BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Laclede Gas Company's Request to Increase Its Revenue for Gas Service	)))	**File No. GR-2017-0215**
In the Matter of Laclede Gas Company d/b/a Missouri Gas Energy's Request to Increase Its Revenues for Gas Service	)))	**File No. GR-2017-0216**

POSTHEARING REPLY BRIEF

OF

MIDWEST ENERGY CONSUMERS GROUP

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January 17, 2018

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COME NOW the Midwest Energy Consumers' Group ("MECG") by and through the undersigned counsel, pursuant to the Commission's May 24, 2017 *Order Adopting Procedural Schedule and Delegating Authority*, and provides its post-hearing reply brief. In this brief, MECG will brief the following issues: (1) Return on Common Equity; (2) Capital Structure; and (3) Revenue Stabilization Mechanism.

I. RETURN ON COMMON EQUITY

● Responds to Laclede / MGE Initial Brief (pages 20-32).

In its Initial Brief, MECG asserted that the Commission should authorize a return on equity of 9.2% (range of 8.9% to 9.4%) as recommended by MIEC / OPC witness Gorman. This range was based upon generally accepted methodologies including the DCF, risk premium and CAPM models. Furthermore, MECG documented the numerous Missouri decisions in which the Commission expressly relied upon the "balanced analysis" provided by Mr. Gorman. [1]

In addition, MECG thoroughly discussed the numerous problems inherent in Laclede / MGE's witness Ahern's analysis. In particular, MECG pointed out that Ms. Ahern did not utilize standardized return on equity methodologies.[2] For instance, instead of a traditional CAPM analysis, Ms. Ahern employed the novel ECAPM methodology.[3] Similarly, instead of a traditional risk premium methodology, Ms. Ahern relied upon the untested predictive risk premium model as well as the prospective utility risk premium model.[4] Furthermore, Ms. Ahern then applied her methodologies to a non-regulated group of companies that have not been shown to be comparable to Spire.[5] Finally, Ms. Ahern proposed to inflate her return on equity recommendation to account for Laclede / MGE's alleged "small size" as well as for the issuance of flotation costs.[6]

As a result of Ms. Ahern's unaccepted methodologies, her return on equity methodology has been routinely disregarded by state utility commissions. As MECG

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[1] MECG Initial Brief, pages 10-12.
[2] Noticeably, the one standardized methodology that Ms. Ahern did employ (the discounted cash flow methodology) was subsequently dismissed by Ms. Ahern because it resulted in a return on equity of 8.68%. (MECG Initial Brief, pages 19-20).
[3] *Id.* at pages 15-16.
[4] *Id.* at pages 16-18.
[5] *Id.* at page 18.
[6] *Id.* at pages 21-25.

demonstrated, state utility commission decisions have averaged 111 basis points below Ms. Ahern's recommendation.[7] Therefore, if the same factor is applied in this case, Ms. Ahern's recommendation is reduced from 10.35% to 9.24% - virtually identical to the 9.2% and 9.25% recommended by Mr. Gorman and Staff respectively.

Given the thoroughness of its Initial Brief, MECG has already anticipated many of the arguments and assertions made by Laclede / MGE in its Initial Brief. Instead of completely repeating those arguments, MECG will instead summarize its arguments and provide citations to the MECG Initial Brief. Ultimately, based upon these arguments, the Commission should realize that Laclede / MGE's 10.35% return on equity recommendation is simply designed to avoid the rate reduction that Laclede / MGE customers deserve.

A. MS. AHERN'S METHODOLOGIES ARE NOT "WELL-RECOGNIZED"

At page 24 of its Initial Brief, Laclede / MGE wrongly claim that "Ms. Ahern conducted several standard analyses – applied several well-recognized cost of common equity models (i.e., the Discounted Cash Flow ("DCF"), the Risk Premium Model ("RPM") and the Capital Asset Pricing Model ("CAPM")." The record clearly indicates that this is false. In actuality, as detailed at pages 15-16 of the MECG Initial Brief, while Ms. Ahern employed the "traditional" CAPM methodology which resulted in a return on equity of 8.81%,[8] she then employed a non-traditional CAPM methodology (the Empirical CAPM ("ECAPM")), designed to inflate her return on equity recommendation. Specifically, rather than use the individual proxy company's beta coefficient, Ms. Ahern employs a weighting methodology which inflates the beta coefficient to 0.77. This is

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[7] *Id.* at page 14.
[8] Exhibit 38, Ahern Direct, Schedule PMA-D5 (page 1 of 2).

noticeably higher than the overall utility beta of 0.69[9] and inflates the return on equity from 8.81% to 9.40%.[10] Certainly, from the Commission's own experience considering return on equity methodologies, there is nothing "well-recognized" about Ms. Ahern's ECAPM methodology.

Noticeably, while touting Ms. Ahern's "well-recognized" methodology, Laclede / MGE did not provide, and a review of Lexis did not reveal, a single instance in which a state utility commission has adopted the faulty ECAPM methodology. In fact, Ms. Ahern's ECAPM methodology has been repeatedly rejected by state utility commissions. For instance, the Indiana Commission found that "the Empirical CAPM is not sufficiently reliable for ratemaking purposes."[11] Additionally, the Illinois Commission held that "the Commission continues to be of the opinion that the use of adjusted betas in the ECAPM is improper and leads to unreliable results."[12] Perhaps, the California Commission provided the best rationale for disregarding the ECAPM methodology.

> We are not persuaded that ECAPM produces a result that should be considered. Electric utilities in general have low betas. Adjusting betas upward guarantees a higher ROE. As Edison's witness says "Investor return requirements are largely a function of long-term expectations and perceptions of long-term risks." ***If betas make sense, then to claim that low-beta stocks tend to have higher risk premia contradicts the efficient market theory***. What is certain is that in every example offered by PG&E's expert the ECAPM results produced higher overall cost of capital estimates than the CAPM results.[13]

Similarly, rather than employ the "well-recognized" version of the risk premium approach, Ms. Ahern utilized: (1) the Predictive Risk Premium Model ("PRPM") and (2)

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[9] Exhibit 414, Gorman Rebuttal, page 30.
[10] Exhibit 38, Ahern Direct, Schedule PMA-D4 (page 1 of 2).
[11] *PSI Energy*, 173 PUR4th 393, Indiana Utility Regulatory Commission (September 27, 1996).
[12] *Consumers Illinois Water Company*, Illinois Commerce Commission, Docket No. 03-0403 (April 13, 2004).
[13] *San Diego Gas & Electric Company*, 196 PUR4th 438, California Public Utilities Commission (June 10, 1999).

the prospective utility risk premium approach.[14] As detailed at pages 16-18 of MECG's Initial Brief, neither approach is "well-recognized" and contain significant flaws simply designed to inflate the return on equity. As with her ECAPM approach, Lexis does not reveal a single instance in which either of Ms. Ahern's novel risk premium methodologies has been adopted by state utility commissions.

Finally, Ms. Ahern takes her flawed approaches and applies them to a Non-Price Regulated Proxy Group that includes competitive companies like AutoZone; Dr. Pepper Snapple; Eli Lilly; Target; and Smuckers. [15]. This results in a return on equity recommendation of 10.45%. As reflected at page 18 of MECG's Initial Brief, there is no real attempt to show that the non-regulated proxy group is "risk comparable" to Laclede and MGE.[16] As such, Ms. Ahern's Non-Price Regulated Proxy Group approach should be disregarded.

In addition to the traditional CAPM methodology that results in a return on equity of 8.81%, the only other "well-recognized" approach utilized by Ms. Ahern is the traditional DCF methodology. This methodology results in a return on equity of 8.68%.[17] Ms. Ahern disregards this "well-recognized" approach on the misplaced assertion that there has been a "dramatic rise in interest rates in response to Federal Reserve comments."[18] As Mr. Gorman demonstrates, however, while the Federal Funds rate has increased, utility capital costs in the form of utility bond yields have actually declined.[19] As such, Ms. Ahern's basis for disregarding the DCF is misplaced.

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[14] Exhibit 38, Ahern Direct, pages 26-36.
[15] *Id.* at page 44.
[16] Exhibit 414, Gorman Rebuttal, page 32.
[17] Exhibit 38, Ahern Direct, Schedule PMA-D3.
[18] *Id.* at page 25.
[19] See, MECG Initial Brief, pages 19-20 (citing to Exhibit 414, Gorman Rebuttal, page 24).

Clearly then, while Laclede / MGE attempt to excuse Ms. Ahern's novel methodologies, by claiming that they are "standard" or "well-recognized", the only well-recognized approaches employed by Ms. Ahern are the traditional DCF and CAPM methodologies. These approaches led to return on equity recommendations of 8.68% and 8.81% respectively.

B. MS. AHERN'S BUSINESS RISK ADJUSTMENT IS MISPLACED

Based upon her faulty methodologies, Ms. Ahern initially concludes that Laclede / MGE should be authorized a return on equity of 10.0%. Subsequently, Ms. Ahern makes two adjustments to inflate the return to 10.35%. At page 25-26, and 29, Laclede / MGE discuss the misplaced "business risk" adjustment. Based upon its alleged "small size", Laclede / MGE posit that investors have an increased risk that must be reflected in the return on equity.

> Ms. Ahern found that Spire Missouri is significantly smaller than the proxy group, both in terms of number of customers and annual revenues. Ms. Ahern considered the small size of Company in her assessment of business risks in order and determined that an adjustment of 0.20% was appropriate to reflect the greater business risk of the Company due to its smaller size relative to the Natural Gas Proxy Group.[20]

Later, Laclede / MGE claim that "Spire Missouri's ***estimated*** market capitalization of $2.5 billion is lower than the average market capitalization of the Natural Gas Proxy Group, $3.2 billion."[21]

As was demonstrated in MECG Initial Brief, Laclede / MGE's proposed business risk adjustment is misplaced. Laclede / MGE reach its faulty conclusion of smaller size by comparing its size as a subsidiary of a larger parent company (Spire) with the parent companies in the proxy group. As indicated in MECG's Initial Brief, a more accurate

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[20] Laclede / MGE Initial Brief, pages 25-26.
[21] *Id.* at page 29 (emphasis added).

comparison would be to compare Spire, as a parent company, to the other parent companies in the proxy group. That comparison reveals that Spire is not smaller than the other companies. In fact, by virtually any metric, Spire is comparable size to the other natural gas companies in the proxy group.

Proxy Company	Market Capitalization	Customers	Net Plant	Total Revenues
Atmos Energy	$7.6 billion	3,000,000	$11.5 billion	$4.7 billion
Southwest Gas	$3.5 billion	2,000,000	$4.9 billion	$2.9 billion
Spire, Inc.	$3.0 billion	1,600,000	$4.0 billion	$2.4 billion
New Jersey Resources	$2.9 billion	512,300	$2.4 billion	$2.6 billion
South Jersey Industries	$2.6 billion	373,100	$3.0 billion	$1.2 billion
Northwest Natural Gas	$1.6 billion	704,000	$2.7 billion	$0.8 billion

Source: Exhibit 38, Ahern Direct, Schedule PMA-D3

Recognizing that, by virtually any metric, Spire is comparable to the proxy group, Laclede / MGE's claim that it "is significantly smaller than the proxy group" is demonstrated to be false. As such, Ms. Ahern's business risk adjustment must be rejected.

C. MS. AHERN'S FLOTATION COST ADJUSTMENT IS MISPLACED

In addition to its misplaced business risk adder, Laclede / MGE also attempt to inflate its return on equity recommendation by claiming an adjustment for alleged flotation costs. Specifically, Laclede / MGE claim that "without such an adjustment, there is no way to recover these legitimate [flotation] costs under the current regulatory model used in Missouri."[22]

[22] Laclede / MGE Initial Brief, page 26. See also, page 30.

Laclede / MGE's request to recover flotation costs through the Commission's authorized return on equity is misplaced. As set forth in MECG's initial brief, neither Laclede nor MGE is publicly traded. Instead, the common stock of each company is wholly-owned by the parent company Spire. As such, neither Laclede nor MGE issues stock or incurs flotation costs.[23] Moreover, while Spire issues common equity and incurs flotation costs, those costs are recovered from Missouri ratepayers in the form of allocated costs.[24] As such, Laclede / MGE's assertion that "there is no way to recover these legitimate [flotation] costs under the current regulatory model used in Missouri" is completely false. Given this, the Commission should reject Laclede / MGE's flotation cost adjustment.

D. THE COMMISSION SHOULD "RELY UPON THE RECOMMENDATION" OF THE "MOST PROMINENT" EXPERT.

While MECG disagrees with most of the assertions that Laclede / MGE make in regard to return on equity, it does agree with one comment. At page 20 of its Initial Brief, Laclede / MGE claim that the Commission should "rely upon the recommendation of the expert with the most reasonable ROE range that is based upon generally accepted and reliable estimates of the returns that investors expect."[25] In its Initial Brief, MECG documented several recent Commission decisions that clearly indicate that the "expert with the most reasonable ROE range" is Mr. Gorman.

For instance, in recent decisions, the Commission has made the following findings regarding Mr. Gorman's credibility and his return on equity recommendations.

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[23] MECG Initial Brief, page 22 (citing to Exhibit 414, Gorman Rebuttal, page 20).
[24] *Id.* (citing to Exhibit 414, Gorman Rebuttal, page 23).
[25] Laclede / MGE Initial Brief, page 20.

> [T]he Commission finds Michael Gorman to be the ***most credible and most understandable*** of the three ROE experts who testified in this case.[26]
>
> Michael Gorman, the witness for SIEUA, AG-P and FEA, did the ***best job of presenting the balanced analysis*** the Commission seeks.[27]
>
> In particular, the Commission accepts as credible the testimony of MIEC's witness, Michael Gorman. . . . Of the witnesses who testified in this case, Michael Gorman, the witness for MIEC, does the ***best job of presenting the balanced analysis*** that the Commission seeks.[28]

In contrast, the Commission has never had to critique Ms. Ahern's return on equity methodology. That said, however, the findings of other state utility commissions provide useful information. In reported utility cases, Ms. Ahern's recommendation has been found to be 111 basis points above that ultimately adopted by the state utility commission.[29] Moreover, as referenced previously in this brief, Ms. Ahern's novel methodologies have been rejected by numerous state utility commissions. Given this, it is clear that Mr. Gorman is the most "prominent expert" with "the most reasonable ROE range."

[26] Case No. ER-2012-0166, *Report and Order*, issued December 12, 2012, at page 70 (emphasis added).
[27] Case No. ER-2007-0004, *Report and Order*, issued May 17, 2007, at page 62 (emphasis added).
[28] Case No. ER-2007-0002, *Report and Order*, issued May 22, 2007, at pages 40-41 (emphasis added).
[29] See MECG Initial Brief, page 14.

II. CAPITAL STRUCTURE

● Responds to Laclede / MGE Initial Brief (pages 32-45).

In its Initial Brief, MECG asserted that the Commission should utilize a ratemaking capital structure consisting of 47.2% common equity and 52.8% long-term debt as recommended by Mr. Gorman. This capital structure is arrived at by simply taking the Laclede / MGE subsidiary capital structure and eliminating $210 million of goodwill equity resulting from the acquisition premium associated with the MGE transaction. The removal of this goodwill equity is mandated by the stipulation in Case No. GM-2013-0254. Furthermore, the elimination of goodwill equity from the ratemaking capital structure constitutes solid regulatory policy as evidenced by 39 other state utility commission decisions.

Alternatively, MECG claims that the consolidated Spire capital structure, as recommended by Staff, is also reasonable for ratemaking. This consolidated capital structure consists of 45.56% common equity; 47.97% long-term debt; and 6.47% short-term debt is also reasonable for ratemaking. Given that Laclede and MGE are not publicly traded, the Spire capital structure is the only capital structure considered by investors. Furthermore, recognizing that Spire and its capital structure are utilized for establishing the proxy group for determining the appropriate return on equity, it would be illogical to apply that return on equity to a subsidiary capital structure.

In its Initial Brief, Laclede / MGE engage largely in hyperbole attack rather than a substantive discussion. For instance, in attacking Mr. Gorman's recommendation to exclude goodwill equity from the capital structure, Laclede / MGE's primary claim is that

the recommendation is "unprecedented".[30] The Companies further assert that the recommendation is simply "opportunistic" and "so obviously outside the mainstream of utility capitalizations" that it should be rejected.[31] As this brief will demonstrate, MECG has already addressed this misplaced assertion in its initial brief.

In response to the Staff's recommendation to use a consolidated capital structure, Laclede / MGE claim that it is "wildly inconsistent with historical norms for the Company as well as the capital structure of its peer utilities."[32] Furthermore, Laclede / MGE assert that "the use of a consolidated parent capital structure for ratemaking purposes may substantially affect the ability of the public utility itself to earn its authorized rate of return on investment."[33]

A. LACLEDE / MGE'S EQUITY-RICH CAPITAL STRUCTURE

1. The Companies' Equity-Rich Capital Structure Is Not Consistent With The Proxy Group.

In its Initial Brief, Laclede / MGE assert that the Mr. Gorman's capital structure proposal, reached by eliminating all goodwill equity, is "wildly inconsistent with the . . . capital structures of its peer utilities."[34] In his testimony, Mr. Gorman specifically considered this assertion and demonstrated it to be completely false. While Mr. Gorman's proposed capital structure includes 52.8% long-term debt and 47.2% common equity, "the proxy group companies have an average capital structure of approximately 51% debt and 49% common equity."[35] Therefore, contrary to Laclede / MGE's hyperbolic assertion that his proposed capital structure is "wildly inconsistent with the

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[30] *Id.* at page 40 ("with one major and unprecedented adjustment"); ("this unprecedented adjustment should be rejected"); ("a capital structure that is inappropriate, unreasonable, and unprecedented.").
[31] *Id.* at page 32.
[32] *Id.*
[33] *Id.*
[34] Laclede / MGE Initial Brief, page 32.
[35] Exhibit 414, Gorman Rebuttal, page 9.

peer utilities", Mr. Gorman's proposal is comparable to these other proxy companies. In contrast, Laclede / MGE While propose a capital structure that is equity rich – containing 54.2% common equity. Clearly then, it is the Laclede / MGE capital structure that is inconsistent with the proxy group of companies.

2. The "Historical Norm" For The Company

In addition, Laclede / MGE argue that Staff's consolidated capital structure is "wildly inconsistent with the historical norm for the Company." Noticeably, however, it is Laclede / MGE that has dramatically departed from its previous capital structure methodology. Specifically, the evidence indicates that Laclede / MGE have historically utilized a consolidated capital structure for ratemaking purposes. Finally, prior to this case, all parties have historically utilized the consolidated capital structure for ratemaking purposes. "Both the Company and Staff have historically recommended the use of the parent company's consolidated capital structure for LAC [Laclede] for ratemaking purposes."[36]

The Companies' sudden departure from the "historical norm" (the use of the consolidated capital structure) is undoubtedly a result of the highly leveraged consolidated capital structure that currently exists. In fact, the presence of this highly leveraged capital structure is so significant that Spire, in its shareholder risk factors, has routinely warned its shareholders of its presence and implications. In its 10K filed on November 15, 2017, Spire references its "substantial indebtedness" as a shareholder risk factor.[37]

[36] Exhibit 359, Staff Cost of Service Report, page 22.
[37] Exhibit 701, page 12.

Clearly then, the use of the consolidated capital structure, as recommended by Staff, is not contrary to the "historical norm." Rather, it is Laclede / MGE's sudden departure from the consolidated capital structure, in light of its "substantial indebtedness", that is contrary to the "historical norm."

B. ELIMINATION OF GOODWILL EQUITY FROM CAPITAL STRUCTURE

1. Elimination Of Goodwill Equity Is Not Unprecedented

As mentioned, Laclede / MGE's primary objection to Mr. Gorman's recommendation to eliminate goodwill equity from Laclede / MGE's capital structure is premised on the misplaced notion that excluding goodwill from the ratemaking capital structure is "unprecedented." In its Initial Brief, MECG demonstrated that the exclusion of goodwill equity from the capital structure is well established in other states. Furthermore, while the elimination of goodwill equity from the capital structure has not been addressed in Missouri, is a new issue for the Commission's consideration, this is simply a result of the fact that no other utility has so blatantly disregarded settlements precluding the recovery of acquisition premiums. As such, what is truly unprecedented is Laclede / MGE's willingness to violate stipulations in order to inflate its revenue requirement.

At pages 37-38 of its Initial Brief, MECG references decisions in 39 cases in which state utility commissions have excluded goodwill equity associated with an acquisition premium from the ratemaking capital structure. For instance, the Massachusetts Department of Telecommunications and Energy has stated, "[b]ecause goodwill is not directly associated with a utility's tangible plant assets, it is appropriate to exclude

goodwill from capitalization."[38] Similarly, the Wisconsin Public Service Commission has stated, "[i]t is reasonable that the amount of equity recorded on the books of the company be reduced by the amount of goodwill recorded on the books for the purpose of determining the equity level within the financial and ratemaking capital structures."[39] Still again, the Connecticut Department of Public Utility Control has held, "[t]he Department believes that by not reducing common stock equity by the accumulated amortization of goodwill, the Company is overstating the equity portion of its capital structure."[40] Finally, the Maine Public Utilities Commission has stated:

> Therefore, including any of this $40 million [of goodwill] in CMP's capital structure in this or any other proceeding implicitly allows the recovery of some portion of the acquisition premium paid by Energy East in the acquisition of CMP. As noted previously, the Commission's Order in Docket No. 99-411 expressly forbids any such recovery absent certain findings made by the Commission. The Commission has not made any such finding, nor has it been presented any basis upon which to do so.[41]

In contrast, while boldly proclaiming that the elimination of goodwill equity is "unprecedented", Laclede / MGE fail to provide a single instance in which a state utility commission has expressly allowed for goodwill equity in the ratemaking capital structure.

While the Missouri Commission has not expressly excluded goodwill equity from the utility's ratemaking capital structure, this is simply a result of the fact that the Missouri Commission has never had to consider this issue. Specifically, as with Laclede's acquisition of MGE, other utility have agreed not to seek recovery of the

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[38] *Boston Gas Company d/b/a KeySpan Energy Delivery New England*, Case No. D.T.E. 03-40, issued October 31, 2003 (citing to D.T.E. 02-27, at 12; Southern Union Company, D.T.E. 01-52, at 11 (2001); D.T.E. 00-53, at 8-9).

[39] *Wisconsin Public Service Corp.*, Wisconsin Public Service Commission Case No. 6690-UR-113, 218 PUR4th 381 (2002).

[40] *Southern Connecticut Gas Company*, Connecticut Department of Public Utility Control, Case No. 08-12-07, issued July 17, 2009, 276 PUR4th 1.

[41] *Central Maine Power Company*, Maine Public Utilities Commission, Docket No. 2004-339, issued December 17, 2004.

acquisition premium, either directly or indirectly, from customers. Unlike Laclede and MGE, however, those other utilities have abided by this commitment. Therefore, Laclede / MGE's assertion that the exclusion of goodwill equity is "unprecedented" is truly irrelevant. As questions from the Chairman to Laclede / MGE's witness reveals, the Companies' characterization of Mr. Gorman's elimination of goodwill equity from the capital structure is misleading.

> Q. Were you in the hearing room when counsel for MECG suggested some explanation for why such an adjustment has not been made in prior cases in this jurisdiction?
>
> A. I was, yes.
>
> Q. And how would you characterize that description or that explanation?
>
> A. Because it really just hasn't been at issue in terms of the -- the goodwill being at the subsidiary level.
>
> Q. Because the parties in those cases specifically mandated that it -- that it not be so recorded, correct?
>
> A. Correct. There would be no recovery of the goodwill either directly or indirectly as there is in this case.
>
> Q. So then it really is somewhat irrelevant that it's unprecedented, because it just hasn't been an issue. So no one's made the request before because it's never been at issue before?
>
> A. No one's made the request for the adjustment that Mr. Gorman has recommended. Is that your point?
>
> Q. Correct.
>
> A. Yes. That may well be, yes, yes.[42]

[42] Tr. 1216-1217.

2. Mr. Gorman's Capital Structure is Reasonable For Ratemaking Purposes

Next, Laclede / MGE seek to undermine Mr. Gorman's elimination of goodwill equity on the basis that it allegedly results in a capital structure that "has a relatively thin amount of common equity."[43] Interestingly, in using this quote, Laclede / MGE purposely eliminated the second portion of the sentence. Specifically, Mr. Gorman said, "I found that my adjustment to the Company's capital structure has a relatively thin amount of common equity, but still reasonably consistent with what we're seeing for other utilities and supporting their bond rating in -- around the country."[44] Indeed, in his testimony, Mr. Gorman notes that, as reported by SNL, his ratemaking capital structure is consistent with the average ratemaking capital structure for natural gas utilities over the past five years.[45] In fact, over the past eight years, the average equity ratio used by state utility commissions has not come close to the 54.2% equity ratio proposed by Laclede / MGE.[46]

Importantly, moments after characterizing his capital structure as containing a "relatively thin amount of common equity," Mr. Gorman pointed out that his capital structure is "reasonable for rate-making purposes."[47] Mr. Gorman's conclusion that his capital structure is reasonable is based upon the fact that "it will support their financial integrity, will support their bond rating, but will do so at a much lower cost to retail customers."[48]

[43] Laclede / MGE Initial Brief, pages 40-41 (citing to Tr. 1375).
[44] Tr. 1375.
[45] Indeed, SNL reports that, over the past five years, the equity ratio for ratemaking purposes has fluctuated between 50.33% and 51.99%. (Exhibit 414, Gorman Rebuttal, page 12).
[46] *Id.*
[47] Tr. 1376.
[48] *Id.*

The fact that Mr. Gorman's capital structure has a "relatively thin amount of common equity" is not a product of his elimination of goodwill equity. Rather, the "relatively thin amount of common equity" is a direct result of Spire's management decision to rely heavily on a leveraged capital structure. Indeed, in its discussion of shareholder risk factors in its 10-K filing with the SEC, Spire specifically notes its heavy reliance of debt: "The Company and its subsidiaries have substantial indebtedness which could adversely affect their financial condition."[49] The implications of this "substantial indebtedness" are also discussed.

> "The indebtedness of the Company and its subsidiaries could have important consequences. For example, it could:
>
> - make it difficult to pay or refinance their debts as they become due during adverse economic and industry conditions;
> - limit flexibility to pursue strategic opportunities or react to changes in its business and the industry in which they operate and, consequently, place them at a competitive disadvantage to competitors with less debt;
> - require a significant portion of cash flows from operations of their respective subsidiaries to be used for debt service payments, thereby reducing the availability of their cash flows to fund working capital, capital expenditures, dividend payments and other general corporate activities;
> - result in a downgrade in the credit rating of Spire's or the Utilities' indebtedness, which could limit the ability to borrow additional funds or increase the applicable interest rates;
> - result in higher interest expense in the event of an increase in market interest rates for both short-term commercial paper or bank loans;
> - reduce the amount of credit available to support hedging activities; and
> - require that additional terms, conditions or covenants be placed on Spire or the Utilities."[50]

Thus, the fact that the elimination of goodwill equity results in a capital structure that "contains a relatively thin amount of common equity" is not a result of some malevolent

[49] Exhibit 701, page 12.
[50] *Id.*

desire on Mr. Gorman's part to be "opportunistic"[51] or "one-sided."[52] Rather, it is entirely the function of Spire's management to maintain a more leveraged capital structure.

3. Mr. Gorman's Capital Structure Is Consistent With The Proxy Group

At page 43, Laclede / MGE claim, without any citation to the record, that Mr. Gorman's "proposed capital structure is not consistent with other similarly situated natural gas companies used in the proxy groups used by Staff and Company."[53] As Mr. Gorman points out, "the proxy group companies have an average capital structure of approximately 51% debt and 49% equity."[54] While the proxy group companies contain 49% equity, Laclede / MGE propose a capital structure that is equity rich – containing 54.2%.

4. Goodwill Must Be Financed Entirely By Equity

At pages 41-42, Laclede / MGE attempt to argue that the goodwill on its financial books was not financed by equity. Instead, Laclede / MGE assert that the goodwill was "financed by a mix of debt and equity."[55] As Mr. Gorman points out, however, this argument ignores the fact that the goodwill asset does not provide any cash flow. "From a credit rating perspective, a goodwill asset has no economic value. A goodwill asset, unlike infrastructure investments that are included in a utility's rate base, produces no cash flow."[56] Given that the goodwill asset does not produce cash flow, it cannot meet

[51] Laclede / MGE Initial Brief, page 32.
[52] *Id.* at page 42.
[53] *Id.* at page 43.
[54] *Id.* at page 9.
[55] Laclede / MGE Initial Brief, page 41.
[56] Exhibit 414, Gorman Rebuttal, page 7.

the service obligations that come with being characterized as debt and, therefore, must be considered equity.

> Therefore, the existence of a goodwill asset cannot be funded by debt because it cannot produce cash flows adequate to meet the debt service obligations on a debt security. Therefore, these premium payments that represent transactions between shareholders, can only prudently and reasonably be financed by utility common equity. It would be imprudent to finance a goodwill asset with debt, because the goodwill asset would default on the obligations to meet the debt service obligation of a debt, and would cause significant distress on the utility's credit standing, and ability to operate as a financially sound going concern.[57]

C. USE OF CONSOLIDATED CAPITAL STRUCTURE

1. Consolidated Capital Structure Allows Opportunity To Earn Return

At page 32 of its Initial Brief, Laclede / MGE boldly assert that "the use of a consolidated parent capital structure for ratemaking purposes may substantially affect the ability of the public utility itself to earn its authorized rate of return on investment." The evidence in this case indicates that this statement is patently false.

Historically, all parties, including Laclede and MGE, have utilized a consolidated capital structure. "Both the Company and Staff have historically recommended the use of the parent company's consolidated capital structure for LAC [Laclede] for ratemaking purposes."[58] Noticeably, the use of the consolidated capital structure has not hindered Laclede and MGE's ability "to earn its authorized rate of return." In fact, the evidence in this case indicates that Laclede / MGE's over-earnings have been so prevalent as to warrant a rate reduction. Given this, the Commission should not be concerned that its continued use of a consolidated capital structure will preclude Laclede / MGE from earning its authorized return.

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[57] *Id.* at pages 7-8.
[58] Exhibit 359, Staff Cost of Service Report, page 22.

III. REVENUE STABILIZATION MECHANISM

A. THE PROPOSED REVENUE STABILIZATION MECHANISM IS UNLAWFUL IN THAT IT IS CAPTURES USAGE VARIATIONS FROM FACTORS OTHER THAN WEATHER AND CONSERVATION.

Repeatedly throughout its brief, Laclede / MGE reference Section 386.266.3 – the statute that authorizes the Commission to implement a revenue stabilization mechanism.[59] Laclede / MGE's reference to the statute, however, is largely lip-service in that the proposed mechanism does not comply with the limitation in the statute to only reflect increases or decreases in usage "due to variations in either weather, conservation, or both." For instance, while Laclede / MGE claim that its proposed mechanism "represents a lawful . . . solution a problem",[60] the fact is that the proposed mechanism is intended to reflect all changes in usage and not simply those variations caused by "weather, conservation or both." Laclede / MGE openly acknowledge that any RSM "should be designed to recover an amount of revenue per customer".[61] Thus, the mechanism would guarantee a certain amount of revenue regardless of changes in factors beyond weather and conservation.

In its Initial Brief, MECG detailed the numerous other factors that affect residential and commercial customers' usage.[62] As reflected in Staff's testimony and the Laclede / MGE 10K SEC filing, these factors include economic affects, increased appliance efficiency and fuel switching. While the statute does not provide for the expansion of the revenue stabilization mechanism to include variations caused by these

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[59] Laclede / MGE Initial Brief, page 70 ("[The revenue stabilization mechanism] is a statutorily authorized tool.").
[60] *Id.* at page 71.
[61] *Id.*
[62] MECG Initial Brief, pages 43-45.

other factors, the Laclede / MGE proposed mechanism would capture variations due to these factors.

In its Initial Brief, Laclede / MGE attempt to excuse the overly broad nature of its proposed mechanism. Specifically, Laclede / MGE claim that such Staff's concerns are "highly exaggerated to the point of being irrelevant."[63] In fact, claiming that the statute was designed to be a "broad grant of authority," Laclede / MGE assert that Staff's concerns turn the statute into a "highly restrictive grant of authority" which is, in essence, an "unreasonable or absurd result."[64]

The Missouri Courts have repeatedly stated that the Commission is a "creature of statute." As such, the Commission's powers are "limited to those conferred by the statutes."[65] Further, "neither convenience, expediency or necessity are proper matters for consideration in the determination of whether or not an act of the commission is authorized by the statute."[66]

In the case at hand, Laclede / MGE assert that the Staff's interpretation is absurd since it is impossible to separate reduced usage resulting from conservation, a "purposeful act", from reduced usage caused from other factors, a non-purposeful act.[67] While MECG can understand Laclede / MGE's frustration in its inability to isolate changes associated with conservation, the fact is that this problem was caused by the gas utilities when they drafted the proposed legislation. As the Courts have noted, "neither

[63] Laclede / MGE Initial Brief, page 76.
[64] *Id.* at pages 76-77.
[65] *State ex rel. Utility Consumers Council of Missouri v. Public Service Commission*, 585 S.W.2d 41, 49 (Mo. 1979).
[66] *Id.*
[67] Laclede / MGE Initial Brief, page 77.

convenience, expediency or necessity" can be used to expand the Commission's authority.

Recognizing that the Laclede / MGE proposed revenue stabilization mechanism runs afoul of the authorizing statute, the Commission should focus its attention solely on the alternative Staff mechanism. As Laclede / MGE indicate, "the Company would be open to adoption of the Weather Normalization Adjustment Rider ("WNAR") submitted by Staff as Exhibit 281."[68]

B. <u>THE PROPOSED REVENUE STABILIZATION MECHANISM IS UNLAWFUL IN THAT IT IS DESIGNED TO GIVE THE UTILITY AN OPPORTUNITY TO OVER-EARN.</u>

Not only do Laclede / MGE attempt to brush aside concerns about its proposed revenue stabilization mechanism being broader than provided by the statutory authority, Laclede / MGE also ignored other requirements of the statute. At the hearing, MECG raised concerns about the requirement in the statute that the revenue stabilization mechanism be "reasonably designed to provide the utility with a sufficient opportunity to earn a fair return on equity."[69] In its Initial Brief, MECG repeated these concerns.[70] Specifically, MECG notes that Laclede has not had a rate increase for approximately seven years. In fact, based upon the evidence in this case, it is likely that Laclede will see a rate reduction. Given this, the current regulatory process, without the requested revenue stabilization mechanism, already provides a "sufficient opportunity to earn a fair return on equity." As such, the requested mechanism would simply be designed to provide the utility with an opportunity to over-earn.

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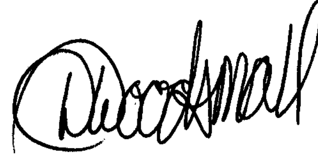
[68] *Id.* at page 79.
[69] Section 386.266.4(1).
[70] MECG Initial Brief, pages 45-47.

While MECG has raised this concern, Laclede / MGE have again ignored the concern and the statutory requirement. Noticeably, nowhere in its Initial Brief do Laclede / MGE address this statutory prerequisite and how their requested mechanism complies with this requirement. Given that the requested mechanism is not designed to provide a "sufficient opportunity to earn a fair return on equity", but instead a sufficient opportunity to earn an unreasonable return on equity, the requested mechanism should be rejected.

Respectfully submitted,

WOODSMALL LAW OFFICE



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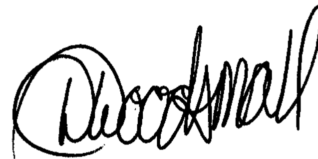
CERTIFICATE OF SERVICE

I HEREBY CERTIFY that I have this day served the foregoing pleading by email, facsimile or First Class United States Mail to all parties by their attorneys of record as provided by the Secretary of the Commission.



David L. Woodsmall

Dated: January 17, 2018