuals who choose to participate in the plan. We looked at actual activity for all employees during a twelve month period in order to account for employees who are ineligible, choose not to participate, or contribute less than a full * *. This resulted in the * * actual matching rate recommended above.

## INTEREST ON CUSTOMER DEPOSITS

**Q. HOW DID STAFF PROPOSE TREATING THE COMPANY'S INTEREST ON CUSTOMER DEPOSITS IN ITS DIRECT TESTIMONY?**

A. Staff made an adjustment to the level of expense expected to be incurred by the Company.

**Q. DOES THE COMPANY TAKE ISSUE WITH THE ADJUSTMENT MADE BY STAFF?**

A. Not the normalized level itself, rather the base test year level. Essentially the original test year amount of expense incurred, $47,032, was left out of the cost of service itself. The Company does not believe this was an intentional omission but rather simply an oversight since the Company records this expense below-the-line.

## DIRECT LABOR EXPENSE

**Q. HOW DID STAFF PROPOSE TREATING THE COMPANY'S LABOR EXPENSE IN ITS ANALYSIS?**

A. Staff performed a detailed analysis of the Company's employees to arrive at an appropriate level of normalized and test year expense for the Company.

**Q. DID THE COMPANY HAVE ANY ISSUE WITH HOW STAFF PERFORMED ITS ANALYSIS OF THE WAGE ANNUALIZATION?**

A. Similar to interest on customer deposits, the Company did not have an issue with the level of expense the Staff calculated on a going forward basis but rather how the annualization is calculated.

**Q. WHAT DO YOU MEAN?**

A. Typically after a level of normalized expense is calculated, that expense level is compared to what was incurred in the test year and the difference is the adjustment. In this case, Staff compared normalized payroll calculated in detail by employee to test year labor amounts included in operation & maintenance accounts. However, we found that some of the accounts labelled "labor" defined labor more broadly than the employee payroll included in this adjustment. For example, labor for outside contractors is included in the accounts but would not be an item subject to an adjustment of Liberty employee payroll.

**Q. WHAT WAS THE IMPACT OF THIS DIFFERENCE?**

A. Since normalized payroll for Liberty employees was compared to test year labor amounts including other non-payroll items, the adjustment was understated. We don't believe that this was in any way intentional but occurred because of confusion over the labelling of the accounts. An adjustment with test year and normalized payroll on a consistent basis would be appropriate.

## OTHER ITEMS

**Q. PLEASE EXPLAIN THE ISSUE WITH OTHER ITEMS.**

A. There are various minor issues with which we have differences with Staff over the manner in which the adjustment was computed. I mention them here because we have not yet reached a final understanding with Staff regarding the proper computations and would reserve the right to continue the issue if necessary. However, we believe that we should be able to resolve these issues, and therefore will not describe each one in detail.

**Q. WHAT ARE THESE ISSUES?**

A. These issues include, without limitation, dues & donations, ESPP O&M expense, transition costs, pipeline rebranding costs, and cost of debt.

**Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY IN THIS PROCEEDING?**

A. Yes.

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

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

**AFFIDAVIT OF JAMES FALLERT**

**STATE OF MISSOURI** )
) ss
**COUNTY OF ST. LOUIS** )

James Fallert, being first duly sworn on his oath, states:

1. My name is James Fallert. I am doing business as James Fallert Consultant LLC and my business address is 3507 Burgundy Way Dr., St. Louis, Missouri 63129.

2. Attached hereto and made a part hereof for all purposes is my Rebuttal Testimony on behalf of Liberty Utilities (Midstates Natural Gas) Corp. d/b/a Liberty Utilities consisting of sixteen (16) pages and Schedules JF-R1 and JF-R2, all of which having been prepared in written form for introduction into evidence in the above-captioned docket.

3. I have knowledge of the matters set forth therein. I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded, including any attachments thereto, are true and accurate to the best of my knowledge, information and belief.

Jim Fallert

James Fallert

Subscribed and sworn before me this 30th day of July, 2014.

Brenda K Luebbers

Notary Public

My commission expires: 06-15-15

NOTARY PUBLIC STATE OF MISSOURI NOTARY SEAL

BRENDA K. LUEBBERS
My Commission Expires
June 15, 2015
St. Louis County
Commission #11421805

**Pensions and OPEBS Tracker Language**

1. Beginning with the effective date of rates in this case, Liberty shall be authorized to record as a regulatory asset/liability, as appropriate, the difference between the pension expense used in setting rates ($153,977; amount stated prior to application of transfers to construction) and the pension expense as recorded for financial reporting purposes as determined in accordance with Generally Accepted Accounting Principles pursuant to Accounting Standards Codification (ASC) 715 (previously FAS 87 and FAS 88, or such standard as the FASB may issue to supercede, amend, or interpret the existing standards), and such difference shall be recovered from or returned to customers in future rates. The difference between the amount of pension expense included in Liberty's rates and the amount funded by Liberty shall be included in the Company's rate base in future proceedings.

2. Liberty commits to contributing amounts to the pension fund equal to expense recorded for financial reporting purposes, subject to the following conditions:
    a. Such funding shall not be less than the ERISA minimum, nor more than the ERISA maximum.
    b. In the event that the contribution amount determined pursuant to the above is insufficient to avoid the benefit restrictions specified for at-risk plans pursuant to the Pension Protection Act of 2006, such contribution may be increased to a level sufficient to avoid such restrictions.
    c. In the event that the contribution amount determined pursuant to the above is insufficient to avoid any Pension Benefit Guaranty Corporation (PBGC) variable premiums, such contribution may be increased to a level sufficient to avoid such premiums.

    Additional contributions made subject to these conditions shall will receive regulatory treatment as provided in paragraph 1.

3. Beginning with the effective date of rates in this case, Liberty shall be authorized to record as a regulatory asset/liability, as appropriate, the difference between the Other Post-Employment Benefits (OPEBs) expense used in setting rates ($491,286; amount stated prior to application of transfers to construction) and the OPEB expense as recorded for financial reporting purposes as determined in accordance with Generally Accepted Accounting Principles pursuant to Accounting Standards Codification (ASC) 715 (previously FAS 106, or such standard as the FASB may issue to supercede, amend, or interpret the existing standards), and such difference shall be recovered from or returned to customers in future rates. The difference between the amount of OPEB expense included in Liberty's rates and the amount funded by Liberty shall be included in the Company's rate base in future proceedings.

4. Liberty commits to contributing amounts to its independent external funding mechanisms equal to OPEB expense recorded for financial reporting purposes, subject to the following condition:

a. Such funding shall not exceed the maximum amount deductible for tax purposes.

Any reduction in contribution amount resulting from this condition shall receive regulatory treatment as provided in paragraph 3.

5. The provisions of ASC 715 (previously FAS 158) require certain adjustments to the prepaid pension asset/OPEB asset and/or accrued liability with a corresponding adjustment to equity (i.e., decreases/increases to Other Comprehensive Income). The Company will be allowed to maintain a regulatory asset/liability to offset any adjustments that would otherwise be recorded to equity caused by applying the provisions of ASC 715 or any other FASB statement or procedure that requires accounting adjustments to equity due to funded status or other attributes of the pension or OPEB plans. The parties acknowledge that the adjustments described in this paragraph shall not increase or decrease rate base.

**Depreciation Capitalized Language**

1. Liberty agrees to adopt the depreciation capitalization method described in Paragraph 9.C.3. of Staff's Direct Report (page 74), retroactive to August 1, 2012. On the effective date of rates in this case, the Company's plant and depreciation reserve balances shall be adjusted as if such method had been in place beginning August 1, 2012 with offsetting entries to depreciation expense.