**STATE OF ILLINOIS**

**ILLINOIS COMMERCE COMMISSION**

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| **Liberty Utilities (Midstates Natural Gas) Corp. d/b/a Liberty Utilities** | : | |
| | : | |
| Proposed General Increase in Gas Rates | : | Docket No. 14-0371 |

# COMPANY INITIAL BRIEF

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# I. INTRODUCTION

## A. Overview / Executive Summary

Liberty Midstates began operating in Illinois in August 2012. This rate case is Liberty Midstates' first as well as the first rate case for this service area since the case filed by United Cities with a test year ending September 30, 1999.[1] With more than fifteen years between that date and the end of the test year in this case, it is impossible to summarize all of the changes that the service area, its operations and even the industry have gone through in that time.[2]

The Company's current rates have little relation to its costs.[3] The Company has been severely underearning since its beginning, and the service area has likely been paying below cost rates for some time before that. The rates initially proposed in this case represent an increase of less than 2.5 percent per year—and based on reductions agreed to by the Company during the course of this proceeding have dropped even lower on an annual basis.[4]

As part of its commitment to service, the Company is in the early stages of a vigorous infrastructure renewal program.[5] The rates requested in this case will help the Company recover the costs of this program which is essential to ensuring the continued provision of safe, reliable gas utility service in the area.[6]

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[1] *See* Company Ex. 1.0 at 6:121-124.
[2] *Id.* at 6:121-8:175.
[3] *Id.* at 8:164-175.
[4] *See* Company Ex. 1.0 at 8:176-181.
[5] *Id.* at 10:213-233.
[6] *Id*.

The Company has demonstrated that its requested revenue requirement and the proposed rates are just and reasonable and directly benefit its customers. In large part, the parties agree on most of the components of those rates—the cost of service, the rate design elements of the tariffs, and even most of the operating expenses and rate base items that are incorporated into the rates. Obviously some issues remain. With respect to the disputed issues, the Company submits that the Commission should decide each in its favor. The major open issues are briefly summarized:

- *Year End Net Plant*-- The Commission should use year-end net plant, rather than average net plant, to determine rate base in this case as this properly recognizes the investment to be made by the Company in the test year;
- *Uncollectible Expense*—The Commission should set the uncollectible expense ratio at 0.70 percent because this figure reflects the Company's actual and historical experience as well as specific factors applicable to the test year and is the best estimate of test year uncollectible expenses;
- *State Income Tax*—The Commission should set the state income tax for ratemaking purposes at 9.5 percent, which represents the most likely tax rate that will be in effect during the test year;
- *Incentive Compensation*— The Commission should include all incentive compensation amounts in rate base and operating expenses as these are reasonable and necessary personnel expenses that enable the Company to provide service;

- *Capital Structure*—The Commission should base rates on the Company's actual capital structure because this will best reflect the Company's actual costs of providing service and is not based on ad hoc and nonstandard calculations; and
- *Cost of Equity*—The Commission should adopt the Company's proposed cost of equity because this cost reflects the actual market conditions faced by the Company, is tailored to the Company's specific circumstances and best reflects the Company's actual cost of providing service.

Finally, while our brief out of necessity focuses on disputed issues, the Company does want to recognize the hard work that Staff has put in during the course of this case and thank Staff for how it has worked with the Company throughout the process.

The Company respectfully requests that the Commission adopt the revenue requirement proposed by the Company in this case. In support of this request and as part of its brief, the Company has attached a proposed draft order as **Attachment A** which sets forth the Company's position in draft order form.

### B. Procedural History

On March 31, 2014, Liberty Utilities (Midstates Natural Gas) Corp. d/b/a Liberty Utilities ("*Liberty Midstates*" or the "*Company*") filed with the Illinois Commerce Commission ("*Commission*"), pursuant to Section 9-201 of the Public Utilities Act (the "*Act*") (220 ILCS 5/9-201), the following second revised tariff sheets: ILL C.C. No. 1 sheets No. 3, 5, and 7. This tariff filing embodied a proposed general increase in gas rates. Through its May 7 (as corrected on May 13) and July 30 suspension and resuspension orders, the Commission suspended the effectiveness of the proposed tariffs to and including February 24, 2015.

The tariff filing was accompanied by direct testimony, other exhibits, and other materials required by 83 Ill. Adm. Code Parts 285 and 286. In response to a May 1, 2014 deficiency letter, the Company provided additional information on May 13 and May 28. The Company posted notice of the proposed tariff changes reflected in these filings in Liberty Midstates' business offices and published notice twice in secular newspapers of general circulation in the Company's service area, in accordance with the requirements of Section 9-201(a) of the Act and the provisions of 83 Ill. Adm. Code Part 255.

Status hearings were held on May 28 and October 9. No petitions to intervene were filed. An evidentiary hearing was held on October 16. Counsel for Liberty Midstates and for Staff witnesses entered appearances and exhibits filed by these parties were admitted into evidence.

### C. Nature of Midstates' Operations

Liberty Midstates is a Missouri corporation engaged in the distribution of natural gas in Illinois, Iowa, and Missouri.[7] Liberty Midstates began operations in August 2012 following the Commission approval of the acquisition of Atmos Energy Corporation's natural gas distribution assets in Docket 11-0559.[8] The Company serves approximately 22,000 customers in Illinois.[9]

### D. Test Year

The Company used a future test year consisting of the twelve months ending December 31, 2015.[10] Staff did not object to the use of this test year.

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[7] *Id.* at 2:41-3:49.
[8] *Id.*
[9] *Id.*
[10] *Id.*

### E. Legal Standard

Section 9-101 of Act requires that “[a]ll rates or other charges made, demanded or received by any product or commodity furnished or to be furnished or for any service rendered or to be rendered shall be just and reasonable.”[11] Conversely, “[e]very unjust or unreasonable charge” or rate are “prohibited and declared unlawful.”[12] Ratepayers are also not required to pay for costs unless those costs can be shown to “directly benefit them or the services” which the utility renders.[13] Section 9-201 (c) of the Act provides in part that the “burden of proof to establish the justness and reasonableness of the proposed rates or other charges . . . shall be on the utility.”[14]

## II. RATE BASE

### A. Resolved Issues

#### 1. Interest Synchronization Calculation

Staff witness Knepler proposed an adjustment for interest synchronization to ensure that the revenue requirement reflects the tax savings generated by the interest component of the revenue requirement.[15] Staff witness Knepler calculated the interest expense component by multiplying rate base by the weighted cost of debt.[16] The calculated interest expense is then compared to the Company’s test year income tax expense.[17] The Company agreed that this methodology is appropriate but disputes the inputs used by Staff.[18] Specifically, the Company objects to (1) the imputed capital

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[11] 220 ILCS 5/9-101.
[12] *Id.*
[13] *Illinois Bell Tel. Co. v. Illinois Commerce Comm.*, 55 Ill. 2d 461, 482 - 483 (1973).
[14] 220 ILCS 9-201(c).
[15] Staff Ex. 1.0 at 6:104-114.
[16] *Id.*
[17] *Id.*
[18] Company Ex. 8.0 at 9:187-10:195.

structure used by Staff to calculate the weighted cost of debt[19] and (2) the state income tax rate.[20] The Company and Staff both agreed that the interest synchronization calculation should incorporate the capital structure and state income tax rate approved by the Commission.[21] These inputs should be the capital structure identified by the Company and the 9.5% state income tax rate for the reasons set forth in sections III.B.1.b and IV.B.1 of this brief.

### 2. Budget Payment Plans

The Company's initial Part 285 filing used a different time period than the required December 2014 through 2015 period to calculate the 13-month average of the account balances for the test year.[22] The Company submitted corrected balances in response to the ALJ's deficiency letter. Staff witness Ostrander proposed an adjustment to rate base of ($26,692) to reflect the Company's corrected 13-month average of account balances of amount of ($3,878).[23] The Company agreed with Staff's proposed adjustment.[24]

### 3. Utility Plant - Meters

The Company inadvertently omitted $403,769 of gross plant related to meters in its rate base.[25] Mr. Krygier testified that the meters were placed in service in 2013 and for the test year, the amounts related to these meters totaled $377,971 of net plant and

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[19] Company Ex. 7.0 Revised at 24:456-461.
[20] Company Ex. 6.0 at 1:20-8:167.
[21] Staff Ex. 6.0 at 13:272-14:280; Company Ex. 8.0 at 9:187-10:195.
[22] Schedule B-14; Staff Ex. 2.0 at 11:235-12:240.
[23] Staff Ex. 2.0 at 11:223-12:240; Staff Schedule 2.03.
[24] Company Ex. 5.0 at 11:240-12:246.
[25] *Id*. at 18:381-392.

total test year accumulated depreciation of $25,797.[26] The Company stated that the meters were necessary to ensure safe and reliable service to Liberty Midstates' customers.[27] Staff witness Ostrander agreed that the meters should be added to rate base.[28] Mr. Ostrander additionally proposed an adjustment to Accumulated Deferred Income Taxes ("*ADIT*") to reflect the addition of the meters.[29]

### 4. Average Net Plant

The Company's proposed rate increase is based on the year-end rate base.[30] Staff witness Ostrander proposed an adjustment to use the mid-year rate base.[31] The Company believes this is an inappropriate adjustment and this issue remains contested. As discussed in Section II.B.1 below, the Company recommends that Staff's adjustment be rejected.

### 5. Accumulated Deferred Income Taxes

Staff witness Ostrander proposed an adjustment to ADIT to reflect an average net plant balance, a state income tax rate of 7.75%, and corrected allocation factor of 28.47% for shared plant allocations.[32] During rebuttal, Mr. Ostrander presented additional adjustments to (1) increase ADIT for the inclusion of the meters omitted from the Company's initial filing and (2) decrease ADIT to reflect Staff's proposed disallowance of capitalized incentive compensation.[33]

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[26] *Id.*
[27] *Id.*
[28] Staff Ex. 7.0 at 10:190-11:199.
[29] *Id*.
[30] Company Ex. 6.0 at 11:228-241; Schedule B-1.
[31] Staff Ex. 2.0 at 3:37-47; Staff Schedule 2.01; Staff Schedule 7.01.
[32] Staff Ex. 2.0 at 8:174-9:183; Staff Schedule 2.02.
[33] Staff Ex. 7.0 at 7:121-137; Staff Schedule 7.02

The Company disputes several of the inputs relied on by Staff witness Ostrander. Specifically, the Company objects to Staff witness Ostrander's use of an average net plant balance, state income tax rate, and his proposed disallowance of capitalized incentive compensation.[34] The Company did not, however, dispute Staff witness Ostrander's methodology of calculating ADIT. As with other issues on which the parties agree regarding the calculation methodology but disagree regarding certain inputs to that methodology, the Commission's adoption of the methodology should be subject to the (1) use of the year-end plant balance for rate base, (2) the use of the 9.5 percent state income tax rate, and (3) the inclusion of capitalized amounts in respect of incentive compensation.

### 6. Original Cost Determination

Staff witness Ostrander stated that data request responses provided by the Company support the plant additions since the last rate case.[35] Mr. Ostrander recommends that the Commission make a finding in this proceeding that the amount of $52,686,071, as of December 31, 2013, be approved for purposes of an original cost determination.[36] Based on the evidence in the record, the Commission should find that the $52,686,071 original cost for plant at December 31, 2013 is unconditionally approved as the original cost of plant.

[34] *See* Company Ex. 6.0 at 18:386-390; Staff Ex. 7.0 at 8:137-144.
[35] Staff Ex. 7.0 at 14:282-15:285.
[36] *Id*. at 15:286-300.

### 7. Cash Working Capital

The Company and Staff agreed that the formula method is an appropriate method to calculate cash working capital in this proceeding.[37] The formula method provides a simplified method of determining cash working capital needs based upon the assumption that a utility requires 45-days or 1/8 of a year to collect cash outlays for the provision of service to its customers.[38]

Staff witness Knepler proposed an adjustment to remove uncollectible expense because it is a non-cash expense, and therefore, does not require a working capital allowance.[39] Mr. Long noted that removing uncollectible expense from the cash working capital calculation is not always appropriate but the Company did not object to its removal in this proceeding.[40]

Although the Company and Staff agree on the methodology for calculating cash working capital, they disagree on the inputs for operating expenses. The parties recommended that the final balance of cash working capital be determined by the level of operating expenses determined to be just and reasonable by the Commission.[41] Accordingly, the level of operating expenses adopted by the Commission should be that recommended by the Company, not incorporating the contested adjustments proposed by Staff. In removing uncollectible expense from cash working capital, the Commission should, for the reasons set forth in Section III.B.1.a of this brief, use the Company's

[37] Staff Ex. 1.0 at 13:260-14:274; Company Ex. 6.0 at 10:214-218.
[38] Staff Ex. 1.0 at 13:260-14:274.
[39] Staff Ex. 1.0 at 13:260-14:274.
[40] Company Ex. 6.0 at 10:222-226.
[41] Staff Ex. 6.0 at 11:225-229; Company Ex. 6.0 at 10:214-218.

recommended uncollectible expense factor of 0.70 percent, rather than Staff witness Knepler's recommendation.

### B. Contested Issues

#### 1. Average Net Plant

In determining the rate base in this proceeding, the Commission must decide whether to use the rate base total at the end of the test year, or the "average rate base," which in this case uses the rate base projected to exist at the mid-year point of the test year. The Company's proposed rate increase is based on the year-end rate base.[42] Staff witness Ostrander proposed an adjustment to use the mid-year rate base.[43] The Company submits that the evidence in this docket demonstrates that a year-end rate base is more appropriate.

The Company acknowledges that the Commission has frequently used average rate base instead of year-end rate base in cases involving future test years. However, most of the cases cited by Staff witness Ostrander were uncontested with regard to this issue. The Company is aware of only three dockets in which this issue was actually contested: Central Illinois Public Service Company's ("*CIPS*") 1990 rate case (Docket 90-0072)[44]; Nicor's 2004 rate case (Docket 04-0779)[45]; and People's Gas 2012 rate case, (Docket 12-0512).[46] In those cases, the Commission made it clear that although it was adopting an average rate base approach, the determination of whether to use an

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[42] Company Ex. 6.0 at 11:228-241; Schedule B-1.
[43] Staff Ex. 2.0 at 3:37-47; Staff Schedule 2.01; Staff Schedule 7.01.
[44] Cent. Ill. Public Service Co., Docket No. 90-0072, 1990 Ill. PUC LEXIS 625 (Order, Nov. 28, 1990). [hereinafter CIPS 1990]
[45] Northern Ill. Gas Co. Docket No. 04-0779 (Order, Sept. 20, 2005). [hereinafter Nicor 2004]
[46] Peoples Gas Light and Coke Co., Docket No. 12-0512(Cons) (Order, June 18, 2013). [hereinafter PGL 2012].

average rate base or a year-end rate base is based on the facts and circumstances in each individual case—as the Commission described it, a “close issue.”[47] The Commission made it clear that the Commission has not adopted a general rule requiring one approach or the other.[48] Instead, the Commission has based its findings on the facts and circumstances of the particular case.[49] The particular facts of this proceeding justify the adoption of a year-end rate base.

To begin with, this proceeding is taking place during a period of significant increasing plant in service.[50] The Company is at the beginning of a vigorous infrastructure improvement program that will last well beyond 2015.[51] The average rate base proposed by Staff witness Ostrander would exist only in June 2015, four months after the rates set in this docket are expected to go into effect. There is a strong likelihood the rates adopted in this proceeding will remain in effect for a number of years.[52] Use of average rate base in a situation such as this, where rate base is substantially increasing over time, will understate rate base for nearly all of the time that rates are in effect.[53]

This is contrary to Mr. Ostrander’s mistaken assertion that a year-end rate base is not more representative of the rate base that will exist when the proposed rates will

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[47] CIPS at 6; *See* PGL 2012 at 38 (finding average rate base is more appropriate based on the facts and circumstances this proceeding).
[48] *See* Nicor 2004 at 7 (noting that previous precedent has not established a general rule).
[49] *See* PGL 2012 at 38 (finding average rate base is more appropriate based on the facts and circumstances of this proceeding); Nicor 2004 at 8 (finding that the facts in this case do not support a year-end rate base).
[50] Company Ex. 6.0 at 16:347-357.
[51] Company Ex. 1.0 at 10:219-11:233.
[52] Company Ex. 9. at 7:156:8-159.
[53] *Id.*

be in effect.[54] The average rate base suggested by Mr. Ostrander would exist only in June 2015, four months after the rates set in this docket are expected to become effective.[55]

In addition, it is undisputed that the Company has been underearning since its inception.[56] This mitigates concerns that might otherwise be associated with the using year-end rate base.[57] The Company will continue to be significantly underearning even during the test year, until approximately early March 2015 when the rates set in this proceeding are expected to go into effect.[58] Use of an average plant net balance for the test year will exacerbate the effects of this underearning because after only a few months the Company's rate base will be greater than that on which its newly adopted rates are based.[59] The Commission can moderate the effects of this underearning by using the year-end rate base to set rates.[60]

Furthermore, Liberty Midstates is in a different position than that of other utilities in cases where the Commission has implemented an average rate base.[61] The other utilities in dockets highlighted by Staff witness Ostrander have been in operation for over a hundred years, were not filing their first rate case, and had not been underearning for such long period of time between rate case filings as the Company.[62]

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[54] Staff Ex. 2.0 at 4:72-5-74.
[55] Company Ex. 9.0 at 8:159-166.
[56] Company Ex. 6.0 at 16:358-17:364.
[57] *Id.*
[58] *Id.*
[59] *Id.*
[60] *Id.*
[61] *Id.* at 17:365-372; *See* CIPS 1990 at 6-7; Nicor 2004 at 7-9; PGL 2012 at 38.
[62] Company Ex. 6.0 at 17:365-372.

Therefore, Liberty Midstates' operating and financial situations are drastically different from these larger utilities.[63]

Part of this difference is manifested in the fact that the Company's projects are not large enough for it to access the capital markets each time it initiates a project, nor is it constantly accessing the capital markets such as larger utilities may do with shelf registrations.[64] Liberty Midstates must aggregate its capital needs and obtain funding in advance for plant.[65] Investors require return from the money they invest, which in Liberty Midstates' case will predate the date on which the plant in service is entered on the books.[66] While this issue exists for Liberty Midstates in any case, using average net plant exacerbates the problem more than using end of year balances.[67] Staff witness Ostrander did not address this important difference in his rebuttal testimony.[68]

The Company disagrees with Staff witness Ostrander's assertion that in future test years an average net plant balance is appropriate because during a time of more frequent rate cases, utilities tend to invest more.[69] Mr. Long stated that in his more than thirty-five years of experience, utilities do not seek funds and then establish what investment can be made with those funds.[70] Rather, utilities establish the necessary investment plan and seek funds to pay for that plan.[71] As a result, the only way the

[63] *Id*.
[64] *Id*. at 17:373-382.
[65] *Id.*
[66] *Id.*
[67] *Id.*
[68] *See* Staff Ex. 7.0.
[69] Company Ex. 9.0 at 7:136-150.
[70] *Id.*
[71] *Id.*

Company can be fairly compensated for investments it will make during 2015 is for rates established for that period to include all investment made during that period.[72]

The Company also disagrees with Staff's claim that an average rate base is appropriate because the future test year itself is forward looking.[73] Using an average plant balance would actually bring the future period back six months assuming investment is made evenly throughout the year.[74] This would place rate-base-related costs out of synch time-wise with the income statement costs used in the revenue requirement.[75] The Company will have expended monies for a full twelve months of investment and operating expense, but the rates would only include compensation for one half of that investment.[76]

Adopting a measurement of net plant that is expected to be exceeded within five months after the rates in this case go effect does not allow Liberty Midstates to recoup its full costs of providing service. The Company will have already made arrangements for the necessary capital to add net plant throughout 2015—it will already be paying investors returns on that plant and therefore needs to recoup those costs. In the first two months of 2015 at least, the Company will be severely underearning. Its net plant in service is expected to exceed Staff's proposed average rate base calculation four short months thereafter. Adopting the year-end net plant reflects the actual investment being made during the test year, more properly matches the period's operating expense and

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[72] *Id.*
[73] Company Ex. 6:120-135.
[74] *Id.*
[75] *Id.*
[76] *Id.*

income to the Company's investment, and allows the Company to recoup its costs of providing service. In this case, rate base should be measured at year-end.

### 2. Accumulated Deferred Income Taxes

As previously described in Section II.A.4, the methodology for calculating ADIT is not contested, but several of the inputs are subject to the contested adjustments discussed in Sections II.B.1, II.B.3, and III.B.1.b. The Company incorporates by reference its: (1) Section II.B.1 arguments in support of a year-end rate base; (2) Section II.B.3 and Section III.B.3 arguments in support of rejecting Staff's adjustment to incentive compensation; and (3) Section III.B.1.b arguments in support rejecting Staff's adjustment to the corporate state income tax rate.

### 3. Incentive Compensation

Staff witness Ostrander proposed adjustments to disallow (1) $8,033 of capital related to the Long Term Incentive Plan ("*LTIP*"); $16,585 of capital related to the Short Term Incentive Plan ("*STIP*") and the Shared Bonus Pool Program ("*SBPP*").[77] Under the discussion of operating expenses, Staff witness Ostrander recommends corresponding disallowances for the operating expense portion of the LTIP, STIP and SBPP.[78] The Company strongly disagrees with Staff's proposed adjustment to the capital portion of the LTIP, STIP, and SBPP for the same reasons it objects to Staff's corresponding adjustment to the operating expense portion of Company's incentive compensation plans. Therefore, the Company incorporates by reference all of its arguments in Section III.B.3 of this brief. Based on the evidence in the record, the

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[77] Staff Schedule 7.03.
[78] *Id.*

Commission should reject Staff's proposed adjustment for the reasons stated in Section III.B.3 of this brief.

### C. Recommended Rate Base

The evidence in the record demonstrates that Staff's adjustments to average net plant, ADIT, and incentive compensation are not supported and should be rejected Accordingly, finding that Liberty Midstates' test year rate base should total $39,922,399 is fully supported by the record.

## III. OPERATING REVENUES AND EXPENSES

### A. Resolved Issues

#### 1. Property Taxes – Test Year Expenses

Staff witness Knepler proposed three adjustments with respect to property taxes: (1) the removal of a duplicative inflation increase; (2) an adjustment of $6,311 related to a correction of the application of an inflation factor; and (3) the removal of a projected amount related to the Company's office building that is in the process of being constructed in Vandalia.[79] Staff's total adjustment to property taxes equals ($73,484).[80] The Company views the adjustments somewhat differently but in an effort to keep matters simple accepted each of Staff's adjustments.[81]

#### 2. Outside Professional Services

The Company requested $452,712 for the recovery of outside professional fees in its initial filing.[82] On rebuttal, Mr. Krygier testified that the Company underestimated

[79] Staff Ex. 1.0 at 9:169-10:202.
[80] Staff Schedule 1.11.
[81] Company Ex. 6.0 at 8:179-185.
[82] Schedule C-4.

that amount and presented a corrected amount of $544,266 based upon 2013 actual expenses ($538,266) and a 3% inflation factor.[83]

Staff witness Knepler recommended that the Commission not include in operating expenses payments made to the Company's predecessor for transition and training services to assist Liberty Midstates in its new ownership and management roles of the Company.[84] Staff witness Knepler testified that if Liberty Midstate's request to establish a Service Company in Docket 14-0269 is approved, it is likely some economies of scale will be achieved which have not been considered in this proceeding.[85] The total of Staff's proposed adjustment to outside services equals ($206,194). The Company did not object to Staff's proposed adjustment.[86] The Company anticipates that including a reduction that reflects potential economies of scale identified by Staff may provide additional support for the Commission's approval of the proposed arrangements in Docket 14-0269.

Staff additionally proposed that the Company report semi-annually to the Manager of Accounting of the Commission its progress in complying with a plan proposed by the Company in Company Exhibit 8.0 to identify and distinguish: (1) Liberty charges that are (a) direct charged to the Illinois jurisdiction, and (b) allocated to the Illinois jurisdiction and (2) other affiliate charges that are (a) direct charged to the Illinois jurisdiction and (b) allocated to the Illinois jurisdiction.[87] Staff stated that the report should be titled, Status Report of Progress in Implementing Accounting Controls and

[83] Company Ex. 5.0 at 5:102-109; Company Ex. 5.06.
[84] Staff Ex. 6.0 at 10:190-201.
[85] *Id*.
[86] Company Ex. 8.0 at 6:122-7:132.
[87] Staff Cross. Ex. 1.

Procedures to Enable Reporting of Costs charged to Liberty Midstates/Illinois from Affiliates.[88] Staff requested that the first report be filed by October 1, 2015 and subsequent reports should be received at six-month intervals until the accounting controls and procedures are effectively implemented.[89] Liberty Midstates agreed to provide this report.[90]

### 3. Rate Case Expense

Section 9-229 of the Act provides that, "[t]he Commission shall specifically assess the justness and reasonableness of any amount expended by a public utility to compensate attorneys or technical experts to prepare or litigate a general rate case filing. This issue shall be expressly addressed in the Commission final order."

In its initial filing, the Company estimated rate case expense in the amount of $707,500.[91] The Company proposed to amortize rate case expense over a three year period.[92] Staff did not object to using a three year period to amortize rate case expense.[93] During rebuttal testimony, the Company revised its rate case expense estimate to $865,478 for an increase of $157,978. It was necessary to revise its estimate based on its understanding of outstanding issues and actual expenses incurred.[94] The Company initially made a very conservative estimate of rate case expense.[95] Staff stated that the Company has supported the proposed increase to its

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88 *Id.*
89 *Id.*
90 *Id.*
91 Schedule C-10.
92 *Id*.
93 Staff Ex. 7.0 at 14:275-280.
94 Company Ex. 5.0 at 13:271-14:291.
95 *Id.*

rate case expense through supplementary response to Staff data requests.[96] The Company presented supporting documentation in the form of all rate case related data request responses in Company Exhibit 8.03. The over 150 pages of supporting documentation included engagement letters, qualifications of rate case consultants, and invoices of actual expenses incurred.[97]

The estimate of $865,478 additionally incorporates two adjustments to rate case expense proposed by Staff.[98] Staff proposed to remove the remaining estimated expenses for ADIT consultant, Mr. Bourrassa because the Company anticipated that Mr. Bourassa's work was materially complete.[99] Staff additionally proposed the recovery of the actual costs of the initial Part 285 consultant, Mr. Schmidt whose costs were not included in the Company initial rate case expense estimate.[100]

Staff witness Ostrander stated that he has reviewed the invoices provided to him by the Company and his opinion the amounts appear to be reasonable.[101] Staff witness Ostrander additionally reviewed the documentation provided by the Company that supports the remaining estimated rate case expense not yet invoiced and stated that it appears the amounts are just and reasonable.[102] Mr. Ostrander proposed that the Commission find that:

> "The Commission has considered the costs expended to compensate attorneys and technical experts to prepare and litigate this rate case

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[96] Staff Ex. 7.0 at 11:214-12:221.
[97] *See* Company Ex. 8.03.
[98] Company Ex. 5.0 at 12:265-13:268.
[99] Staff Ex. 2.0 at 12:244-250.
[100] *Id*.
[101] Staff Ex. 7.0 at 13:241-247.
[102] *Id*.

> proceeding and assesses that such costs in the total of amount of $856,478, which is $288,493 amortized over 3 years, are just and reasonable pursuant to Section 9-229 of the Act (220 ILCS 5/9-229)."[103]

The Company agrees with Staff's proposed finding and submits this finding is fully supported by the record.

#### 4. Allocation from Shared Services ("*LABS*")

Staff witness Knepler initially proposed a disallowance for allocations for shared services (LABS) because it believed Liberty Midstates did not have an affiliate agreement with (LABS).[104] On rebuttal, Mr. Krygier clarified that what the Company calls Shared Services (LABS) is provided pursuant to a Commission-approved affiliate agreement with Liberty Utilities (Canada) Corp. (also called LUC).[105] Mr. Krygier explained that LABS is a business group within LUC and not a separate legal entity.[106] Additionally, the costs related to the shared services LABS group that is part of LUC are test year expenses that are necessary in providing services to Liberty Midstates customers and should be included in rates.[107]

Following the Company's explanation, Staff withdrew its proposed adjustment to allocations from shared services.[108] Based on Staff's withdrawal of its adjustment and the evidence in the record, a finding that no adjustment is necessary is appropriate.

#### 5. Depreciation Expense

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[103] Staff Ex. 7.0 at 14:275-280.
[104] Staff Ex. 1.0 at 12:234-239.
[105] Company Ex. 5.0 at 10:209-218.
[106] *Id.*
[107] *Id.*
[108] Staff Ex. 6.0 at 11:216-221

Staff proposed an adjustment to depreciation expense to correct the depreciation rate for Account 365.1 Land Right of Ways. Staff states that the correct depreciation rate is zero, since land is not depreciable.[109] This adjustment results in a reduction of test year depreciation expense of $879.[110] The Company accepted Staff's proposed adjustment.[111]

**B. Contested Issues**

**1. Gross Revenue Conversion Factor**

Staff and the Company agree on the method for calculating the Gross Revenue Conversion Factor ("*GRCF*"), but disagree on the inputs. The parties dispute the appropriate level of uncollectible expense and the state income tax rate. As discussed below, the Commission should reject Staff's adjustments to the uncollectible expense rate and the state income tax rate.

**a. Uncollectible Expense Rate**

In determining its revenue requirement, the Company used an uncollectible expense rate of 0.70%.[112] The Company identified this rate as its best estimate of the likely uncollectible expense rate to be in effect in the test year.[113] Staff witness Knepler, however, proposed the use of a five-year historical average of uncollectible expense from 2009 through 2013 (combining reports from the Company and from the Company's predecessor) resulting in an uncollectible expense rate of 0.51%.[114] Staff's proposed adjustment is mistaken, however, because it uses data that predates the Company's

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[109] Staff Ex. 2.0 at 14:286-291.
[110] Staff Schedule 2.05.
[111] Company Ex. 5.0 at 14:303-306.
[112] Schedule C-16.
[113] Company Ex. 9.0 at 3:57-59.
[114] Staff Ex. 1.0 at 8:155-9:167.

existence and is clearly erroneous, does not take into account the Company's actual experience, and fails to consider the likely effects of future increases.[115]

The Company's own recent experience indicates a higher level of uncollectibles than suggested by Staff.[116] Liberty Midstate's actual uncollectible rate in 2013 was 1.03%.[117] The Company also stated that it is reasonable to expect an increase in uncollectible expense in the test year due to the impact of the first rate increase in this service area in over fourteen years.[118] Based on these factors, the uncollectible expense ratio of 0.70% is reasonable.[119] Staff's approach fails to take into consideration these factors that are likely to affect test year uncollectibles.[120] The Company's proposed uncollectible rate takes into account that the Company's belief that it will be able to improve collections over time relative to its prior year's experience.[121]

To address Staff's concern regarding year-to-year fluctuations, the Company presented a calculation of a three-year average rate of uncollectibles.[122] The uncollectible rate using a three-year average is 0.68%, which is consistent with and supports the Company's proposed rate of 0.70%.[123] The three-year average indicates the Company's proposal is reasonable and not unduly affected by a single year's fluctuations.[124]

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[115] Company Ex. 9.0 3:57-6:112.
[116] Company Ex. 5.0 at 4:67-76.
[117] *Id.*
[118] *Id.*
[119] *Id.*
[120] Company Ex 5.0 at 4:81-5:88.
[121] Company Ex. 8.0 at 4:84-87.
[122] Company Ex. 5.0 at 4:77-87.
[123] *Id.*
[124] *Id.*

Staff witness Knepler's use of a five-year average in this case is problematic for a number of reasons, all of which remain unaddressed by Staff.[125] First, the five-year average ignores the more recent data used by the Company which indicates a higher level of uncollectibles. The more recent data is a better indicator of the level of uncollectible expense that would be expected to occur in the test year -- the data used by Staff reaches back to 2009.[126] Staff's five-year average also relies primarily on data from a different company. [127] The Company is not aware of any instance where the Commission has required a utility to recover costs based on the uncollectible data of another company that no longer operates in the state. This is particularly troublesome where that data is clearly inaccurate. For instance, the data for 2010 indicates a negative uncollectible amount.[128] There is nothing in the record to explain how such a negative amount could arise. Staff did not explain this anomaly, and the Company has not been able to verify any of the non-Company data used by Staff in its five-year average.[129]

Staff additionally presented an average rate of uncollectibles based on a four-year average of 2010 through 2013 and additionally an average rate with high and low years removed.[130] The Company's objection to the questionable data continues to apply to Staff's four-year average calculation. Likewise, the exclusion of the high year in Staff's calculation inappropriately excludes the most recent data from 2013, which is

[125] Company Ex. 5.0 at 3:52-64.
[126] *Id.*
[127] *Id.*
[128] *Id.*
[129] *See* Company Ex. at 8.0 3:65-4:70.
[130] *See* Staff Ex. 6.0 at 7:124-135; Staff Schedule 6.08.

actually the most relevant and most reliable figure.[131] Staff's approach results in a calculation that is too far removed from the 2015 test year to present a reliable indication of the level of uncollectible expense that will be incurred in the test year.[132] Further, the high and low year exclusion method would only rely on five months of operations by Liberty Midstates itself.[133] All of the other data is from a different company and may be derived using different methodologies (or may simply be inaccurately low).[134]

Staff witness Knepler testified that the Commission had used a five-year average in certain other cases. In none of the cases testified to by Staff did the Commission use data from companies other than the utility seeking a rate increase. In addition, all but one of the cases testified to by Staff did not involve future test years.[135] The Commission has previously and explicitly found that the methodology used in cases using a historical test year is not determinative in rate cases using a future test year.[136] Instead, the Commission has examined the facts and circumstances of a particular rate case to determine the reasonableness of an uncollectible expense estimate, rather than mandating a particular methodology be used.[137]

Based on the facts in this proceeding, including historical data, the Company's best estimates, and identifiable and specific circumstances, the Company's proposal of

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[131] Company Ex. 8.0 at 4:73-80.
[132] *Id.*
[133] *Id.*
[134] *Id.*
[135] Company Ex. 8.0 at 5:93-107.
[136] *Id; See* Northern Ill. Gas Co., Docket 08-0363 at 30 (Order, March 25, 2009) ("Because the recent Ameren Illinois rate cases did not involve use of a future test year, what was done in that Docket, Docket 07-0585, is not determinative.").
[137] Company Ex. 8.0 at 5:93-107.

0.70% represents the best estimate of uncollectible expense that will occur in the test year.[138] Staff's approach ignores the data reliability issues raised by the Company and the likely challenges that will be faced in the test year and should be rejected.[139]

### b. State Income Tax Rate

The Illinois corporate income tax rate in place when the Company prepared and initiated the filing of its rate case was 9.5%[140] and this rate represents the most likely corporate income tax rate to be in effect in 2015.[141] Staff objected to the use of the 9.5% state income tax rate because the state income tax rate is scheduled to reduce to 7.75% absent legislative action on January 1, 2015.[142]

The Company disagreed with Staff's proposed adjustment and noted that the absence of legislation extending the 9.5% state income tax rate during the testimony phase of this proceeding is not indicative of the rate of taxes that will be in effect in 2015.[143] Liberty Midstates noted that the most likely time for the state income tax extension to be addressed by the General Assembly is after the November election, and probably even after the start of 2015.[144]

The Company is not seeking to game the state income tax rate.[145] If evidence becomes available that demonstrates it is more likely that the current corporate income

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[138] *Id.*
[139] *Id*.
[140] The 9.5% rate consists of a 7% state corporate income tax and a 2.5% personal property replacement tax. For simplicity purposes, these two taxes are combined and referred to as the 9.5% state income tax rate.
[141] Company Ex. 6.0 at 2:39-42.
[142] The 7.75% rate consists of a 5.25% state corporate income tax and a 2.5% personal property replacement tax. For simplicity purposes, these two taxes are combined and referred to as the 7.75% state income tax rate.
[143] Company Ex. 6.0 at 3:61-4:79.
[144] *Id.*
[145] Company Ex. 6.0 at 5:93-99.

tax rate will be changed (lower or higher for that matter) for 2015, a change to the proposed rates would be warranted.[146] However, the Commission may be required to make a determination regarding which tax rate is more likely to be in effect in 2015. The Company has presented evidence showing that the most likely tax rate will be 9.5%.

It is very unlikely the state corporate income tax will be 7.75% in 2015.[147] Based on the state's financial condition and statements made by the current governor and state legislators, it is highly likely the current state corporate income tax rate of 9.5% will remain in place beyond January 1, 2015.[148] Liberty Midstates noted that Speaker of the House Madigan and Senate President Cullerton (with their intact veto-proof majorities in the general assembly) support extending the 9.5% corporate income tax rate.[149] Outgoing Governor Quinn also supports the extension—a clear sign that the state needs the revenues that the tax generates.

Illinois has the lowest credit rating of all fifty states and without additional revenues faces severe budget shortfalls.[150] The Company presented a Moody's Sector Comment for Illinois dated June 5, 2014, that indicated if legislators do not reverse or offset the scheduled tax reduction in some fashion, Illinois' backlog of payments to vendors, municipalities, public universities, and other entities will triple to $16.2 billion in the next three years.[151] Likewise, Governor Quinn's FY 2015 Budget Address noted that "[if action is not taken to stabilize our revenue code . . . extreme and radical cuts will be

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[146] *Id.*
[147] Company Ex. 6.0 at 5:109-8:167.
[148]Company Ex. 6.0 at 5:109-7:159; *See* Company Ex. 6.2-6.5.
[149] Company Ex. 6.0 at 5:115-117.
[150] *Id.* at 5:118-124.
[151] *Id;* Company Ex. 6.1.

imposed on education and critical public services."[152] Even with a new governor taking over later in 2015, these budgetary pressures remain as strong as ever.

Statements made by Senate President Cullerton, Speaker of the House Madigan, Senator Kirk Dillard (R-Hinsdale) describe the State's need for revenue and the likelihood that tax rates will need to be addressed in the near future.[153] In addition to the general acknowledgement by legislators and the governor that income tax revenues must remain, Company witness Long stated that he is not aware of any credible proposals by leading politicians that would allow for a reduced corporate income tax rate.[154] While there is some support for reducing *individual* income tax levels in 2015, Mr. Long is not aware of evidence indicating strong support specifically for the reduction of state *corporate* income tax rates.[155] Mr. Long additionally stated that he does not know a single person who believes this state would ever reduce taxes being collected.[156]

The Commission has previously used for ratemaking purposes a state tax rate that had not yet been adopted based on the likelihood of the extension of the tax.[157] To the extent that the tax rate for 2015 is not definitively known, the Commission must review the available evidence to determine the most likely income tax rate that will apply in the test year. The Company submits that, absent a conclusive legal action, the record

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[152] Company Ex. 6.0 at 6:125-130; Company Ex. 6.2.
[153] Company Ex. 6.0 at 7:130-8:167; Company Ex. 6.3-6.5.
[154] Company Ex. 6.0 at 8:160-167.
[155] *Id.*
[156] Company Ex. 9.0 at 2:44-3:46.
[157] *See* Iowa-Illinois Gas and Electric Co., Docket 92-0357 (Cons.), 1993 Ill. PUC LEXIS 245, *67 (Order, July 21, 1993)(approving expired surtax on the likelihood of its continuance).

evidence can only support the conclusion that the most likely corporate income tax rate for 2015 is 9.5%.

### 2. Incentive Compensation

Staff proposes disallowing approximately: (1) $18,682 of costs related to the LTIP, consisting of $10,649 of expenses and $8,033 of capital; (2) $38,530 of costs related to the STIP and SBPP consisting of $21,962 of expenses and $16,568 of capital.[158] Staff's proposed adjustment is not supported by the record and should be rejected.

The Commission should reject Staff's proposed adjustment for three reasons.[159] First, incentive compensation is a cost that was incurred in the test year and will be incurred going forward.[160] Second, incentive compensation is an important recruiting and retention tool.[161] Third, financial incentives are important metric which ultimately benefit customers.[162]

Staff does not dispute that incentive compensation costs will be incurred in the test year or that incentive compensation can be useful recruiting tool.[163] The Company disagreed with Staff that basing incentive compensation on financial metrics do not benefit customers. [164] Financial metrics provide benefits by encouraging more efficient operations, the benefits of which ultimately flow to customers.[165] Efficiency is encouraged because the Company's financial metrics are not only impacted by

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[158] Staff Ex. 5.0, Schedule 5.01.
[159] Company Ex. 5.0 at 5:317-323.
[160] *Id.*
[161] *Id.*
[162] *Id.*
[163] Staff Ex. 7.0 at 9:176-177
[164] Company Ex. 8.0 at 9:179-185.
[165] Company Ex. 5.0 at 16:351-357.

revenues, but costs as well.[166] Ratepayers directly benefit from the cost controls incentivized by the Company's financial metrics.[167] Finally, customers benefit from the financial health and stability of the utility and encouraging workers to enhance that stability should be encouraged.[168]

Additionally, the incentive compensation packaged offered by the Company to its employees should be viewed as an overall package that has financial performance as one of many goals.[169] The packages, as a whole, benefit customers by encouraging employees to reach higher levels of on-the-job performance overall.[170] Segregating and disallowing particular portions of the incentive packages miss the point that these plans are set up to have significant benefits for all stakeholders of the Company.[171]

### C. Recommended Operating Income / Revenue Requirement

The evidence in the record demonstrates that Liberty Midstates should have a revenue requirement as set forth in the Company's testimony.

## IV. RATE OF RETURN/COST OF CAPITAL

### A. Resolved Issues

#### 1. Short-Term Debt Ratio

Staff proposed that the Company's capital structure contain 0.46% short-term debt.[172] Staff calculated the short-term debt ratio by measuring the average net short-

[166] *Id*.
[167] *Id*.
[168] *Id.*
[169] Company Ex. 5.0 at 17:358-365.
[170] *Id.*
[171] *Id.*
[172] *See* Staff Schedule 8.01.

term outstanding for the Company for the twelve months ending June, 2014.[173] To narrow the issues in this proceeding, the Company accepted Staff's recommended short-term debt ratio.[174]

**2. Cost of Short-Term Debt**

Staff estimated the cost of short-term debt equal to 1.41.%[175] Staff estimated the cost of short-term debt by starting with the average one-month LIBOR rate for the 30 days ending January 31, 2014, which equals 0.162%.[176] Staff then added 1.25% to the one-month LIBOR rate to derive the Company's cost of short-term debt.[177] The Company accepted Staff's proposed cost of short-term debt.[178]

**3. Embedded Cost of Long-Term Debt**

The embedded cost of long-term debt is not contested in this proceeding. The Company and Staff agreed on a long-term debt cost of 4.81%.[179]

**B. Contested Issues**

**1. Common Equity and Long-Term Debt Ratios**

The Company recommends that its actual capital structure be adopted and Staff's proposed imputed capital structure be rejected. The Company's actual capital structure is just, reasonable, and consistent with relevant and observable benchmarks. Staff's proposed imputed capital structure is entirely ad hoc without any support from commission precedent or financial literature.

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[173] Staff Ex. 3.0 at 6:110-7:113.
[174] Company Ex. 10.0 at 4:75-81.
[175] Staff Ex. 3.0 at 9:152-158.
[176] *Id.*
[177] *Id*.
[178] Company Ex. 10.0 at 4:75-81.
[179] *See* id; Staff Ex. 8.0 at 2:19-25; Staff Schedule 8.03.

### i. Actual Capital Structure

The Commission has previously taken the position that "a hypothetical capital structure should only be used when the utility's actual capital structure is found to be unreasonable, imprudent or unduly affected by such circumstances as double leverage as so to unfairly burden the utility's customers."[180] Liberty Midstates' actual capital structure consists of 60.10 percent common equity, 0.46 percent short-term debt, and 39.44 percent long-term debt.[181] No evidence has been introduced that shows this structure to be unreasonable, imprudent or affected by double leverage or similar circumstances. The Commission should use Liberty Midstates' actual capital structure.

The Company presented the testimony of expert witness Robert Hevert on issues relating to capital structure and cost of equity.[182] Mr. Hevert noted that one reasonable means of assessing the Company's capital structure is to consider the observable and relevant benchmarks such as the capital structures in place at the proxy companies (used by both Mr. Hevert and Ms. Phipps in determining cost of equity), or that of Liberty Midstates ultimate parent company, APUC. Mr. Hevert testified that Liberty Midstates' 60.10 percent equity ratio is within the range of the equity ratios of the companies that make up the proxy group that both Mr. Hevert and Staff witness Rochelle Phipps use to evaluate the Company's cost of equity.[183] In addition, Mr. Hevert pointed out that Liberty Midstates' actual capital structure is generally consistent with

[180] Ill. Bell Tel. Co. v. Ill. Commerce Comm'n, 283 Ill. App. 3d 188, 205 (2d Dist. 1996) (citing People ex. rel. Hartigan III, 214 Ill. App. 3d 222, 228 (1991)); *See* Cent. Ill. Light Co., Docket 06-0070 at 102 (Order, Nov. 21, 2006 ) (noting that starting point is typically testimony and data from the utility's tariff filing, which typically reflects an actual capital structure").
[181] Company Ex. 10.0 at 42:789-790.
[182] *See* Company Ex. 4.0; Company Ex. 7.0 Revised; Company Ex. 9.0.
[183] Company Ex. 7.0 Revised at 12:207-216.

the 56.64 percent average equity ratio of APUC (which is the ultimate source of both Liberty Utilities Co. ("*LUCo*") and Liberty Midstates' equity, and influences the credit rating of the debt that finances their operations) over the past eight fiscal quarters.[184] The Commission has previously compared the equity ratio of a utility to its ultimate parent in Docket 11-0281 when reviewing the reasonableness of a capital structure.[185]

The equity ratio is an important factor in a company's overall risk profile and has a strong influence on its credit rating and, therefore, cost of capital.[186] As the equity ratio decreases, the degree of financial leverage and, therefore, financial risk increases.[187] In Mr Hevert's expert opinion, in recommending a relatively low equity ratio, Staff is asking the Company to adopt a degree of financial leverage that is far removed from industry practice, and which exposes Liberty Midstates to additional risk.[188]

Utilities face both business and financial risk.[189] With regard to financial risk, increasing financial leverage increases the risk that a company may not have adequate cash flow to meet its financial obligations.[190] All else remaining equal, a meaningful increase in financial leverage is likely to lead to a higher cost of both debt and equity.[191] Because APUC's and LUC's credit ratings already are below the proxy group's average

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[184] *Id.*
[185] *See* Peoples Gas Light and Coke Co., Docket 11-0281(Cons) at 108 (Order, Jan 10, 2012 ) (comparing equity ratio of utility and ultimate parent).
[186] Company Ex. 7.0 Revised at 11:188-190.
[187] *Id.* at 11:190-192.
[188] *Id.* at 11:191-193.
[189] *Id.* at 11:194-195.
[190] *Id*. at 11:95-197.
[191] *Id.* at 11:197-198.

credit rating, Ms. Phipps' proposal would only further increase the Company's financial risk.[192]

Liberty Midstates faces incremental business risks associated with its relatively small size, regulatory environment and exposure to weather variability. As explained by Mr. Hevert, under these circumstances it is reasonable for the Company to finance its operations with an equity ratio above the average equity ratio of the proxy group companies, not substantially below, as Ms. Phipps suggests.[193] The Commission has previously found that "[ i]f the levels [of equity and debt] are not set properly, the Company may experience negative market consequences. A severe error may result in rates that are not just inappropriate, but confiscatory."[194]

Staff witness Phipps stated that she chose to impute a capital structure because she did not have confidence in the Company's capital structure data.[195] Ms. Phipps' lack of confidence is misplaced. [196] To begin with, the fact that Ms. Phipps considered certain updates by the Company to include information the Company previously omitted from a filing to mean that its capital structure data was unreliable.[197] For example, the Company did not include retained earnings in Schedule D-1 of its initial filing, but included it in them in its revised filing. Ms. Phipps did not allege that the retained earnings figures were unreliable-- the figures simply were inadvertently not included on a schedule.[198]

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[192] *Id.* at 11:198-201.
[193] *Id*. at 22:201-12:205.
[194] Commonwealth Edison. Co., Docket 05-0597 at 57 (Order on Rehearing, Dec. 20, 2006).
[195] *See* Staff Ex. 3.0 at 3:56-57.
[196] Company Ex. 8.0 at 10:206-11:218.
[197] *Id*.
[198] *Id.*

Perhaps more importantly at this point, following the submission of corrective responses, Ms. Phipps did not identify any area where she remained uncertain regarding the Company's capital structure.[199] In fact, Ms. Phipps did not express disagreement with the final capital structure reported by the Company. Therefore uncertainty as to the Company's capital structure cannot be a reason to impute a capital structure.[200]

The Company has demonstrated through expert testimony, through comparison to similarly situated companies, and through a demonstration regarding the financial and operational risks faced by it in providing service in Illinois that its actual capital structure is reasonable and prudent. The Company has also shown that Staff's criticisms of its actual capital structure are not valid and moreover, that they do not address issues that the Commission considers in determining not to use a utility's actual capital structure. The Commission should adopt the Company's actual capital structure of 60.10 percent common equity, 0.46 percent short-term debt, and 39.44 percent long-term debt in this case.

### ii. Staff's Imputed Capital Structure

Staff witness Phipps initially recommended an imputed capital structure including 43.51 percent common equity, 56.03 percent long-term debt and 0.46 percent short-term debt.[201] To arrive at her imputed capital structure, Ms. Phipps began with a three year average equity ratio (for Staff's proxy companies) of 49.91 percent and deducted

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[199] *Id.*

[200] In any case, the correct response to any initial uncertainty regarding a utility's capital structure is to further clarify and investigate the relevant facts to determine that capital structure. There is no authority or principle of ratemaking that would require imputing a capital structure in response to initial uncertainty regarding a utility's capital structure.

[201] Staff Schedule 3.01.

6.40 percentage points from that amount.[202] Ms. Phipps' downward adjustment was based on her observation that Standard & Poor's ("*S&P*") currently rates LUC BBB, whereas the proxy group average credit rating is A-. Reasoning that the difference between BBB and A- represents two of the three credit "notch" differences in a letter grade (*e.g.*, the difference between A and BBB), Ms. Phipps reduced her proposed equity ratio by two-thirds of the difference between the equity ratio benchmarks for Moody's equivalent ratings (*i.e.*, the difference between A and Baa).[203] In rebuttal testimony Ms. Phipps proposed a revised imputed capital structure to correct an inconsistency caused by the LUC capital structure reflecting a short-term debt balance net of CWIP, whereas the proxy groups capital structure did not.[204] Ms. Phipps' proposed revised capital structure consists of 45.59 percent common equity, 53.95 percent long term debt, and 0.46 percent short-term debt.[205]

The approach adopted by Ms. Phipps is completely ad hoc and with no support in Commission precedent or in financial literature. Ms. Phipps cited to no authority for the manner in which she imputed a capital structure for the Company—neither in her direct testimony nor her rebuttal testimony. Staff's suggestion that the Company's equity ratio should be reduced to reflect the Company's lower credit rating is misplaced. A company's credit rating does not determine its equity ratio, rather a company's credit rating is dependent on its equity ratio (among other risk factors). Authorizing an equity ratio below the Company's current actual equity ratio (and below the equity ratios in

[202] Staff Ex. 3.0 at 5:85-6:101.
[203] *See* Staff Ex. 3.0 at 5:85-6:101.
[204] Staff Ex. 8.0 at 3:48-4:66.
[205] Staff Schedule 8.01.

place at the proxy group companies) would increase the Company's financial risk, and serve to exacerbate the Company's elevated risk level relative to the proxy group.[206]

In addition, Mr. Hevert testified that it is unclear that the data Ms. Phipps relied on to develop her proposed ROE adjustment is directly comparable to the data she uses to develop her beginning capital structure estimate.[207] The Commission has previously rejected an imputed capital structure where it expressed concerns about complications caused by the introduction of possible measurement errors to determining the cost of capital.[208] Mr. Hevert identified significant inconsistencies and complications regarding Ms. Phipps' ad hoc adjustments—inconsistencies that Staff has not addressed.

Mr. Hevert identified areas of Ms. Phipps approach that in his expert opinion are suspect.[209] Ms. Phipps relies on reported capital structure data to establish the baseline equity ratio for A-rated utilities on the one hand, and rating agency guidelines to calculate the 6.40 percentage point decrement associated with BBB-rated utilities on the other.[210] Mr. Hevert questioned whether the two are sufficiently comparable that differences in rating agency guidelines can be applied to accounting data for the purpose of creating a reasonable hypothetical capital structure.[211] Schedule 10.3 -- 2013-2014 Reported Authorized Returns on Equity, Natural Gas Utilities Rate Cases[212] demonstrates that the average authorized equity ratio since January 2013 for BBB-rated

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[206] Company Ex. 7.0 Revised 11:183-12:205.
[207] *See* Company Ex. 10.0 at 7:142-8:163.
[208] *See* Cent. Ill. Light Co., Docket 06-0070 at 102 (Order, Nov. 21, 2006 )(rejecting imputed capital structure in favor of actual capital structure).
[209] Company Ex. 10.0 at 7:142-8:163.
[210] *Id.*
[211] *Id.*
[212] Company Schedule 10.3.

natural gas utilities was 50.07 percent, or 4.48 percentage points above Ms. Phipps' 45.59 percent imputed equity.[213] This calls Ms. Phipps conclusion into serious question.

Mr. Hevert further stated that there is reason to believe the accounting data used to develop Ms. Phipps capital structure estimates may differ from rating agency benchmarks.[214] Moody's makes a series of adjustments to the ratio of debt to capitalization and therefore it is quite possible Moody's definition of "total capital" may differ from the data gathered by Ms. Phipps.[215] As to its "standard adjustments", Moody's considers almost a dozen categories for adjustment.[216] Mr. Hevert testified that while it is unclear whether or to what extent those adjustments would be made to the accounting data relied on by Ms. Phipps, the simple fact that Moody's tends to apply such adjustments calls into question the premise of Ms. Phipps' calculation.[217]

In addition, Moody's presents guidelines for both its "Standard Grid" and its "Low Business Risk Grid" and it is unclear whether or how Ms. Phipps relied on one or both of those "Grids" in developing her 6.40 percentage point adjustment.[218] Assuming the midpoint of the ranges (as Ms. Phipps had done) indicates that the Moody's guidelines imply equity ratios for A-rated companies in the range of 55.00 percent to 60.00 percent.[219] The midpoint of that range, 57.50 percent, is 7.59 percentage points above the 49.91 percent equity ratio that forms the basis of Ms. Phipps' analysis. Applying Ms. Phipps 6.40 percentage point adjustment to the 57.50 percent midpoint produces an

[213] *Id.*
[214] *Id. at* 8:164-10:207.
[215] *Id.*
[216] *Id.*
[217] *Id.*
[218] *Id.*
[219] *Id.*

adjusted equity ratio of 51.10 percent, which itself is 5.51 percentage points above Ms. Phipps' 45.59 percent hypothetical equity ratio.[220] Mr. Hevert concluded that Ms. Phipps analysis is disconnected from the rating agency benchmarks and must be viewed with caution.[221]

### iii. Other Benchmarks

Although the Company believes that its actual capital structure is the correct capital structure for purposes of ratemaking in this case, Mr. Hevert recognized that the Commission may look to other benchmarks as measures of industry practice and, therefore, as measures of a reasonable imputed capital structure and for confirmation that Ms. Phipps' recommended capital structure is over-leveraged.[222] Mr. Hevert noted that the average authorized equity ratio for BBB-rated gas utilities of 50.07 percent, the overall average authorized equity ratio of 51.48 percent, and the 56.40 percent proxy group average equity ratio are all meaningful benchmarks that may inform the Commission's decision.[223] Mr. Hevert stated that although the average of those data points is 52.65 percent, the middle of the three observations noted above (i.e., 51.48 percent) also would be a reasonable basis for an imputed equity ratio.[224] Ms. Phipps' ad hoc proposal is far below any of these more reasonable and straightforward benchmarks.

The evidence in the record fully supports a finding that Staff's proposed imputed capital structure should be rejected. The Company's actual capital structure is just and

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[220] *Id.*
[221] *Id.*
[222] Company Ex. 10.0 at 17:345-19:381.
[223] *Id.*
[224] *Id.*

reasonable, and Staff's reasons for implying a capital structure are invalid. In addition, Staff inappropriately relies on an ad hoc and unsupported method of calculating its imputed capital structure. Ms. Phipps' approach involves a convoluted and non-standard jumble of inconsistent data and methods instead of relying on simple and specific benchmarks. In the event that the Commission decides an imputed capital structure is more appropriate in this proceeding, the benchmarks presented by Mr. Hevert (ranging from 50.07 percent to 56.40 percent) all present a more reasonable basis for determining an imputed capital structure.

### 2. Cost of Common Equity

#### i. Overview

The Company proposes a reasonable and appropriate 10.50% return on equity ("*ROE*"). Staff witness Phipps proposes that the Company's ROE be set at 9.23%. The Company does not agree with Staff's recommended ROE. Liberty Midstates submitted the expert testimony of Mr. Hevert in support of its requested ROE. Mr. Hevert relied on two widely-accepted approaches to develop his ROE recommendation: the Multi-Stage Discounted Cash Flow ("*DCF*") model and the Capital Asset Pricing Model ("*CAPM*").[225] To assess the reasonableness of his DCF and CAPM results, Mr. Hevert also considered the results of a Bond Yield Plus Risk Premium analysis.[226] Mr. Hevert also took into consideration the Company's risk and cost profile, in particular (1) its relatively small size; (2) the regulatory environment in which the Company operates; (3) weather variability; and (4) the direct costs associated with equity issuances.

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[225] Company Ex. 4.0 at 14:258-262.
[226] Company Ex. 4.0 at 15:283-286.

As discussed later in this Section, the evidence demonstrates that the Company's ROE is reasonable and should be adopted.

**ii. Applicable Authority**

Under long established federal and Illinois constitutional law, and Illinois ratemaking law, a utility's rates must be set so as to allow it the opportunity to obtain full recovery of its prudent and reasonable costs of service, including its costs of capital.[227] The legal standards governing a utility's right to a fair and reasonable rate of return, in particular, are well established and familiar. A public utility has a constitutional right to a return that is "reasonably sufficient to assure confidence in the financial soundness of the utility and [is] 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."[228] The authorized return on equity "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."[229] The Commission "fully embraces the principles set forth" in the Bluefield and Hope cases. [230]

Further, Section 9-230 of Illinois' Public Utilities Act (220 ILCS 5) specifically addresses financial involvement with nonutility or unregulated companies:

> In determining a reasonable rate of return upon investment for any public utility in any proceeding to establish rates or charges, the Commission shall not include any (i) incremental risk, (ii) increased

[227] *See* Bluefield Water Works v. Public Service Comm'n, 262 U.S. 679 (1923); Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S 591 (1944).
[228] Bluefield, 262 U.S. at 693.
[229] Hope, 320 U.S. at 603.
[230] Consumers Ill. Water Co., Docket No. 03-0403 at 41(Order April 13, 2004).

> cost of capital […] which is the direct or indirect result of the public utility's affiliation with unregulated or nonutility companies.[231]

Absent substantial defects in a parties' analysis, the Company recognizes that recent Commission orders have shown a preference towards using an average of the parties DCF and CAPM -- i.e. taking the average of the ROE witnesses' DCF results and combining that with the average of ROE witnesses CAPM results and dividing by two.[232] The Commission has emphasized that using such an approach is not an endorsement of every input or rationale presented by the parties.[233] The Commission has previously stated that such an approach "significantly diminishes any perceived upward or downward bias as set forth in the different positions of the parties."[234] Combining Mr. Hevert's 9.60 percent mean DCF result with Staff's 8.00 percent DCF result would produce an average DCF estimate of 8.80 percent.[235] Combining the 10.68 percent average of Mr. Hevert's standard CAPM results with Staff's 9.72 percent average CAPM result would produce an average CAPM estimate of 10.20 percent.[236] The average of those two estimates (8.80 percent and 10.20 percent) is 9.50 percent. However, both Staff and Mr. Hevert have testified that the Company's level of risk, and

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[231] 220 ILCS 5, Public Utilities Act, Section 9-230.
[232] *See A*meren Ill. Co. Docket No. 13-0192 at 166 (Order, Dec. 18, 2013) ("In determining an appropriate ROE in its rate Orders in Dockets Nos. 11-0282, 12-0511/12-0512, and many other rate cases, the Commission has averaged the DCF and CAPM results which were found to be appropriate"); Peoples Gas Light and Coke Co., Docket 12-0512 (Cons) at 208 (Order, June 18, 2013 (finding an averaging method should be used to determine ROE).
[233] *See* Ameren Ill. Co. Docket No. 13-0192 at 163 (Order, Dec. 18, 2013).
[234] *Id.*
[235] Company Ex. 7.0, Schedule 7.1; Staff Ex. 8.0 at 2:35-36.
[236] Company Ex. 7.0, Schedule 7.5; Staff Ex. 8.0 at 3:39-40.

therefore required ROE, is higher than the proxy group's average.[237] Adding Staff's 32 basis point incremental risk adjustment to the 9.50 percent average of the DCF and CAPM estimates, the resulting ROE would be 9.82 percent.[238]

Nonetheless, the Company believes that in this case, the Commission should adopt the Company's proposed ROE of 10.50%. As described below, this approach reflects a more rigorous ROE analysis as well as a reflection of factors specific to the Company's individual circumstances—particularly the judgment that the Company's particular risk profile would indicate that its ROE should be at the high end of the indicated range.

**iii. The Company's Proposed ROE is Based on Widely Accepted Models**

The Company presented the testimony of Mr. Hevert in this proceeding which included the DCF model, CAPM, and the Bond Yield Plus Risk Premium approach.[239] Mr. Hevert's analytical approach reflects certain preferences expressed by the Commission in Docket No. 11-0292 and Docket No. 13-0192.[240] Because the ROE is a market-based concept, and Liberty Midstates is not a publicly traded entity, Mr. Hevert established a group of comparable publicly-traded companies to serve as its "proxy."[241] Mr. Hevert applied these models to this proxy group of comparable gas utilities. Mr. Hevert recognized that the Commission has been inclined to consider both the DCF and

[237] Company Ex. 4.0 at 36:656-46:870; Staff Ex. 3.0 at 35:621-625.
[238] Staff Ex. 3.0 at 35:623-625.
[239] Company Ex. 4.0 at 3-64-78.
[240] *Id.*
[241] *Id.* at 10:187-13:257.

CAPM approach.[242] Accordingly, Mr. Hevert primarily relied on the DCF model and CAPM, and used the Bond Yield Plus Risk Premium analyses as a corroborating methodology.[243] Staff found Mr. Hevert's ROE models and proxy group to be sufficiently reasonable to adopt them in this proceeding, although Staff adjusted certain inputs.[244]

In direct testimony, Mr. Hevert's ROE analyses, using data as of January 31, 2014, included a mean multi-stage DCF result of 9.94% and an average standard CAPM result of 10.38%.[245] Mr. Hevert reviewed the reasonableness of those estimates using a Bond Yield Plus Risk Premium analysis and an alternate CAPM analysis.[246] In rebuttal testimony, Mr. Hevert updated his ROE analyses using data as of July 31, 2014, Mr. Hevert's updated analyses produce a mean multi-stage DCF result of 9.60% and an average standard CAPM result of 10.68%.[247] Based on this analysis, Mr. Hevert determined that a reasonable range for ROE is 10.00 to 10.50 percent. [248] After considering the Company's regulatory and business risks relative to the proxy group, Mr. Hevert stated that 10.50 percent is a reasonable ROE for Liberty Midstates.[249]

Mr. Hevert updated his analysis in his rebuttal testimony to ensure that the Commission is provided with accurate information. [250] Mr. Hevert's recommended ROE remained unchanged following this update and throughout this proceeding.[251]

**a. DCF**

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[242] Company Ex. 4.0 at 8:126-135.
[243] Company Ex. 4.0 at 14:267-270.
[244] *See* Staff Ex. 3.0 at 173-177 (beginning with Mr. Hevert's DCF and CAPM).
[245] Company Ex. 4.0 at 6:115-7:118.
[246] *Id.* at 15:279-286.
[247] Company Ex. 7.0 Revised at 6:98-99.
[248] Company Ex. 7.0 Revised at 54:1018-1025.
[249] Company Ex. 4.0 at 8:126-135.
[250] Company Ex. 7.0 Revised at 4:60-65.
[251] Company Ex. 7.0 Revised at 54:1018-1025; Company Ex. 10.0 at 41:782-788.

The DCF model is widely recognized in regulatory proceedings, as well as in financial literature.[252] The DCF approach is based on the theory that a given stock's current price represents the present value of its expected future cash flows.[253] In its simplest form, the DCF model expresses the Cost of Equity as the sum of the expected dividend yield and long-term growth rate.[254]

Mr. Hevert relies on a form of the DCF model referred to as multi-stage DCF.[255] The multi-stage DCF model sets the subject company's stock price equal to the present value of future cash flows received over three "stages".[256] In the first two stages, "cash flows" are defined as projected dividends.[257] In the third stage, "cash flows" equal both dividends and the expected price at which the stock will be sold at the end of the period (*i.e.*, the "terminal price").[258] Mr. Hevert calculated the terminal price based on the Gordon model, which defines the price as the expected dividend divided by the difference between the Cost of Equity (*i.e.*, the discount rate) and the long-term expected growth rate.[259] In essence, the terminal price is defined by the present value of the remaining "cash flows" in perpetuity.[260] In each of the three stages, the dividend is the product of the projected earnings per share and the expected dividend payout ratio.[261]

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252 Company Ex. 4.0 at 15:296-300.
253 Company Ex. 4.0 at 15:302-16:325.
254 Company Ex. 4.0 at 15:294-297.
255 Company Ex. 4.0 at 17:326-339.
256 *Id.*
257 *Id.*
258 *Id.*
259 *Id*
260 *Id*
261 *Id.*

Staff agreed that the Multi-Stage DCF model should be relied upon, but adjusted certain input assumptions including: (1) removing the “sv” component of the sustainable growth formula; (2) assuming the long-term payout ratio will remain constant after Value Line’s 2017-2019 projection period; and (3) assuming a percent 4.67 long-term growth rate (updated from 4.76 percent in Staff's direct testimony).[262]

Staff’s removal of the “sv” component of the Retention Growth model is not appropriate. The Retention Growth estimate allows for earnings growth through reinvested earnings as well as earnings growth funded through external equity.[263] Ms. Phipps explained that she excluded the “sv” component because she believes Value Line forecasts no new common equity share issuances for the proxy companies.[264] Ms. Phipps' belief that Value Line does not forecast new common equity share issuances for the proxy companies is clearly incorrect.[265] Company Schedule 7.2 shows that Value Line projects six out of nine proxy companies to increase their common shares outstanding from 2014 through the 2016 - 2018 forecast period.[266] Ms. Phipps’ recommendation has not been adjusted to remove this error.

The Company also does not agree with Staff’s assumption that the long-term payout ratio will remain constant. Ms. Phipps stated that historical data may reflect condition that may not continue in the future and alleged that investors are indifferent as to whether their returns come from dividends or capital appreciation.[267] However,

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[262] Staff Ex. 3.0 at 11:182-197; Staff Ex 8.0 at 2:31-35.
[263] Company Ex. 7.0 Revised at 26:493-509.
[264] Staff Ex. 3.0 at 13:220-228.
[265] Company Ex. 7.0 Revised at 27:517-527.
[266] Company Schedule 7.2
[267] Staff Ex. 8.0 at 16:270-277.

companies adjust their payout ratios to reflect changing capital investment cycles.[268] By relying on Value Line's forecasted payout ratios for the 2017-2019 period, Ms. Phipps has essentially picked a point in the proxy companies' capital investment cycles and has assumed it represents the long-term (that is, in perpetuity) expected financing practices of those companies.[269] It is more reasonable to consider historical data (as Mr. Hevert did) that covers a range of capital market conditions and individual utility capital investment levels. The calculation in Mr. Hevert's model represents a reasonably long period and is an appropriate estimate of the expected payout ratio.[270] Ms. Phipps has not suggested any alternative time period, nor has she demonstrated Mr. Hevert's analysis is inappropriate.

Further, payout ratios for gas utility companies are currently at the low end of observed historical levels.[271] It is reasonable to assume the currently low payout ratios are related to the elevated level of capital expenditures the industry is facing in the near term and therefore can be expected to increase over time.[272] Ms. Phipps provided no empirical support for her implicit assumption that there has been a permanent, structural downward shift in natural gas utility company payout ratios. Consequently, it remains reasonable to assume that over the long-term, dividend payout ratios for gas utility companies will converge to their long-term historical median of 68.85 percent.[273]

The Company additionally disagrees with Staff's use of a long term GDP growth rate of 4.67 percent. Ms. Phipps relies on projected real GDP growth estimates from

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[268] Company Ex. 10.0 at 409-434.
[269] Company Ex. 10.0 at 21:411-22:434.
[270] *Id.*
[271] Company Ex. 10.0 at 22:438-439.
[272] *Id.* at 22:438-23:451.
[273] *Id.*

both the Energy Information Administration ("*EIA*") and Global Insight that end from approximately 26 to 30 years from now, while Mr. Hevert considered the long-term average real GDP growth rate over the 1929 to 2013 period.[274] Ms. Phipps' reliance on the EIA and Global Insight's forecasts results in an unreasonably low nominal growth rate in the context of historical growth rates.[275] On the other hand, Mr. Hevert cited to several examples industry literature indicating that investors expect companies to grow at historical average rates.[276] Additionally a 4.67 percent long-term growth rate is not consistent with the growth rate implied by recently authorized ROEs.[277]

Mr. Hevert's analysis is well supported in the record. Mr. Hevert's final DCF calculation provided in rebuttal contained a low of 9.28%, a mean of 9.6% and a high of 10.05%.[278]

**b. CAPM**

The CAPM analysis is a risk premium method that estimates the Cost of Equity for a given security as a function of a risk-free return plus a risk premium (to compensate investors for the non-diversifiable or "systematic" risk of that security).[279] In Docket 13-0192, the Commission stated its preference for (1) Beta coefficients calculated over five years; and (2) the exclusion of non-dividend paying companies from

[274] Company Ex. 10.0 at 23:457-567.
[275] Company Ex. 10.0 at 26:501-505.
[276] Company Ex. 10.0 at 26:506-534.
[277] Company Ex. 10.0 at 28:535-546.
[278] Company Ex. 7.0 at 5:91-6:99.
[279] Company Ex. 4.0 at 24:450-454.

the DCF analysis when calculating the required market return.[280] Mr. Hevert performed his CAPM analyses reflecting those preferences. [281]

Mr. Hevert's approach to estimating the Market Risk Premium ("*MRP*") is based on the market-required return, less the current 30-year Treasury bond yield.[282] To estimate the market required return, Mr. Hevert calculated the market capitalization weighted average ROE based on the Constant Growth DCF model relying on data from two sources: Bloomberg and Value Line. [283] Mr. Hevert selected a 30-year yield because natural gas utilities typically are long-duration investments and as such, the 30-year Treasury yield is more suitable for the purpose of calculating the Cost of Equity.[284]

Mr. Hevert considered two methods of calculating the Beta coefficient. [285] The first approach simply employs the average reported Beta coefficient from Value Line for each of the proxy group companies. [286] Mr. Hevert also calculated Beta coefficients over five years using monthly returns.[287] Mr. Hevert calculated the "raw" Beta coefficient for each member of the proxy group and adjusted those raw Beta coefficients to address the tendency to regress toward the market Beta coefficient of unity. [288] For the purpose of that calculation, Mr. Hevert relied on monthly returns, and performed a regression analysis of the data over the five-year period ended January 31, 2014. [289]

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[280] *See* Ameren Ill. Co., Docket No. 13-0192 at 164-165 (Order, December 18, 2013).
[281] Company Ex. 4.0 at 3:54-63.
[282] *Id.* at 27:486-502.
[283] *Id.* at 27:492-510.
[284] *Id.* at 29:535-539.
[285] *Id.* at 28:503-510.
[286] *Id.*
[287] *Id.*
[288] *Id.* at 28:511:521.
[289] *Id.*

Staff agrees that reliance on the CAPM approach is appropriate, including the use of a 30-day average 30-year treasury yields as the risk-free rate and an MRP based on a similarly derived, forward-looking expected market return.[290] The Company and Staff disagree over (1) the selection of the risk-free rate component of the model; (2) the appropriate Beta Coefficients; and (3) the calculation of the expected return on the overall market, which is used to determine the ex-ante MRP. [291]

Staff witness Phipps claims that it is a flaw to use the forecasted U.S. Treasury bond yield as a proxy for the risk-free rate of return.[292] Mr. Hevert explained that the Cost of Equity is a forward-looking concept. Since the purpose of this proceeding is to establish the Cost of Equity for Liberty Midstates' gas utility operations on a forward-looking basis, it is necessary to develop a CAPM analysis that reflects investor expectations concerning the risk-free rate.[293] Mr. Hevert observed that Ms. Phipps calculates an implied 20-year forward U.S. Treasury yield in ten years of 4.27 percent as part of her calculation of expected inflation using the TIPS spread; that estimate is 71 basis points above the 3.56 percent 30-day average 20-year Treasury yield as of the same date). [294] That calculation clearly shows an expectation of rising interest rates. [295] Blue Chip's near-term forecast of the 30-year Treasury yield, which is the consensus projection of over fifty business economists for the average 30-year U.S. Treasury yield in the coming six quarters, also indicates investors expect interest rates to rise. [296]

[290] Company Ex. 7.0 Revised at 8:125-133.
[291] Company Ex. 10.0 at 587-591.
[292] Staff Ex. 3.0 at 21:363-367.
[293] Company Ex. 10.0 at 31:592-598.
[294] Company Ex. 7.0 Revised at 36:675-37:693.
[295] *Id.*
[296] *Id.*

Expectations for rising interest rates are not surprising given the ongoing tapering of the Federal Reserve's Quantitative Easing program (which was intended to lower long-term rates) that started in December 2013. [297] Therefore, it is appropriate to consider both current and projected 30-year Treasury yields when estimating the risk-free rate component of the CAPM. [298]

Mr. Hevert's primary analyses reflect the Commission's preference for Beta coefficient calculated over five-years. [299] Mr. Hevert also believes it is important to consider Beta coefficient estimates that reflect current and expected levels of systematic risk. [300] Therefore, Mr. Hevert also performed an alternate set of CAPM analyses using Bloomberg Beta coefficient which are calculated over two-years and regression Beta coefficient calculated over 18-months. [301] Staff believes the alternate CAPM Beta coefficients are calculated over too short of a time period to be reliable and are "more prone to measurement error arising from short-term changes in risk and investor risk preferences".[302]

Mr. Hevert noted that a five-year period is not required to calculate beta. [303] Mr. Hevert observed Ms. Phipps' Beta coefficient estimates do not cover a full business cycle.[304] Looking at Beta coefficients over differing periods, as Mr. Hevert has done, is entirely consistent with industry practice and provides additional information and

[297] *Id.*
[298] *Id.*
[299] Company Ex. 7.0 Revised at 39:730-736.
[300] *Id.*
[301] *Id.*
[302] Staff Ex. 3.0 at 27:482-28:484.
[303] Company Ex. 7.0 Revised at 39:737-40:763.
[304] Company Ex. 7.0 Revised at 40:773-41:778.

perspective that should not be disregarded. [305] Ms. Phipps' concern about statistical relevance overlooks the fact that Mr. Hevert's 18-month Beta coefficient relies on more observations than at least two of Ms. Phipps' estimates. [306] Ms. Phipps' regression Beta and Zacks' Beta coefficients compare the monthly returns of a given company relative to a market index (*i.e.*, five years result in 60 observations), Mr. Hevert compares the monthly returns of the subject company to the S&P 500 on a daily basis (*i.e.,* the monthly returns for each trading day in the 18 months, which results in 379 trading days). [307]

The MRP estimates in Mr. Hevert's analyses are quite reasonable relative to the observed MRPs from 1926 to 2013. Staff witness Phipps' suggestion that these estimates are too high fails to recognize that the mean and median long-term Treasury yields over the same period were substantially higher (5.09 percent and 4.26 percent, respectively). [308] Given that the MRP is calculated as the expected market return less the yield on long-term government bonds, it is quite reasonable for the current MRP to be moderately above the long-term average.[309]

Moreover, taking into consideration the volatility of historical MRPs, even the highest of Mr. Hevert's MRP estimates is statistically indistinguishable from the historical mean at a 95.00 percent confidence interval.[310] Therefore, Mr. Hevert's *ex-ante* market-DCF derived MRPs used in his CAPM analyses are reasonable.

[305] Company Ex. 7.0 Revised at 43:812-814.
[306] *Id.* at 43:815-836.
[307] *Id.*
[308] Company Ex. 10.0 at 35:668-686.
[309] *Id.*
[310] *Id.* Assuming a 10.32 percent mean MRP estimate, 88 MRP observations, the 6.95 percent mean MRP, and the 20.29 percent historical standard deviation.

### c. Bond Yield Plus Risk Premium

Mr. Hevert used the Bond Yield Plus Risk Premium method to corroborate the reasonableness of his DCF and CAPM estimates. This approach is based on the basic financial tenet that, since equity investors bear the residual risk associated with ownership and therefore require a premium over the return they would have earned as a bondholder. [311] That is, since returns to equity holders are more risky than returns to bondholders, equity investors must be compensated for bearing that risk. [312] Risk premium approaches, therefore, estimate the Cost of Equity as the sum of the equity risk premium and the yield on a particular class of bonds. [313]

Mr. Hevert first defined the Risk Premium as the difference between authorized ROEs and the then-prevailing level of long-term (*i.e.*, 30-year) Treasury yields. [314] Next, Mr. Hevert gathered data from 988 natural gas rate proceedings between January 1, 1980 and January 31, 2014. [315] In addition to the authorized ROE, Mr. Hevert calculated the average period between the filing of the case and the date of the final order (the lag period). [316] In order to reflect the prevailing level of interest rates during the pendency of the proceedings, Mr. Hevert calculated the average 30-year Treasury yield over the average lag period (approximately 187 days).Because the data covers a number of economic cycles, the analysis also may be used to assess the stability of the Equity Risk Premium.[317] Prior research, for example, has shown the Equity Risk Premium is

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[311] Company Ex. 4.0 at 32:585-33:597.
[312] *Id.*
[313] *Id.*
[314] *Id.* at 33:600-607
[315] *Id.*
[316] *Id.*
[317] *Id.* 33:608-609.

inversely related to the level of interest rates.[318] This analysis is particularly relevant given the relatively low, but increasing level of current Treasury yields. [319]

The results of this approach results in an implied ROE between 10.17 percent and 10.68 percent. [320] While the Commission has not relied on returns authorized to other utilities when determining the appropriate authorized ROE for a particular utility, it has recognized the value of observing general market conditions and trends, including the recent average of authorized ROEs, when assessing parties ROE recommendations.[321]

**iv. Staff's ROE Recommendation Is Not Reasonable**

Prior to a 32-basis point credit rating adjustment, Staff is recommending an ROE of 8.91% which is below recently authorized natural gas ROEs in Illinois and other jurisdictions. Staff's unduly low ROE estimate was determined by giving 50% weight to a multi-stage DCF result of 8.26% (updated to 8.00% in rebuttal testimony), which is more than 80 basis points below the lowest authorized ROE for a natural gas utility since at least January 2013.[322] Even after applying a 32 basis point upward adjustment to Ms. Phipps' ROE estimate to reflect the Company's relatively lower credit rating compared to the proxy group average credit rating, Ms. Phipps' 9.32% ROE recommendation is well below the average authorized natural gas ROE since January 2013 of 9.65%.[323]

[318] *Id.* at 33:309-34:612.
[319] *Id.*
[320] *Id.* at 35:634-638.
[321] Peoples Gas and Light Co., Docket 12-512 at 205 (Order, June 18, 2013).
[322] Company Ex. 7.0 Revised at 4:70-79.
[323] *See* Schedule 7.13.

Staff's unreasonably low ROE estimate is due to notable flaws in Staff's analysis that were addressed in the testimony of Mr. Hevert. Most significantly, Staff's Non-Constant Growth DCF result relies on the unfounded assumption that near-term projections from Value Line (for dividend payout ratios) and medium-term projections from the Energy Information Administration and Global Insights (for real GDP growth) reflect investors' expectations for the long-term (i.e., in perpetuity).[324] Mr. Hevert, on the other hand, relied on the more reasonable assumption that earnings growth and dividend payout ratios would revert toward long-term observed historical averages over time.[325]

Ms. Phipps' DCF analysis is also fundamentally flawed because of her mistaken exclusion of the "sv" component based on her demonstrably incorrect belief that Value Line does not forecast new common equity share issuances for the proxy companies.[326]

Additionally, Staff's CAPM model failed to recognize market expectations for rising interest rates. Mr. Hevert's analysis, however, reflects the consensus view of over fifty business economists surveyed for Blue Chip's monthly Financial Forecast publication. [327]

### C. Recommended Overall Rate of Return

The Company recommends that the Commission adopt an overall rate of return of 7.97% as set forth below:

| | Proportion | Cost | Weighted Cost |
|---|---|---|---|
| Short Term Debt | 0.46% | 1.41% | . 0.01% |

[324] Company Ex. 7.0 at 28:542-29:552; Company Ex. 10.0 at 25:472-26:505.
[325] Company Ex. 7.0 Revised at 32:598:612; Company Ex. 10.0 at 27:499-:28:534.
[326] Company Ex. 7.0 Revised at 27:517-527.
[327] *Id.* at 36:683-37:687.

| | | | |
|---|---|---|---|
| Long Term Debt | 39.44% | 4.81% | 1.65% |
| Common Equity | 60.10% | 10.50% | 6.31% |
| Total | 100.00% | | 7.97% |

Pursuant to Condition 9 of Docket 11-0559 and as described in Section 4.D below, the actual revenue requirement attributable to the Company's cost of capital may, however, be reduced.

**D. Ability to Satisfy Docket No. 11-0559 Condition**

In Docket 11-0559, the Commission ordered that:

> For the next rate proceeding for Liberty Energy Midstates, the pre-tax cost of capital will be set using no higher than the lower of (1) the pre-tax cost of capital that Liberty Energy Midstates would have had if (a) its debt to equity ratio was the same as Atmos' equity ratio as of September 30, 2011 (including short-term debt), and (b) the cost of its debt were the same as the cost of debt held by Atmos on September 30, 2011, and (2) the pre-tax cost of capital based on the actual capital structure of Liberty Energy Midstates. The FERC Form 2 Annual Report for the year ended December 31, 2011 will be used as the basis for the purpose of calculating the cost of debt for Atmos. (Section 7-204(b)(7)).[328]

Accordingly, Condition 9 may impose a limitation on weighted cost of capital that the Company may recover in this case. The Commission identified two possible approaches to determining the pre-tax cost of capital, one using the Company's actual capital structure, and one using its predecessor's capital structure and cost of debt. The Company is required to use the lower of the two. Therefore if the Company's actual capital structure results in a lower pre-tax cost of capital, no adjustment is necessary. If, however, the Company's actual capital structure results in a higher pre-tax cost of

[328] Atmos Energy Corporation and Liberty Energy (Midstates) Corp., Docket 11-0559 (Order, Appendix A, June 27, 2012).

capital, an adjustment is necessary to reduce the cost of capital in this case to that which would be determined using its predecessor's capital structure and cost of debt.

The Company presented a calculation of the Condition 9 adjustment under its actual capital structure as well as the three benchmark capital structures identified by Mr. Hevert.[329] Because that calculation contained a clear error—the Company's cost of debt was transposed from 4.81 percent to 4.18 percent—the Company has attached a revised calculation as Attachment B to its brief.[330] Based on the revised schedule, the use of the Company's actual capital structure, cost of equity and rate base, the overall revenue requirement would need to be adjusted downwards by $344,918 to reflect the application of Condition 9.

Of course, this downward adjustment would need to be reduced or eliminated in the event the inputs to the calculation, such as the capital structure used in this case, the cost of equity, and the rate base, are different than those set forth in Attachment A.

## **V. COST OF SERVICE - Uncontested**

The Company presented a cost of service ("*COS*") study in the direct testimony of Mr. Long.[331] The Company's COS study shows by customer class the distribution of revenue responsibility necessary to achieve equalized rates of return on investment at the Company's proposed revenue requirement.[332] The study identifies the revenues, costs, and profitability for each customer class.[333] It also serves as a partial basis for the

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[329] Company Ex. 10.0 at 19:378-387.
[330] Because the Company's cost of debt is higher than was indicated in the original calculation, Attachment B represents an additional reduction to revenue requirement. In other words, the revised Attachment B is unfavorable from a revenue perspective to the Company.
[331] Company Schedule 3.1.
[332] Staff Ex. 4.0 at 5:85-92
[333] *Id.*

Company's proposed rate design.[334] Generally, Mr. Long prepared the COS study utilizing three major steps: (1) functionalization; (2) cost classification; and (3) cost allocation of all the cost of the utility's system to customer classes.[335]

Staff did not object to the Company's COS, nor did Staff present its own COS. Staff witness Boggs concluded the Company's COS study appropriately assigns costs to the various functions and rate classes.[336]

## VI. <u>RATE DESIGN - Uncontested</u>

### A. Overview

The Company and Staff agreed that the Company's proposed rate design is reasonable and should be adopted.[337] The Company did not base the customer charges strictly on the COS study.[338] Instead, the Company used what it described as a "sensitivity allocation" approach to determine customer charges for each class of service.[339] Under this approach, the Company applied the overall 38.54% revenue increase only to the residential class.[340] The other proposed revenue increases applied by the Company were 41.32% to the commercial class and 20% to the industrial class.[341] Company witness Long stated this approach used both the iterative process as well as his professional judgment to mitigate the extreme results of other approaches.[342] Mr. Long explained that his main consideration for this approach is the very small

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[334] *Id.*
[335] *Id.*
[336] Staff Ex. 4.0 at 13:254-260.
[337] Staff Ex. 4.0 at 22:427-428; Company Ex. 6.0 at 18:403-19:409.
[338] *Id.* at 16:318-327.
[339] *Id*. at 17:329-344.
[340] *Id.*
[341] *Id.*
[342] *Id;* Company Ex. 4.0 at 44:944-966.

industrial class that consists of only eight customers.[343] Mr. Long explained that a purely cost based revenue allocation would produce a large rate increase for this class.[344] Mr. Long used the class revenue allocations and the billing determinants from the forecasted test year to calculate the amount needed on a monthly basis from each customer class to recover the customer-related costs related to providing natural gas service.[345]

Staff witness Boggs testified that he assessed the proposed class revenue allocations and proposed customer charges presented by the Company. Mr. Boggs compared the proposed rates with the rates that would result based on the COS study.[346] Mr. Boggs determined that under a strictly cost-based approach, residential customer charges would nearly double from their current levels.[347] For commercial customers the customer charge would decrease but usage charges would more than double.[348] For the industrial classes, customer charges would have increased four-fold and usage charges would have to more than triple to meet the proposed test year revenue requirement.[349] Mr. Boggs concluded that cost based rates shaped solely by the COS study would produce excessive increases to the industrial class customer charge and usage charge such that the needed increases would most likely have an adverse impact on the monthly bills of the eight industrial customers.[350] Mr. Boggs

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343 Company Ex. 4.0 at 44:944-966.
344 *Id;* Staff Ex. 4.0 at 17:343-344
345 Staff Ex. 4.0 at 17:348-18:352.
346 Staff Ex. 4.0 at 18:356-359.
347 *Id*. at 20:375-383.
348 *Id.*
349 *Id.*
350 *Id.* at 20:385-21-393.

further stated the decline in the commercial class customer charge indicates a different rate design could be developed.[351]

Mr. Boggs then concluded that the rate design proposal presented by the Company is the most appropriate.[352] Mr. Boggs noted that the Company's proposal still requires large percentage increases in the customer charge for each customer class.[353] Mr. Boggs recommended that the Commission approve the Company's rate design and revenue allocation proposal.[354] Mr. Boggs noted that after fifteen years without any rate increases, the cost to serve Liberty Midstates customers has increased considerably and all customers will receive a significant increase.[355]

**B. Residential**

The Company proposed to increase the current $9.90 customer charge to a $23.00 fixed monthly customer charge and initially proposed a per therm usage charge of $.02459.[356] Staff recommended that the Commission approve the Company's proposed customer charge and that the remainder of the revenue requirement, as adjusted by the Commission, be collected through the usage charge.[357] The Company agreed with Staff's recommendation.[358]

**C. Commercial**

The Company proposed to increase the current $25 customer charge to an $80.00 fixed monthly customer charge and initially proposed a per therm usage charge

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[351] *Id.*
[352] *Id*. at 21:397-410.
[353] *Id.*
[354] *Id.* at 22:427-432.
[355] *Id.*
[356] Company Schedule 3.4.
[357] Staff Ex. 4.0 at 22:425-23:445
[358] Company Ex. 6.0 at 19:404-408.

of $.2244.[359] Staff recommended that the Commission approve the Company's proposed customer charge and that the remainder of the revenue requirement, as adjusted by the Commission, be collected through the usage charge.[360] The Company agreed with Staff's recommendation.[361]

### D. Industrial

The Company proposed to increase from the current $100 customer charge to a $200 fixed monthly customer charge and initially proposed a per therm usage charge of $.3450.[362] Staff recommended that the Commission approve the Company's customer charge and that the remainder of the revenue requirement, as adjusted by the Commission, be collected through the usage charge.[363] The Company agreed with Staff's recommendation.[364]

### E. Customer Classes 150, 190, 191, and 192

Liberty Midstates currently has no customers under Customer classes 150, 190, 191, and 192.[365] The Company stated that it did not intend to update or eliminate these customer classes because a new customer in the future may take services under these classes.[366] Staff witness Boggs recommends in the event a new customer takes services under one of the aforementioned customer classes, that the Company be

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[359] Company Schedule 3.4.
[360] Staff Ex. 4.0 at 22:425-23:445.
[361] Company Ex. 6.0 at 19:404-408.
[362] Company Schedule 3.4.
[363] Staff Ex. 4.0 at 22:425-23:445.
[364] Company Ex. 6.0 at 19:404-408.
[365] Staff Ex. 4.0 at 23-447-459.
[366] *Id.*

required to perform a new COS study.[367] The Company agreed with Staff's recommendation.[368]

### F. Conclusion

The evidence in the record fully supports a finding that the rate design agreed to between Liberty Midstates and Staff is appropriate.

## VII. OTHER

### A. Quality of Future Rate Filings and Reports

Staff witness Knepler recommended that the Commission put Liberty Midstates on notice that the quality of its supporting data must improve in its next rate case.[369] Mr. Krygier testified that this proceeding presented unique challenges that are not anticipated to be present in future rate cases.[370] Mr. Krygier noted that the Company's longer operating history at the time of next rate case will enable it provide the Part 285 schedules entirely from its own records, eliminating delays in retrieving data from its predecessor.[371] Mr. Krygier identified Liberty Midstates' short operating history and the more than fourteen years since its predecessor's last rate case as challenges in this proceeding.[372] Mr. Krygier stated that Liberty Midstates has the ability to and will provide more complete supporting documentation in its next rate case filing.[373] The Company has every incentive to provide more complete supporting documentation in its next rate case due to the burden of proof placed on Liberty Midstates by Section 9-

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[367] *Id.* at 26-503-506.
[368] Company Ex. 6.0 at 19:404-408.
[369] Staff Ex. 1.0 at 14:227-279.
[370] Company Ex. 5.0 at 23:501-24:521.
[371] *Id.*
[372] *Id.*
[373] *Id.*

201(c). Further, the Commission already has in place procedures to ensure that the Commission has the necessary data for it to make a determination.[374] In fact, those procedures were followed to rectify deficiencies in this case to ensure that the Commission had all necessary information. Mr. Krygier did express that Liberty Midstates understood that the process was not ideal from Staff's perspective, and highlighted Staff's cooperation and efforts in working with the Company in this case.[375]

Staff witness Knepler additionally asserted that the Commission should require Liberty Midstates to provide certain supplemental ILCC Form 21 information beyond what is required by Form 21.[376] Mr. Krygier expressed concerns that the adoption of Company-specific requirements based on the unique circumstances for this rate case will subject it to a regulatory regime that is not applicable to any other utility and that it may be administratively difficult to comply with.[377] The Company believes that changes to the Form 21 requirements may be better suited for a rulemaking proceeding. Subject to the Company's concern, Mr. Krygier indicated it believes it could use reasonable efforts to comply with making certain otherwise inapplicable Form 21 requirements applicable to the Company as proposed by Staff.[378] Mr. Krygier urged that in the event the Commission adopts Staff's proposal, that it be limited in time to the next rate case filed by the Company, after which the need for any such obligations could be re-assessed.[379]

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[374] *See* 83 Ill. Adm. Code § 285.145.
[375] Company Ex. 5.0 at 23:518-24:521.
[376] Staff Ex. 1.0 at 14:280-283.
[377] Company Ex. 8.0 at 12:248-257.
[378] *Id.*
[379] *Id.*

The Company is willing to use reasonable efforts on an informal basis to provide Staff with requested information (making certain otherwise inapplicable Form 21 requirements applicable to the Company) between now and the next rate case. The Company, however, suggests that imposing Company-specific Form 21 requirements in the context of a rate case bypasses the more structured approaches to rulemaking from which the Form 21 requirements originate. Company-specific requirements are also difficult to interpret other than on a reasonable efforts basis, because Commission guidance on interpretation of one set of rules would not apply to these special requirements applicable only to the Company.

### B. Property Taxes – Request for Deferred Accounting

The Company will establish a new office building in Vandalia during the test year.[380] The Company states that property taxes will not be assessed until the following year.[381] Staff asserts this timing difference means the Company cannot recover property taxes in rates resulting from this proceeding because the first time taxes will be incurred falls outside the test year.[382]

The Company did not contest Staff's position regard the incorporation of these taxes into rates in this case. However, the Company seeks approval to treat the property taxes paid on this property between now and its next rate case as a regulatory asset for which it can seek recovery separately in its next rate case proceeding.[383] Mr. Long testified this is appropriate because the taxes are recurring costs of determinable amounts, they are used to provide service, and they are relatively large for a utility of

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[380] Company Ex. 6.0 at 9:187-188.
[381] *Id.* at 9:189-191.
[382] Staff Ex. 1.0 at 9:171-175.
[383] Company Ex. 6.0 at 9:198-201.

the Company's size.[384] In addition, Mr. Long stated that this is a unique circumstance because the test year happens to be the first year in which the building operates and it is only during this year that the property taxes are not assessed[385]. In any other year, the property taxes will be assessed and paid.[386]

Staff witness Knepler alleges that treatment of these taxes as a deferred asset was precluded by the Commission's decision in Docket 98-0895 regarding Y2K costs.[387] The facts of this proceeding are distinguishable from Docket 98-0895. As Mr. Long noted, unlike the property taxes for which the Company is requesting deferred asset treatment, the Y2K costs involved one-time non-recurring costs that would not be incurred year after year.[388]

The evidence in the record fully supports a finding that Liberty Midstates should be entitled to treat the property taxes related to the Vandalia office building as a regulatory asset for which it can seek recovery separately in its next rate case proceeding.

## VIII. CONCLUSION

Therefore, Liberty Midstates, for all the reasons set forth above, appearing in the record, or reflected in the Company's draft proposed order, respectfully requests that the Commission enter findings and make conclusions on all uncontested and contested issues consistent with the Company's positions.

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[384] Company Ex. 9.0 at 5:91-97.
[385] *Id.*
[386] *Id.*
[387] Staff Ex. 6.0 at 12:238-13:255.
[388] Company Ex. 9.0 at 4:73-81.

Respectfully submitted,

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

__/S/______________________________
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