**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 REPLY BRIEF**

TABLE OF CONTENTS

# I. INTRODUCTION

## A. Overview / Executive Summary

Both Staff and Liberty Midstates recognize that, as a result of the fifteen-year gap between rate case test years[1] the Company has been significantly underearning since it began operations.[2] The rates initially proposed by the Company represent an increase of less than 2.5 percent per year and based on reductions agreed to by the Company have dropped even lower on an annual basis.[3] The Company has demonstrated that its proposed rates are reasonable and will enable it to continue to provide safe and reliable gas utility service. The Company's positions on the few remaining open issues are supported by the record and by law, and the Commission should find in its favor on each of them.

## B. Procedural History

## C. Test Year

## D. Legal Standard

# II. RATE BASE

## A. Resolved Issues

### 1. Interest Synchronization Calculation

### 2. Budget Payment Plans

### 3. Utility Plant - Meters

### 4. Average Net Plant

[1] *See* Company Initial Brief at 1.
[2] *See*, *e.g.*, Staff Initial Brief, Appendix A, page 1 Columns (b) and (d), indicating the Company's current negative net operating income under either party's position.
[3] *See* Company Ex. 1.0 at 8:176-181.

### 5. Accumulated Deferred Income Taxes

### 6. Original Cost Determination

### 7. Cash Working Capital

## B. Contested Issues

### 1. Average Net Plant

Staff continues to propose that the Commission compute the components of rate base as an average balance. The Company disagrees with Staff's proposed adjustment and recommends that the components of rate base be calculated using the year-end balances. Staff claims that the Company "incorrectly assumes for rate setting purposes, that all investments are made at the beginning of the test year."[4] This is not at all what the Company assumes. Rather, the Company assumes that rate base should include all investments made throughout the test year.

Staff states that "[a] test year is a time period used to develop costs representative of the first year in which rates being set will be in effect."[5] Staff is wrong that the purpose of a test year is limited to the first year in which rates are in effect. The Commission has stated that "[g]enerally speaking, the test year is utilized so that revenues and expenses are matched relatively well for *the period when rates will be in effect*."[6] In fact, in a docket involving a future test year, the Commission has previously considered whether rates set in the test year are representative of future periods

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[4] Staff Initial Brief at 6.
[5] Staff Initial Brief at 6. Staff did not cite any case law in support of its assertion in its Initial Brief nor in the testimony cited in the Initial Brief.
[6] Ill. Am. Water Co., Docket 09-0319 at 87 (Order, April 13, 2010)(emphasis added).

beyond the test year.[7] The rates set in this case will be in effect presumably for years after the end of the test year and the end of the first year following the adoption of new rates. Staff's recommendation of an average rate base is based on its misunderstanding of the purpose of a test year and therefore should not be given weight.

Perhaps because of its misunderstanding of the purpose of the test year, Staff's initial brief did not address any of the unique facts and circumstances in this particular case that were explained in detail in the record. Particularly, Staff did not address the fact that that Liberty Midstates' operating and financial situations are drastically different from the larger utilities in the dockets cited by Staff.[8] The Company's initial brief noted that its capital 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.[9] Instead, Liberty Midstates must aggregate its capital needs and obtain funding in advance for plant.[10] 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.[11] While this issue exists for Liberty Midstates in any case, using average net plant exacerbates the problem more than using end-of-year balances.[12] Although Staff's initial brief (and Staff witness testimony) cited cases that made clear that use of average rate base or year-end rate base was to be decided on a case-by-case basis, Staff's initial brief did not address any of the

[7] *Id.* (rejecting a capital structure that was arguably reasonable for the test year because it may not be representative of future periods).
[8] Company Ex. 6.0 at 17:365-382.
[9] *Id*. at 17:373-382.
[10] *Id.*
[11] *Id.*
[12] *Id.*

particular facts at issue in this case. And those facts show that, in this case, rate base should be measured at year end.

Contrary to Staff's claim, the Company's proposal to use year-end ratebase is not "deeply flawed." The Company will significantly underearn even during the test year, until approximately early March 2015 when the rates set in this proceeding are expected to go into effect.[13] 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.[14] Use of average rate base would understate rate base for nearly all of the time that rates are in effect.[15] Such an effect would be contrary to the Commission stated purpose of a test year.

In light of the unique and compelling facts of this case, the Company submits that the Commission's previous description of this issue as a "close issue" would effectively be rendered meaningless if a year-end rate base is not adopted in this proceeding. The Company has shown that its rates should take into account all of the investment that it will make in the test year.

**2. Accumulated Deferred Income Taxes**

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

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[13] *Id.* at 7:151-8:165.
[14] *Id.*
[15] *Id.*

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*"); and (2) $16,585 of capital related to the Short Term Incentive Plan ("*STIP*") and the Shared Bonus Pool Program ("*SBPP*").[16] Under the discussion of operating expenses, Staff witness Ostrander recommends corresponding disallowances for the operating expense portion of the LTIP, STIP and SBPP.[17] The Company 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 Commission should reject Staff's proposed adjustment to incentive compensation.

## 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.

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[16] Staff Schedule 7.03.
[17] *Id.*

## III. OPERATING REVENUES AND EXPENSES

### A. Resolved Issues

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

#### 2. Outside Professional Services

#### 3. Rate Case Expense

The amount of rate case expense is not disputed by the Company and Staff.[18] Staff witness Phipps points out that the Company's estimate for Sussex Economic Advisors ("*SEA*") could be too low, because the Company's actual expenditures for work by SEA to date is almost equal to the total forecasted amount, and because SEA did additional work that was not originally anticipated during the case.[19] However, these comments are irrelevant to the proceeding given that the Company is not proposing that any additional amounts be added to the rate case expense amounts that the parties have agreed upon and that there is no disputed issue regarding rate case expense. The Company does not believe the comments need to be addressed further.

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

#### 5. Depreciation Expense

### 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

[18] Staff Initial Brief at 10-13; Company Initial Brief at 18-20.
[19] Staff Initial Brief at 11.

below, the Commission should reject Staff's adjustments to the uncollectible expense rate. With respect to the state income tax rate, the Commission should either reflect future legislative developments, or absent definitive action, reject Staff's proposed adjustment on this point.

#### a. State Income Tax Rate

As noted by Staff, a procedure is in place to present any new legislation on the state income tax rate prior to the Commission's Order. Ideally, this legislation will be enacted prior to the time the Commission must render its determination. In that case the Company and Staff agree that the General Assembly's action would be incorporated into the record. In the event the General Assembly does not act in time, the Commission should conclude that 9.5 percent is the appropriate test year state income tax rate for the reasons set forth in the Company's initial brief. Liberty Midstates incorporates by reference its Section III.B.1.a arguments from its initial brief.

#### b. Uncollectible Expense Rate

Staff continues to propose an uncollectible expense rate of 0.51 percent based on the five most recent historic years 2009-2013.[20] Staff's proposed adjustment should be rejected because it relies on clearly erroneous data, does not take into consideration the Company's recent actual experience, and fails to consider the likely effects of future increases.[21]

Staff's reliance on clearly inaccurate data from 2010 is troublesome. The 2010 data indicates a negative level of uncollectible expense. There is nothing in the record to explain how such a negative amount could arise and Staff's brief fails to address this

[20] Staff Initial Brief at 13-14.
[21] Company Ex. 9.0 3:57-6:112.

anomaly. Staff's five-year average additionally ignores the more recent data used by the Company which indicates a significantly higher level of uncollectible expense, 1.03 percent. The more recent data is a better indicator of the level of uncollectible expense that would be expected to occur in the test year. Staff's data reaches back to 2009 and is simply too far removed the 2015 test year to be considered relevant. Staff's approach illogically assumes there will be an over 50 percent reduction in the level of uncollectibles from the most recent actual data. Staff's excessive adjustment is even more troubling when the likely 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 is considered.[22]

Staff also presented two additional averages: (1) the average for the four most recent years (2010-2013), and (2) the average uncollectible rate for the period 2009 through 2013 but excluding the high year of 2013 and the low year of 2010.[23] Both of Staff's alternative calculations contain similar flaws to its five-year average. Staff's four-year average relies on the same clearly inaccurate 2010 data. Staff's second alternative method inappropriately excludes the most recent data from 2013, which is actually the most relevant and most reliable figure.[24] 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.[25] Further, the high and low year exclusion method would only rely on five months of operations by Liberty Midstates

[22] *Id.*
[23] Staff Initial Brief at 14.
[24] Company Ex. 8.0 at 4:73-80.
[25] *Id.*

itself.[26] All of the other data is from a different company and may be derived using different methodologies (or may simply be inaccurately low).[27]

Staff incorrectly states that the Company's estimate "was based upon the average uncollectible rate for the three historical years 2011-2013 of 0.68 percent plus .02 percent for the expected rate impact from the instant proceeding."[28] The Company only calculated the three-year average in response to Staff's concern about year-to-year fluctuations.[29] Had the three year average indicated that there was something severely wrong with the Company's estimate, the Company would have considered revising the estimate. As it stood, the three-year average corroborated the reasonableness of Liberty Midstates' estimate.[30]

Instead, Liberty Midstates' estimate of test year uncollectible expense was based on the Company's most recent actual experience from 2013. The Company applied downward adjustment to the 1.03 percent 2013 actual data to reflect the Company's expectation that it will be able to increase collections over time.[31] This adjustment was tempered by the Company's estimation that uncollectibles will rise after the first rate increase in over a decade.[32]

The Company's estimate is the only approach in the record that considers the facts and circumstances applicable to this proceeding. Staff seeks to apply a formulaic approach to determining the Company's uncollectible rate without looking at any of the

[26] *Id.*
[27] *Id.*
[28] Staff Initial Brief at 13.
[29] *See* Company Ex. 5.0 at 4:77-87.
[30] *Id.*
[31] Company Ex. 8.0 at 4:81-5:90.
[32] *Id*.

individual circumstances of this case. Staff's brief (and its proposed calculation) failed to address: (1) the clearly erroneous data; (2) the Company's most recent actual experience; and (3) the likely effect of the future rate increase. Based on the facts in this proceeding, including historical data, the Company's best estimates, and identifiable and specific circumstances applicable to the test year, the Company's proposal of 0.70 percent represents the best estimate of uncollectible expense for the test year.

**b. 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; and (2) $38,530 of costs related to the STIP and SBPP consisting of $21,962 of expenses and $16,568 of capital.[33] Staff's proposed adjustment is not supported by the record and should be rejected.

The Company agrees with Staff that the Commission standard for recovery of incentive compensation is that such plans provide tangible benefits to ratepayers. The Company has met this standard. The Company presented evidence that financial metrics provide benefits by encouraging more efficient operations, the benefits of which ultimately flow to customers.[34] Efficiency is encouraged because the Company's financial metrics are not only impacted by revenues, but costs as well.[35] Ratepayers directly benefit from the cost controls incentivized by the Company's financial metrics.[36]

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[33] Staff Ex. 5.0, Schedule 5.01.
[34] Company Ex. 5.0 at 16:351-357.
[35] *Id*.
[36] *Id*.

Additionally, customers benefit from the financial health and stability of the utility and encouraging workers to enhance that stability should be encouraged.[37]

Staff's initial brief does not address any of the factors presented by the Company. Staff simply provides a blanket assertion that the Company has not demonstrated that its plan produce tangible benefits. Staff has not identified any reason why the evidence presented by the Company does not provide tangible benefits to ratepayers, nor has Staff provided a citation to the record. Accordingly, the Commission should reject Staff's proposed adjustment.

### C. Recommended Operating Income / Revenue Requirement

'Appendix A to Staff's initial brief accurately reflects the Company's calculation of the revenue requirement in page one of Appendix A to Staff's initial brief at column identified "Company Rebuttal Pro Forma Present."

## IV. <u>RATE OF RETURN/COST OF CAPITAL</u>

### A. Resolved Issues

#### 1. Short-Term Debt Ratio

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

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

Staff's suggestion that the Company did not provide supporting documentation for its debt is not accurate.[38] The cost of debt proposed by the Company was based on Liberty Midstates' issuances and equaled 4.43 percent.[39] The Company provided support for its proposed cost of debt. Staff subsequently proposed that Liberty Midstates

[37] *Id.*
[38] *See* Staff Initial Brief at 18.
[39] Schedule D-3 (Second Deficiency Response).

cost of debt be determined using additional non-utility issuances made by Liberty Utilities Co. ("*LUCo*")[40]. Understandably, the Company did not initially provide supporting documentation for these non-utility issuances because the Company did not propose using this method. However, for the purposes of this proceeding and in order to narrow the issues in the case, the Company agreed to Staff's calculation of long-term debt. Any lack of support cited by Staff applies to Staff's calculation, not to the Company's proposal. As this is not a contested issue the Company will not address it further.

## B. Contested Issues

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

#### a. Overview

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."[41] Staff has not presented a sufficient justification for the Commission to depart from the Company's just and reasonable actual capital structure. Staff misstates the law with respect to Section 9-230 and reaches factual conclusions that are unsupported by the record.

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[40] Staff refers to the Liberty Utilities Co. as "LUC." Consistent with Staff's request in Section VII that a consistent naming convention be used in Commission Dockets, the Company has identified Liberty Utilities Co. as LUCo. The "LUC" designation referred to by Staff is commonly used by the Company in other dockets to refer to Liberty Utilities (Canada) Corp. and to avoid confusion the Company has not used that designation to refer to LUCo.

[41] 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)).

In the event the Commission determines that Liberty Midstates' capital structure should be imputed, the Commission should not adopt Staff's proposed capital structure. Staff's proposed imputed capital structure relies on unsound methodology that is not supported by Commission precedent or financial literature. If the Commission were to adopt Staff's recommendation, it would only further increase the Company's financial risk and, therefore, its cost of capital. Instead, if the Commission does not use the Company's actual capital structure, it should look to the benchmarks presented Mr. Hevert.

**b. Section 9-230**

Staff claims that Liberty Midstates' actual capital structure would violate Section 9-230.[42] Staff is incorrect. Liberty Midstates' cost of capital does not include any incremental risk or increased cost of capital which is the direct or indirect result of its affiliation with unregulated or nonutility companies. To begin with, LUCo's subsidiaries are almost entirely regulated utilities. Second, the non-regulated power generation unit held by Algonquin Power & Utilities Corp. ("*APUC*") generally sells that power to utilities under long-term contracts.[43] Consequently, there is no reason to believe that the power generation unit has merchant or other unregulated risk that is reflected in APUC's capital structure.

Staff claims that Liberty Midstates proposes to increase its rate of return by using the cost of debt of LUCo with its actual common equity ratio.[44] To begin with, Staff is incorrect that the Company proposed using LUCo's cost of debt of 4.81 percent. As

[42] Staff Initial Brief at 19-20.
[43] *See* 285.305(l) at Schedules A and B.
[44] Staff Initial Brief at 20.

noted in Section IV.A.3, the Company proposed a cost of debt based solely on Liberty Midstates issuances equaling 4.43 percent.[45] It was Staff that proposed using LUCo's embedded long-term debt cost of 4.81 percent.[46] The Company accepted Staff's proposal to narrow the issues in this proceeding. Staff should not be able to now argue that its own proposal violates the Public Utilities Act.[47]

As discussed in greater detail below, Staff misstates the applicable law and incorrectly claims that Liberty Midstates could issue debt at a lower cost on a standalone basis.

### i. Staff Misstates the Applicable Law

Staff claims that because Liberty Midstates' cost of debt is that of LUCo, it cannot have a higher common equity ratio than LUCo.[48] Staff is plainly misstating the applicable rule. Section 9-230 does not allow (much less require) reductions to the equity ratio simply because a parent company has a lower equity ratio. The higher cost of capital contemplated by Section 9-230 must be *caused by the affiliation*. The plain language of Section 9-230 states the Commission shall not include incremental risk or increased cost of capital "which is the *direct or indirect result* of the public utility's affiliation with unregulated or nonutility companies."[49] Likewise, appellate courts have stated the Commission is required to determine whether a utility's risk or cost of capital

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[45] *See* Schedule D-3 (Second Deficiency Response).
[46] Staff Schedule 8.01; Staff Schedule 8.03.
[47] Put differently, it would be far more reasonable for the Commission to adopt the Company's actual capital structure and the cost of debt proposed by the Company than for it to impose an imputed capital structure because of a cost of debt that Staff proposed.
[48] Staff Initial Brief at 20.
[49] *See* 220 ILCS 5/9-230 (emphasis added).

was increased "*because* of its affiliation."[50] Section 9-230 clearly imposes a causation requirement, but Staff has not even attempted to make a showing that there is an increased cost of capital that is the "result of" Liberty Midstates' affiliation with LUCo. Instead, Staff made a blanket assertion that is not supported by facts or legal authority. There is nothing in the record to support a finding of higher costs, let alone higher costs caused by affiliation.

The Commission recently rejected a similar argument by Staff in Docket 11-0767.[51] In that docket, Illinois American Water Company ("*IAWC*") forecasted a test year common equity ratio of 50.51 percent based on its actual capital structure.[52] Staff proposed to impute the 42 percent equity ratio of IAWC's parent, American Water Works.[53] The Commission ultimately approved an equity ratio of 48.10 percent for IAWC (over 6 percent higher than its parent) and found no indication of incremental risk or increased cost of capital due to affiliation with nonutilities or unregulated companies.[54]

Because APUC's and LUCo's credit ratings already are below the proxy group average, Staff's recommendation would only further increase the Company's financial risk and, therefore, its cost of capital.[55] To the extent lower credit ratings reflect

[50] *See Ill. Bell Tel. Co. v. Ill. Commerce Comm'n,* 283 Ill. App. 3d 188, 206 (2 Dist. 1996)(emphasis added).
[51] *See Ill. Am. Water Co.*, Docket 11-0767 at 78-79 (Order, Sept. 19, 2012)(approving a capital structure higher than IAWC's parent and finding no evidence of incremental risk or increased cost of capital due to affiliation with nonutilities or unregulated companies).
[52] *Id*. at 71.
[53] *Id.* at 75.
[54] *Id.* at 78-79.
[55] Company Ex. 7.0 Revised at 11:194-12:205.

heightened business risk, it would be reasonable to have a higher level of equity in the capital structure.[56]

### ii. LUCo can Issue Lower Cost Debt than Liberty Midstates Could on a Standalone Basis

Staff alleges that Liberty Midstates could issue debt cheaper on a standalone basis than through LUCo. Staff's assertion has no support in the record and is severely mistaken. Staff presents a hypothetical that assumes a higher common equity ratio automatically results in a lower cost of debt.[57] No expert witness presented evidence supporting this hypothetical and there is zero record support for assuming it is true. In reality, there are several additional factors that affect the cost of debt besides common equity ratio.

In this case, Mr. Hevert testified that the market for debt associated with a company the size of Liberty Midstates is limited; the Company's issuance would likely be far lower than the minimum threshold to be eligible for the Moody's Utility Baa Bond Index.[58] Issuances that are not "index-eligible" have significantly less liquidity than larger debt issuances from more established issuers.[59] Consequently, smaller, privately-placed debt typically is more expensive and has more onerous loan covenants than larger, index-eligible issuances.[60] Mr. Hevert concluded that access to debt capital ultimately issued at LUCo, affords the company better access to capital on more

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[56] Company Ex. 7.0 Revised at 11:194-12:205.
[57] Staff Initial Brief at 19.
[58] Company Ex. 7.0 Revised at 22:393-406.
[59] *Id.*
[60] *Id.*

reasonable terms.[61] This is the only record evidence regarding the relative cost of debt—LUCo's cost of debt is much, much lower than Liberty Midstates.

Additionally, because issuances through LUCo are subject to Section 7-101 approval, the issue of whether LUCo has a lower cost of debt has previously been examined. For instance, in Docket 12-0326 Staff did "not object to the Company's proposal to issue the indebtedness through its affiliate LUC[o], since such issuance should result in a lower overall cost to Liberty Midstates than an independent debt issuance made by the Company."[62]

Without any record support, Staff goes on to assume that its hypothetical is true. Staff alleges that "Liberty Midstates seeks to combine its 60.10 percent common equity ratio with the higher cost debt resulting from LUCo's lower common equity ratio."[63] In addition to lacking any record support, Staff has failed to provide any frame of reference for its notion that 4.81 percent is a higher cost of debt. The Company's embedded cost of debt of 4.81 percent is below the 5.17 percent (mean) and 5.39 percent (median) embedded cost of debt implied from authorized equity returns from 1/31/13 to 1/31/14.[64] Staff's own data does not even support a finding that 4.81 percent is a higher cost of debt; Staff refers to a Baa yield of 5.02 percent, which is still above 4.81 percent.[65]

Staff's claims that Liberty Midstates' cost of debt is lower than its parents' are unsupported by the record, prior Commission decisions and common sense.

### iii. Confidentiality of LUCo Capital Structure

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[61] *Id*.
[62] *Liberty Energy (Midstates) Corp*. Docket 12-0326 at 2-3 (Order, Jan. 24, 2013).
[63] Staff Initial Brief at 20.
[64] Company Ex. 4.0 at 55:1013-1019.
[65] *See* Staff Initial Brief at 27.

Staff's initial brief complains generally that LUCo's capital structure is confidential and states that the Commission should not rely on a confidential capital structure. [66] It is not clear to the Company why Staff makes this argument a focus of its brief. No party has moved that LUCo's capital structure, properly identified as confidential by the Company,[67] be made public. No party has proposed that LUCo's capital structure be the basis for a Commission decision. The Company, in fact, agrees with Staff that the Commission should not base its decision on LUCo's capital structure.

The Company agrees the capital structure that the Commission approves should be in the record. No party has proposed that LUCo's capital structure be used in this proceeding. No party presented any expert testimony that LUCo's capital structure should be relied on this proceeding. Nor did any party present any evidence such reliance would be reasonable.

The Company's actual capital structure is clearly stated, publicly, in the record.[68] The Company has also indicated other benchmarks that show that its capital structure is significantly more reasonable than the imputed, highly leveraged, capital structure proposed by Staff.[69] The confidentiality issue is a red herring—the more important principle at issue is that the Commission bases its decisions on record evidence. And there is no record evidence supporting the Commission's consideration of LUCo's capital structure in determining the rate of return in this proceeding.

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[66] Staff Initial Brief at 20.

[67] The Company validly designated the information as confidential. LUCo's capital structure contains highly sensitive information that has not been disclosed publicly. While APUC's capital structure is public, the capital structure of one of a number of mid-tier subsidiaries is neither public nor particularly relevant to the proceeding.

[68] *See, e.g.,* Schedule D-1 (Second Deficiency Responses); Company Ex. 7.0 Revised at 12:211-215; Company Ex 7.0 at 17:295-300; Company Ex. 7.0 Revised at 54:1026-55:1030.

[69] Company Ex. 10.0 at 18:352-364.

The only relevance this discussion has with respect to the Commission's decision in this case is that Staff's Brief claims that one reason Ms. Phipps proposed an imputed capital structure was because LUCo's capital structure is confidential.[70] There is no record support for this assertion and Staff has not provided any cite to the record.[71] Either Staff's assertion is incorrect, or Staff is stating that Ms. Phipps had a secret, unexpressed basis for her proposed imputed capital structure. This may explain the real reason behind Ms. Phipps' arbitrary, nonstandard and *ad hoc* capital structure calculations. However, presenting that reason now, when it is not subject to rebuttal or surrebuttal testimony, or cross examination, is unfair. More to the point, it indicates that Staff's position is not supported by the record.[72] Rather than worrying about the Commission adopting a position that no party has supported, Staff should avoid requesting that the Commission rely on expert evidence that did not disclose the basis of its conclusions.

Accordingly, the Commission should give no weight to Staff's imputed capital structure recommendations.

#### c. Staff has not Provided Sufficient Justification to Adopt a Hypothetical Capital Structure

[70] *See* Staff Initial Brief at 20-21. ("In Staff's view, the Commission should not rely upon a confidential capital structure for ratemaking purposes . . . [t]hus, Ms. Phipps proposes using an imputed capital structure…").
[71] Staff's brief on page 21 provides a cite to its proposed capital structure but not the confidentiality of LUCo's capital structure as Staff's basis for imputing a capital structure.
[72] There is nothing about the confidentiality of LUCo's capital structure that would have prevented Staff from presenting expert testimony that the LUCo capital structure is relevant or forms the basis of Ms. Phipps' belief. Staff can maintain confidentiality while making arguments that rely on confidential information, as it has done in testimony and its brief in this case.

Staff claims that it has two additional reasons for imputing a capital structure.[73] First, Staff claims that the Company's capital structure and cost of debt data is inaccurate. Staff asserts that the Company's data is unreliable because it does not provide audited financial statements.[74] However, Part 285 has no requirement that financial statements be audited.[75] Rightly so-- requiring audited financial statements at the Liberty Midstates level would be costly with no offsetting benefit. In addition, Staff provides only one example of a possible inaccuracy in Liberty Midstates financial statements by claiming that the Company's balance sheet is not "balanced."[76] The "imbalance" Staff refers to is a $120 difference out of over $175 million dollars of assets equaling less than a 0.00007 percent difference.[77] Hardly an indication of unreliability.

Second, Staff claims that because Liberty Midstates obtains debt and equity through LUCo, only LUCo has an investor claim on Liberty Midstates' cash flow.[78] Staff is incorrect. The fact that a single entity holds both debt and equity capital does not diminish the priority claim afforded debt securities, nor does it confer a priority position on residual cash flows.[79] The allocation of cash flows is determined by the terms of the securities, not by the identity of the securities' holders.[80] For example, it is entirely likely that institutional investors could hold both debt and equity securities in a given company.[81] That they would do so simply is a function of their investment policies and

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[73] Staff Initial Brief at 21.
[74] *Id.*
[75] *See* 83. Ill. Adm. Code § 285.4090.
[76] Staff Initial Brief at 21.
[77] *See* Staff Ex. 8.0, Att. C.
[78] Staff Initial Brief at 21.
[79] Company Ex. 7.0 Revised at 10:165-182.
[80] *Id.*
[81] *Id.*

objectives.[82] In Mr. Hevert's practical experience, it is unlikely that an institutional investor would invest in the debt and equity securities of a given company, but make no distinction in the returns required for each.[83] Yet, that is what Ms. Phipps' position appears to suggest.

Ms. Phipps' position also suggests that two firms identical in all respects but for the identity of the debt and equity investors would have different fundamental valuations.[84] That is not feasible since such valuation differences would be arbitraged away.[85] In addition, Ms. Phipps' position suggests that a firm's value could change not because its fundamental risks and expected cash flows had changed, but because the identity of its investors had changed.[86] Again, that is not a feasible outcome.[87]

Staff has failed to provide a sufficient basis for the Commission to depart from its prior 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."[88]

**d. Staff's Hypothetical Capital Structure is Severely Flawed**

Staff's methodology for imputing a capital structure is ad hoc and unsupported by Commission precedent or financial literature. Staff's brief provides no citation for any authority to impute a capital structure in this manner. Further, Mr. Hevert has identified

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[82] *Id.*
[83] *Id.*
[84] *Id.*
[85] *Id.*
[86] *Id.*
[87] *Id.*
[88] *See* 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)).

significant inconsistencies and complications regarding Ms. Phipps' *ad hoc* adjustments that Staff's brief fails to address.

Staff's approach to imputing its capital structure relies on two assumptions: (1) the prevailing equity ratio for A-rated utilities is 49.91 percent; and (2) the difference in equity ratios of A and BBB-rated utilities equals two-thirds of the difference in the mid-point equity ratio benchmarks for A and Baa-rated companies (as defined by Moody's).[89] According to Ms. Phipps, the latter assumption represents a difference of 6.40 percentage points.[90] Both of these assumptions and Ms. Phipps approach are suspect.

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.[91] 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.[92] As a point of reference, Schedule 10.3 -- 2013-2014 Reported Authorized Returns on Equity, Natural Gas Utilities Rate Cases[93] demonstrates that the average authorized equity ratio since January 2013 for BBB-rated natural gas utilities was 50.07 percent, or 4.48 percentage points above Ms. Phipps' 45.59 percent imputed equity ratio.[94] This calls Ms. Phipps'

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[89] *See* Staff Initial Brief at 21.
[90] *Id.*
[91] Company Ex. 10.0 at 8:154-163.
[92] *Id.*
[93] Company Schedule 10.3.
[94] Company Ex. 10.0 at 8:154-163.

conclusion into serious question. Neither the testimony of Ms. Phipps nor Staff's initial brief provides answers to those questions.

Further, 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.[95] As to its "standard adjustments", Moody's considers almost a dozen categories for adjustment.[96] Mr. Hevert testified it is unclear whether or to what extent those adjustments would be made to the accounting data relied on by Ms. Phipps.[97] The fact that Moody's tends to apply such adjustments calls into question the premise of Ms. Phipps' calculation.[98] Again, Staff has no answers to those questions.

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.[99] 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.[100] 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 adjusted equity ratio of 51.10 percent, which itself is 5.51 percentage points above Ms. Phipps'

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[95] *Id.*at 8:164-207.
[96] *Id.*
[97] *Id.*
[98] *Id.* at 9:195-10:207
[99] *Id.*
[100] *Id.*

45.59 percent hypothetical equity ratio.[101] Because the beginning point of Ms. Phipps' analysis is disconnected from the rating agency benchmarks on which she relies for her adjustment, her proposed common equity ratio should be rejected.[102]

Staff claims that its proposed capital structure is reasonable in relation to other similar companies.[103] However, the benchmarks presented by Mr. Hevert demonstrate that Staff's proposed capital structure represents a significant departure from authorized capital structures in other jurisdictions. Mr. Hevert noted the average authorized equity ratio for BBB-rated natural gas utilities was 50.07 percent, or 4.48 percentage points above Ms. Phipps' revised recommendation; the average equity ratio for A-rated companies was 52.02 percent; and for all utilities was 51.48 percent.[104] In the event the Commission does conclude that an imputed capital structure is required, Mr. Hevert noted 50.07 percent to 51.48 percent would represent a reasonable range.[105] Mr. Hevert additionally noted that to the extent Liberty Midstates faces incremental business risks, that it would be reasonable for the Company's authorized capital structure to be above the median of recently authorize capital structures.[106]

### 2. Cost of Common Equity

#### a. Overview

Staff continues to support its 9.23 percent ROE recommendation, claiming that its models were "correctly specified and thus contain no source of bias."[107] Staff further

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[101] *Id.*
[102] *Id.* at 10:201-11:214.
[103] Staff Initial Brief at 22.
[104] Company Ex. 10.0 at 18:352-364.
[105] Company Ex. 10.0 at 19:374-20:388.
[106] Company Ex. 7.0 Revised at 14:243-15:256.
[107] Staff Initial Brief at 27.

states that because it used a sample group of companies, it has minimized measurement error. Regarding the latter point, since Staff adopted the sample companies used in Mr. Hevert's analysis, it follows that Mr. Hevert's analysis likewise has minimized measurement error. As to Staff's assertion that its models are correctly specified and contain no source of bias, the Company respectfully disagrees. Although neither the Company nor Mr. Hevert suggests that Staff purposefully biases its models, there are many points of disagreement as to the correct specification of those models; those points of difference are the subject of considerable testimony in this proceeding.

**b. Staff's Credit Adjustment**

In its initial brief, Staff notes that Ms. Phipps developed her 9.23 percent ROE recommendation by combining her 8.91 percent ROE estimate with a 32 basis point adjustment, which was meant to reflect the difference between Liberty's credit rating, and the sample group's average credit rating.[108] Putting aside the unreasonably low 8.91 percent ROE estimate, Ms. Phipps' credit adjustment, does not adequately compensate investors for the considerably greater business and financial risk that Liberty faces.[109]

Fundamentally, Staff's position that differences in credit ratings "notches" among investment grade utilities can be used as a proxy for differences in the Cost of Equity fails to recognize the senior position that debt holders have relative to equity holders, and the investment horizon considered by equity holders. A long-term issuer credit rating is an opinion regarding the subject company's overall financial capacity to pay its financial obligations as they come due and payable; it is not a direct measure of equity

[108] Staff Initial Brief at 28.
[109] Company Ex. 7.0 Revised at 15:258- 260.

risk.[110] Because debt and equity are different securities, with different risk and return parameters, one cannot be used as a direct measure of the other.

The relationship between debt yields on the one hand, and Cost of Equity on the other are is not simple and linear, as Ms. Phipps' approach suggests. Academic research discussed in the record has clearly demonstrated that the Equity Risk Premium (that is, the difference between debt yields and the Cost of Equity) is inversely related to interest rates: at lower levels of interest rates the Equity Risk Premium is larger.[111] Staff's adjustment does not reflect that relationship and as such, its 32 basis point adjustment, while directionally proper, is an insufficient measure of the Company's incremental risk.

Looking only at the issue of financial risk, Mr. Hevert demonstrated that Staff's 32 basis points ROE adjustment is substantially less than the required incremental return necessary to compensate the Company for the increase in financial leverage arising from Staff's proposed equity ratio.[112] Using the Hamada Equation, Mr. Hevert calculated that the incremental required return associated with Staff's 640 basis point downward adjustment to the equity ratio is approximately 60 basis points.[113] That estimate, which is based on equity prices, not debt yields, is some 28 basis points above Ms. Phipps' proposed adjustment.

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[110] Company Ex. 7.0 Revised at 16:278-292.

[111] Company Ex. 4.0 at 34:619, citing Robert S. Harris and Felicia C. Marston, *Estimating Shareholder Risk Premia Using Analysts' Growth Forecasts*, <u>Financial Management</u>, Summer 1992, at 63-70; Eugene F. Brigham, Dilip K. Shome, and Steve R. Vinson, *The Risk Premium Approach to Measuring a Utility's Cost of Equity*, <u>Financial Management</u>, Spring 1985, at 33-45; and Farris M. Maddox, Donna T. Pippert, and Rodney N. Sullivan, *An Empirical Study of Ex Ante Risk Premiums for the Electric Utility Industry*, <u>Financial Management</u>, Autumn 1995, at 89-95.

[112] Company Ex. 7.0 Revised at 15:257-266.

[113] Company Ex. 7.0 Revised at 16:278-292.

Taken from another perspective, Staff's proposal would be the lowest combination of authorized equity returns and equity ratios, by far, of any natural gas utility company since January 2013.[114] While there may be differences across regulatory jurisdictions in the calculation of equity ratios, and viewing one company relative to another may not always be an apt comparison, Staff's proposed ROE and capital structure recommendations are so far removed from those recently observed in the industry that it is difficult to reconcile the difference.[115]

### c. Multi-Stage Discounted Cash Flow Model

#### i. Retention Growth rate

The "br + sv" form of the Retention Growth estimate used in Mr. Hevert's DCF analysis is meant to reflect growth from both internally generated funds (*i.e.*, the "br" term) and from issuances of equity (*i.e.*, the "sv" term).[116] In this form, the "sv" term reflects an element of growth as the product of (a) the growth in shares outstanding, and (b) that portion of the market-to-book ratio that exceeds unity.[117] Staff asserts that "the source of Mr. Hevert's external financing forecast, Value Line, forecasts that none of the sample companies will issue shares at the market price."[118] Staff's assertion, however, is incorrect. As shown in Company Schedule 7.2, all of the components of Mr. Hevert's Retention Growth model are derived from data provided by Value Line. In fact, Staff Cross Exhibit 7 provides the Value Line summaries from which Mr. Hevert's

[114] Company Ex. 7.0 Revised at 13: 239-242.
[115] Company Ex. 10.0 at 18 346-348.
[116] Company Ex. 4.0, at 22:391-393.
[117] Company Ex 4.0 at 22:400-402.
[118] Initial Brief of Staff at 30, citing Staff Ex. 3.0 at 12.

estimates were drawn. There, and in Company Exhibit 7.0, Schedule 7.2, it is clear that six of the nine companies in Mr. Hevert's group are expected to issue shares of common stock between 2015 and 2019, and that the expected market price is greater than the book value for all nine companies. Staff's error is very clear from the record, and Staff did not provide any response to Mr. Hevert's illustration of that error. Consequently, there is no basis to exclude the "sv" portion of the Retention Growth estimate.[119]

**ii. Long-Term Growth Rate**

The long-term growth rate included in Mr. Hevert's Multi-Stage DCF model, which represents the expected rate of long-term growth beginning in the year 2024, is measured by the expected rate of nominal growth in Gross Domestic Product (GDP). Staff does not take issue with that assumption. Nor does Staff disagree with Mr. Hevert's position that nominal GDP growth is the combination of (1) real growth, and (2) the expected rate of inflation. Moreover, Staff and Mr. Hevert agree that market-based data relating to nominal and Treasury Inflation-Protected yields may be used to estimate the expected rate of inflation beginning in 2024.[120] The remaining point of difference relates to the proper measure of expected long-term real GDP growth.

Staff asserts that Mr. Hevert's expected rate of real GDP growth "exceeds the estimates of professional forecasters and, thus, should be rejected."[121] As Staff points out, those forecasts extend, in some cases, to the year 2040. Here, Staff is willing to

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[119] Staff's citation to Nicor is inapplicable because it was based on additional criticisms not raised in this proceeding and the Company has fully responded to Staff's criticism, unlike the utility in Docket 08-0363.
[120] Staff Initial Brief at 31.
[121] Staff Initial Brief at 31.

rely on "numerous forecasters" for long-term forecasts beginning ten years in the future. Yet, Staff is critical of forecasters' ability to project interest rates within the course of the current year, noting that they not only over-estimated Treasury yields in 2014, "they did not even correctly guess the trend."[122] Moreover, Staff observes that "forecasters are economists rather than investors."[123] Thus, Staff's position that forecasters' long-term growth projections may be used as a basis of criticism for Mr. Hevert's expected growth rate is quite at odds with its position that forecasters are not investors and cannot "correctly guess the trend" of interest rates less than one year hence. Staff can't have it both ways. This is one of many examples where Staff takes inconsistent positions in its own analysis.

Recognizing that the principal issue regarding the long-term forecast is that it reflects long-term growth expectations *beginning* ten years in the future, Mr. Hevert's projection is based on the assumption that absent specific knowledge to the contrary, it is reasonable to assume that over time, real GDP growth will revert to its long-term average.[124] As Mr. Hevert demonstrates, industry literature indicates that long-term historical real GDP growth is a proper estimate of expected long-term real growth.[125] Morningstar, a source cited by Staff, notes that "[g]rowth in real GDP (with only a few exceptions) has been reasonably stable over time; therefore, its historical performance is a good estimate of expected long-term (future) performance."[126] In fact, Morningstar's

[122] Staff Initial Brief at 34.
[123] Staff Ex. 8.0:364-365.
[124] Company Ex. 4.0 at 23:413-415.
[125] Company Ex. 10.0 at 26:506–28:534.
[126] Company Ex. 10.0 at 27:521-524.

long-term estimate of real GDP growth (3.22 percent) is within five basis points of the 3.27 percent growth rate assumed in Mr. Hevert's Multi-Stage DCF analyses.[127] Similarly, Mr. Hevert pointed out that there is academic support for his approach and long-term expected growth rate: "Expected growth rates vary somewhat among companies, but dividend growth for most mature firms is generally expected to continue in the future at about the same rate as nominal gross domestic product (real GDP plus inflation). On that basis, one might expect the dividends of an average, or "normal," company to growth at a rate of 5 percent to 8 percent a year."[128]

Staff next argues that Mr. Hevert's long-term growth rate is "not sustainable", reasoning that the Return on Equity needed to produce a 5.72 percent growth rate, assuming the long-term payout ratio included in his Multi-Stage DCF model is "implausible".[129] Staff's argument, however, is based on the simple "b times r" formula it proposes, rather than the more sophisticated model on which Mr. Hevert relies. The simple "b times r" formula has not, in fact, been a limiting factor for gas utilities' historical growth. As Mr. Hevert demonstrated, South Jersey Industries' ten-year average earnings growth was 9.00 percent and its average payout ratio 50.25 percent. By Staff's logic, the company would have needed to earn an 18.09 percent ROE over that ten-year period to achieve its actual growth.[130] Over the same period, Piedmont Natural Gas had average growth in earnings of 5.00 percent while maintaining a 69.49 percent average payout ratio, which would imply a 16.39 percent earned ROE using the simple

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[127] Company Ex. 10.0 at 27:519-526.
[128] Company Ex. 10.0, at 28:529-29:534, citing Eugene Brigham and Michael Ehrhardt, <u>Financial Management: Theory and Practice</u>, 12th Ed. (Mason, OH: South-Western Cengage Learning, 2008), at 291.
[129] Staff Initial Brief, at 31.
[130] Company Ex,10.0, at 29:561-573.

"b times r" model. Similarly, Southwest Gas Corporation had ten-year average earnings growth rate of 9.50 percent while maintaining a 47.84 percent average payout ratio, which would imply an 18.21 percent earned ROE. Staff's objection is not so much a criticism of Mr. Hevert's analysis as it is an indication that Staff's DCF model is incorrect and that its positions in this case are, again, internally inconsistent.

Lastly, from a practical perspective the Multi-Stage DCF model allows the analyst to assess the reasonableness of the inputs and results by checking certain internal ratios and metrics against comparative benchmarks.[131] As Mr. Hevert pointed out, the terminal values in his Multi-Stage DCF model, which are derived from the expected long-term growth rate, reflect a contraction in Price/Earnings ratios from current levels.[132] Staff, on the other hand, provided no such corroborating analysis of its assumptions.

**iii. Long-term Payout Ratio**

Lastly, Staff argues that it "identified a problem" with Mr. Hevert's Multi-Stage DCF model because the resulting dividend growth rate exceeded the earnings growth rate in the later stages. Contrary to Staff's assertion, there is no "problem" with those relationships. The Multi-Stage DCF model is important precisely because earnings and dividend growth rates are not expected to be equal, nor is the payout ratio expected to remain constant in perpetuity: "…the model enables analysts to reflect assumptions regarding the timing and extent of changes in the payout ratio to show, for example, increases or decreases in expected capital spending, or transition from current payout

[131] Company Ex. 4.0 at 19:358-362.
[132] Company Ex. 10.0 at 30:577-581, citing Company Exhibit 7.0, Schedule 7.1.

levels to long-term expected levels."[133] The growth rates that Staff sees as a "problem" simply reflect the rational observation that as capital spending requirements fall, payout ratios will increase.

Staff asserts that the long-term industry payout ratio should be based on the level projected by Value Line for the years 2016 to 2018.[134] Those payout ratios are well below the long-term industry average of 68.85 percent.[135] The historically low payout ratios that Staff assumes will persist in perpetuity are predicated on elevated levels of capital expenditures that the industry, including the proxy companies, face through the 2016 – 2018 period. As the capital investment cycle declines, payout ratios would be expected to increase.[136] Staff, on the other hand, assumes that the proxy companies' payout ratios will remain at the level projected by Value Line for the years 2016 to 2018,[137] even though Value Line also projects that seven of the nine proxy companies will experience elevated capital investments during that time.[138] Nonetheless, Staff provides no empirical basis for its assumption that there has been a permanent, structural downward shift in natural gas utility payout ratios. Rather, Staff assumes, with no supporting analysis, that payout ratios will forever reflect the heightened capital investment requirements that Value Line also projects for the 2016 to 2018 period.

Staff further argues that the change in payout ratios reflects a "trade off between present and future dividends", and that "an increasing dividend payout ratio results in a

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[133] Company Ex. 4.0 at p.18:339-343.
[134] Staff Initial Brief at 24.
[135] Company Ex,7.0, Schedule 7.1.
[136] Company Ex. 10.0 at 23:442-451, citing SNL Energy, *Financial Focus, Capital Expenditure Update*, May 31, 2013, at 1.
[137] Staff Initial Brief at 24.
[138] Staff Cross Ex. 7.

temporary acceleration of near term dividend growth that is exactly offset by a reduction in long term sustainable growth because less earnings are retained for reinvestment."[139] Again, Staff's argument is predicated on the simple "retention growth" or "b plus r" model which, as demonstrated above, is contradicted by experience and produces results that Staff itself finds unreasonable.

#### d. Risk Premium Analysis

Staff argues that certain elements of Mr. Hevert's "Risk Premium Analysis", which he refers to as the Capital Asset Pricing Model, or CAPM, are inconsistent with prior findings made by the Commission. Mr. Hevert, however, structured his analyses in keeping with the Commission's guidance: "In Docket No. 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 the DCF analysis when calculating the required market return (which is used to estimate the MRP). Consequently, Mr. Hevert performed CAPM analyses reflecting these assumptions." [140]

Mr. Hevert's Alternate CAPM analyses reflect other assumptions. But, as Staff acknowledges he does not make specific adjustments to his ROE range or recommendation based on those analyses.[141] Staff's criticisms are therefore inapplicable, as they fail to take into account the analysis actually performed by Mr. Hevert to develop his Risk Premium Analysis in this case.

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[139] Staff Initial Brief at 33.
[140] Company Ex. 4.0 at 26: 481-27:485; citing Ameren Ill. Co., Docket No. 13-0192 at 164-165 (Order, December 18, 2013).
[141] Staff Initial Brief at 36.

### i. Risk Free Rate of Return

Staff and Mr. Hevert agree that the yield on 30-year Treasury securities is the proper measure of the Risk Free rate in the Capital Asset Pricing Model. Staff and Mr. Hevert further agree that the 30-day average Treasury yield is appropriate for that purpose.[142] Although Staff notes that the 30-year "includes an interest rate premium associated with its relatively long term to maturity",[143] it also is the case that 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.[144]

Staff argues that Mr. Hevert erred by including a near-term projection of the 30-year Treasury yield in his CAPM analysis.[145] Staff's position, however, fails to acknowledge several important points. First, and as a practical matter, Mr. Hevert clearly provided his CAPM results based only on the same 30-day average Treasury yield that Staff included in its CAPM analyses.[146] Those results, which ranged from 9.93 percent to 10.47 percent in Mr. Hevert's Direct Testimony, [147] and 10.23 percent to 10.45 percent in his Rebuttal Testimony[148] fall squarely within his recommended ROE range of 10.00 percent to 10.50 percent.

Second, Staff's suggestion that all relevant information is captured in current Treasury bond yields is an over simplification of investor expectations and the market

[142] Company Ex. 4.0, Schedule 4.5; ICC Staff Exhibit 3.0, Schedule 3.06; including only dividend-paying companies.
[143] Staff Initial Brief at 34.
[144] Company Ex. 4.0 at 29:537-539.
[145] Staff Initial Brief at 34.
[146] Company Ex.4.0, Schedule 4.5; ICC Staff Exhibit 3.0, Schedule 3.06; including only dividend-paying companies.
[147] Company Ex. 4.0, Schedule 4.5; including only dividend-paying companies.
[148] Company Ex. 7.0, Schedule 7.5.

forces influencing current interest rates; the forward yields on which Staff relies for its long-term GDP growth calculation clearly reflect investors' expectations of increased interest rates.[149] Staff does not argue against the use of forward yields as a measure of market expectations. Indeed, Staff acknowledges that Treasury yields reflect market forces.[150] Although the market expectations embedded in Staff's long-term GDP growth rate reflect yields ten years in the future, the same holds true for near-term periods; even over the coming three years investors' expectations call for increased long-term Treasury yields.[151]

Lastly, as discussed earlier Staff is content to rely on economists' projections of real GDP growth over periods up to 25 years in the future. Thus, Staff does not apply the same dim view of economists' ability to project interest rates in the near term to their ability to project macroeconomic growth far in the future. Again, Staff can be seen to be picking and choosing individual components based on outcome rather than adopting a consistent approach throughout its analysis.

#### ii. Market Rate of Return

Staff suggests that Mr. Hevert's estimate of the Market Rate of Return is biased because (1) it reflects companies with both high and low growth rates, (2) it includes companies that pay dividends for which the expected growth rate is zero, and (3) that the dividend yield, and market capitalization values provided by Mr. Hevert's two

[149] Company Ex. 7.0 Revised at 36:679-683.
[150] Staff Initial Brief at 34.
[151] Company Ex. 4.0 at 50:942-51:957.

sources (Value Line and Bloomberg) are not one and the same. [152] Staff's arguments are directed at Mr. Hevert's analyses that exclude non-dividend paying companies. [153]

As to Staff's concern with the variability of growth rates, industries, and individual companies within those industries, face constantly evolving business and financial opportunities (and risks). It therefore is entirely reasonable for a broad market index such as the S&P 500 to contain companies with relatively high and relatively low growth rates at any given time. Given the 500 companies contained in the S&P 500 Index, it is possible to select individual company growth estimates that appear unreasonable. As shown in Company Exhibit 7.0, Schedules 7.3 and 7.6, as many as ten had growth rates below 0.00 percent; as many as 19 companies had earnings growth rates below the 2.37 percent inflation rate assumed in the long-term growth estimate included in Mr. Hevert's DCF analyses. [154]

Moreover, the work papers supporting Staff's calculation of the expected market return also reflect substantial variability on a company-by-company basis - growth rates range from negative 24.70 percent to 41.08 percent. That is not surprising, given that Mr Hevert's primary market return analyses incorporates the same companies as Staff's analysis and the end results (that is, the expected market return) are relatively similar.[155]

Staff also asserts that "because a publicly-traded company's market capitalization is observable, it should be the same in both the Bloomberg and Value

[152] Staff Initial Brief at 35.
[153] Staff Initial Brief at 35
[154] Company Ex. 10.0 at 37: 699-705.
[155] Company Ex. 10.0 at 37: 706-711.

Line analyses."[156] As Mr. Hevert explained in his surrebuttal testimony and Staff ignored in its Brief, however, Bloomberg uses intraday prices in calculating the reported market capitalization, while Value Line uses previous day's closing prices.[157] The fact that those services, both of which are highly reputable and relied upon by investors, apply different approaches in no way detracts from their usefulness.

In a similar vein, Staff argues that "…dividend yields are observable; yet, Mr. Hevert's Bloomberg and Value Line analyses use the same dividend yield for a given company in only a handful of instances."[158] As Mr. Hevert also explained (and Staff also inexplicably ignored), Bloomberg's reported dividend yield is based on analysts' consensus estimate of the current calendar year dividend amount, whereas Value Line's reported dividend yield is based on the dividends paid over a trailing twelve-month period.[159] As such, there will be some difference between the values reported by the two within a given day.[160]

Staff's conclusion – that the differences in results reported by Value Line on the one hand, and Bloomberg on the other renders their results so questionable that they should be disregarded – ignores the very reasonable and rational explanation of those differences. This difference was explained to Staff in testimony, but Staff's initial brief ignored the explanation. Equally important, both Value Line and Bloomberg are well-established sources of financial data and provide reasonable measures of the assumptions used by equity investors. Nowhere has Staff established otherwise.

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[156] Staff Initial Brief at 35.
[157] Company Ex. 10.0 at 37:715-38:716.
[158] Staff Initial Brief at 35-36.
[159] Company Ex. 10.0 at 38: 716-719.
[160] Company Ex. 10.0 at 38:717-721.

### iii. Alternate CAPM Analyses

Although Staff acknowledges that Mr. Hevert did not make specific adjustments to his ROE range or recommendation based on the alternate CAPM analyses (meaning that, in the end, the Alternative CAPM analysis are only tertiary confirmations of Mr. Hevert's independently supported conclusions), Staff does argue that certain elements of that analysis are in error. In particular, Staff argues that Beta coefficients calculated over eighteen to twenty-four month periods are "…more prone to measurement error arising from short-term changes in risk and investor risk preferences, which can bias the beta estimate."[161] Staff further argues that: "A decrease in a company's systematic risk could increase its estimated beta even though generally an increasing beta would be interpreted as signaling an increase in a company's systematic risk. Conversely, an increase in a company's systematic risk could lower its calculated beta even though generally a decreasing beta would be interpreted as signaling a decrease in a company's systematic risk."[162]

Staff draws a distinction between "systematic risk" and Beta coefficients even though they are one and the same. Systematic, or "non-diversifiable" risk, is a fundamental component of Modern Portfolio Theory, the central theme of which is that rational investors make investment decisions reflecting the inherent aversion to taking on additional risk without being compensated by additional returns. In the context of Modern Portfolio Theory, risk is defined as the uncertainty, or variability, of returns.[163] Modern Portfolio Theory was advanced by recognizing that total risk can be separated

[161] Staff Initial Brief at 36.
[162] Staff Initial Brief at 36.
[163] Company Ex. 7.0 Revised at 41:783-789.

into two distinct components: (1) systematic or non-diversifiable risk, which is that portion of risk that can be attributed to the market as a whole; and (2) non-systematic (or diversifiable) risk, which is attributable to the subject company, itself. In applying the CAPM, it is systematic risk (as opposed to non-systematic risk) that determines the Cost of Equity.[164] Moreover, considering Beta coefficients over differing periods is entirely consistent with industry practice and provides additional information and perspective that should not be disregarded.[165] Consequently, Staff's argument that systematic risk can is a separate issue from the Beta coefficient that somehow diminishes that the usefulness of Beta coefficients measured over different time periods is incorrect.

Staff also argues that having calculated Beta coefficients over eighteen-month periods for three consecutive years to demonstrate that they change over time.[166] ICC Staff Exhibit 3.0, page 29, however, clearly indicates that the systematic risk of the proxy group increased over the 2009-2014 period. As Mr. Hevert noted, "This makes intuitive sense as utilities' appeared relatively stable during the height of the market's elevated volatility during the 2007-2009 financial crisis, but have reverted toward a more normal systematic risk level as the economic recovery continues (and perhaps even faced relatively elevated risk compared to the overall market as interest rates rose sharply during the second half of 2013).[167]

Staff's criticsims of Mr. Hevert's Alternative CAPM analyses are incorrect, and given that Staff acknowledges that those analyses did not result in specific adjustments

[164] Company Exhibit 7.0 Revised at 41:790–42:797.
[165] Company Exhibit 7.0 Revised at 42:812-814.
[166] Staff Initial Brief at 37.
[167] Company Exhibit 7.0 Revised at 43:829-836.

to Mr. Hevert's recommendations, they do not affect the validity and weight of those recommendations and should be ignored.

**e. Bond Yield Plus Risk Premium Analysis**

Staff argues that Mr. Hevert's Bond Yield Plus Risk Premium analysis suffers from certain flaws, including the use of authorized returns from jurisdictions across the U.S., reliance on historical data (which Staff argues includes the years 1992 through 2010), and the difficulty in determining the appropriate period on which to rely.[168] Regarding the historical period, Mr. Hevert's analysis begins in 1980 and ends in 2014.[169] As Mr. Hevert points out, that period covers a number of economic cycles, a point that is important to Staff in other applications.[170] Staff continues to inconsistently insist on something in one part of its analysis, while criticizing the inclusion of the same principle in Mr. Hevert's analysis. Moreover, contrary to Staff's assertion, there is no difficulty in determining the appropriate period on which to rely: the analysis includes the entire 34-year period to assess the stability of the Equity Risk Premium.[171]

As to the use of returns from other jurisdictions, the Commission has recognized that such data is a relevant consideration: For example, in Docket No. 12-0511 the Commission stated:

> While we adhere to the position that the Commission does not base utility returns on those approved for other utilities, the

[168] Staff Initial Brief at 39.
[169] *See* Staff Initial Brief at 39 (identifies the correct period later).
[170] In support of its five-year Beta coefficient calculation period, Staff Initial Brief at 37 cites Ibbotson Associates stating, in part, "Using five years of data would ideally cover a number of different economic scenarios such as expansion and contraction in the economy."
[171] Company Ex. 4.0 at 33:608-34:612.

> Commission will consider general market conditions and trends to be apprised of current market conditions, but only to the extent such data are verifiable and unbiased.
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> ***
>
> Based on the record, the Commission recognizes that the average of recent ROEs authorized for natural gas utilities is 9.94%...The Commission also notes that A-rated utility equity risk premiums have recently increased significantly as interest rates remain at historic lows…These general market data provide relevant comparative information as we assess the parties' various ROE provisions.[172]

Staff further argues that Mr. Hevert's results are "nonsensical" because it suggests that the Cost of Equity would increase at levels below 2.90 percent (in his original analysis).[173] Mr. Hevert explained, however, that the relationship makes perfect sense. For example, low levels of Treasury yields observed during the financial crisis were due, in large measure, to the tendency of investors to seek the safety of Treasury securities as a means of avoiding equity risk.[174] As a result of that aversion and the resulting increased demand for Treasury securities, investors would require a lower yield on Treasury securities, while at the same time increasing the return required to take on the risks associated with equity ownership.[175]

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[172] Company Ex. 4.0 at 36:642 – 655.
[173] Staff Initial Brief at 39.
[174] Company Ex. 10.0 at 39: 749 – 752.
[175] Company Ex. 10.0 at 39:752-40:756.

The inflection point noted by Staff is the point at which the decrease in Treasury yields is more than offset by an increase in the Equity Risk Premium.[176] In that scenario, the Cost of Equity rises as Treasury yields decrease.[177] That relationship is both empirically and theoretically reasonable.[178] During periods of extreme instability, investors are willing to accept very low yields on Treasury securities in order to avoid the risk of capital losses from equity investments, while increasing the return that they require to take on the risk of equity ownership.[179] Consistent with that relationship, Mr. Hevert's analysis, which is meant to capture market relationships at extreme levels of interest rates, demonstrates that the Cost of Equity increases to reflect the risk inherent in periods during which interest rates fall to unusually low levels.[180]

Mr. Hevert's results are both theoretically sound and supported by empirical evidence. If anything is "nonsensical" it is Staff's continued criticism of these results after being presented with this evidence.

#### f. Flotation Costs

Flotation costs are the direct costs associated with issuance of common equity, many of which are incurred prior to the test year, but which remain part of the cost structure during the test period, and beyond.[181] Staff does not appear to disagree with Mr. Hevert that flotation costs represent a permanent reduction to the capital used to finance rate base, nor does Staff appear to disagree with the method that Mr. Hevert

[176] Company Ex. 10.0 at 40:759–760.
[177] Company Ex. 10.0 at 40:761.
[178] Company Ex. 10.0 at 40:762.
[179] Company Ex. 10.0 at 40:762-766.
[180] Company Ex. 10.0 at 40:759-41:773.
[181] Company Ex. 4.0 at 46:873-875.

used to estimate the effect of flotation costs. Rather, Staff argues that because "Mr. Hevert's calculation is not based on issuance costs that the Company has incurred but not previously recovered through rates, it should not be considered in setting the investor-required rate of return on common equity."[182]

As Mr. Hevert noted in his Direct Testimony, however, his flotation cost adjustment recognizes the costs of issuing equity that were incurred by APUC.[183] Mr. Hevert also pointed out that his calculation of flotation costs includes the last two equity issuances for APUC and as such, the Company has incurred actual flotation costs that have not been previously recovered through rates.[184] Even though Mr. Hevert does not make a specific adjustment for flotation costs, they are necessary and legitimate costs that can be properly considered in determining the Company's Cost of Equity.

Acknowledgement that the costs exist when determining the Cost of Equity is different than attempting to seek recovery of specific flotation costs, which the Company has not requested in this docket. Staff is again arguing against a position that no party has taken in this docket.

### C. Recommended Overall Rate of Return

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

| | Proportion | Cost | Weighted Cost |
|---|---|---|---|
| Short Term Debt | 0.46% | 1.41% | . 0.01% |
| Long Term Debt | 39.44% | 4.81% | 1.65% |
| Common Equity | 60.10% | 10.50% | 6.31% |

[182] Staff Initial Brief at 40.
[183] Company Ex. 4.0 at 47:894–896.
[184] Company Ex. 7.0 at 50:955–957.

| | | |
|---|---|---|
| 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

Based on Staff's initial brief, the Company does not believe there is any dispute between the Company and Staff over the applicability of Docket 11-0559, Condition 9. Nor is there any dispute over how an adjustment based on Condition 9 should be calculated. The Company presented a calculation of the Condition 9 adjustment for various capital structures, but noted that the final calculation may differ depending on the capital structure and cost of equity approved by the Commission.

## V. COST OF SERVICE - Uncontested

## VI. RATE DESIGN - Uncontested

## VII. OTHER

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

Staff's brief recommends that Commission put Liberty Midstates on notice that the quality of its next rate case filing must improve.[185] However, Staff does correctly acknowledge that the Company was presented with unique circumstances in this proceeding that will not be present in the next proceeding.[186] The Company maintains its position from its initial brief that the Commission already has sufficient procedures in place to ensure that the Commission has the necessary data for it to make a

[185] Staff Initial Brief at 52-53.
[186] *Id*.

determination.[187] The Company also notes that it has already stopped using the term "Liberty" in response to Staff's position that this term causes confusion. Throughout its briefs, the Company has consistently referred to itself as Liberty Midstates. The Company has adopted similar naming conventions for its other affiliated companies. For instance, Liberty Utilities Co. was referred to as LUCo by the Company. The Company intends to maintain these naming conventions in its future filings with the Commission. A Commission order is not required to address every aspect of the parties' back and forth on filing issues; the parties can and are working it out on a voluntary basis.

Staff also continues to recommend that the Company provide certain supplemental ILCC Form 21 information beyond what is required by Form 21.[188] The Company maintains its 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.[189] The Company continues to believe 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.[190] The Company also recommends that in the event the Commission adopts Staff's proposal, that it be limited in time to the next rate case

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[187] *See* 83 Ill. Adm. Code § 285.145; Company Initial Brief at 62.
[188] Staff Initial Brief at 54-55.
[189] Company Ex. 8.0 at 12:248-257.
[190] *Id.*

filed by the Company, after which the need for any such obligations could be re-assessed.[191]

Finally, Staff has for the first time in its initial brief a new proposal directing Staff and the Company to develop accounting controls and procedures in Docket 14-0269.[192] Because this position was not advanced until Staff's initial brief, there is no support in the record for Staff's proposed directive. For that reason alone, the Commission should reject Staff's proposed directive. The Company did agree to Staff's original semi-annual report condition that Staff has requested be withdrawn.[193] The Company is still willing to comply with this condition.

Of course, the Company is also willing to voluntarily work with Staff in Docket 14-0269 to develop mutually agreeable accounting controls and procedures, but does not believe a directive in this proceeding is appropriate in this proceeding and is best left to Docket 14-0269. The Company notes that Docket 14-0269 is an ongoing docket involving the same Staff witnesses who will have the ability to raise this issue in that proceeding. Further, now that Staff has identified this as an important issue in Docket 14-0269, the Company has no doubt that the Commission will fully consider Staff's accounting control and procedure recommendations in that docket. The Company also notes that Staff's proposal has already changed once within the last month.[194] It is possible that further changes could arise as Staff and the Company begin working together and a directive in this proceeding may unnecessarily limit flexibility.

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[191] *Id.*
[192] Staff Initial Brief at 55-56.
[193] *Id.;* Staff Cross Ex. 1.
[194] *Id.*

Because there is no support in the record for Staff's new proposal and the Company has voluntarily agreed to work with Staff, the Commission should decline to adopt Staff's proposal.

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

Staff suggests that the Company's proposal to treat deferred property taxes as a regulatory asset is prohibited by the Illinois Supreme Court's decision in BPI II.[195] It is true that BPI II sets forth the standard for recording and recovery of a regulatory asset; however, Staff misapplies the standard for recovery of a regulatory asset to the Company's request rather than the standard for recording a regulatory asset which Liberty Midstates seeks. The Commission would determine recovery in the Company's next rate case. The court in BPI II set forth the standard for recording deferred charges as requiring the utility to show: (1) circumstances beyond its control have created a significant regulatory lag between the in-service date and the date of the Rate Order; and that (2) denial of the accounting variance could significantly and adversely affect the company's earnings, as well as its short-term and long-term capital.[196] As Mr. Long testified, the Company will establish a new office building in Vandalia during the test year.[197] Property taxes will not be assessed until the following year.[198] Mr. Long testified that after the first year timing difference, Liberty Midstates will never realize cost recovery for taxes accrued for the period from January 1, 2016 until the beginning of the

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[195] Staff Initial Brief at 60; *See Business and Profession People v. Commerce Commission,* 146 Ill.2d 175 (1991) ("BPI II").
[196] *Id.*at 233.
[197] Company Ex. 6.0 at 9:187-188.
[198] *Id.* at 9:189-191.

test year for the Company's next rate case.[199] Mr. Long further testified that these costs are relatively large for a utility of the Company's size.[200]

The evidence in the record demonstrates that Liberty Midstates has established that circumstances beyond its control have created a significant lag between the in-service date and the date of the rate order and that denial of the Company's request for deferred accounting treatment could significantly and adversely affect the Company's earnings. The Company's evidence regarding the two BPI factors is uncontroverted in the record because Staff never disputed this evidence.

Accordingly, 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, reflected in the Company's initial brief or 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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[199] Company Ex. 9.0 at 3:48-58.
[200] *Id.*

Respectfully submitted,

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

__/S/______________________________
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Dated: November 21, 2014