

STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

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

REPLY BRIEF ON EXCEPTIONS OF THE STAFF
OF THE ILLINOIS COMMERCE COMMISSION
(PUBLIC)

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NOW COME the Staff witnesses of the Illinois Commerce Commission ("Staff"), by and through its undersigned attorneys, and pursuant to Section 200.830 of the Rules of Practice of the Illinois Commerce Commission ("Commission"), 83 Ill. Adm. Code Section 200.830, and respectfully submit this Reply Brief on Exceptions ("RBOE") responding to the Brief on Exceptions ("BOE") filed by Liberty Utilities (Midstates Natural Gas) Corp. d/b/a Liberty Utilities ("Liberty Midstates" or "Company")¹ which was filed on January 6, 2015 in response to the Proposed Order ("PO") issued by the Administrative Law Judge ("ALJ") on December 15, 2014. Staff addresses issues to which it replies in the order in which they appear in the PO.

¹ Staff uses Liberty Midstates or Company to designate the Illinois operations of Liberty Utilities (Midstates Natural Gas) Corp.

I. INTRODUCTION

- A. Overview**
- B. Procedural History**
- C. Nature of Liberty's Operations**
- D. Test Year**
- E. Legal Standard**

II. RATE BASE

A. Resolved Issues

- 1. Interest Synchronization Calculation**
- 2. Budget Payment Plans**
- 3. Utility Plant – Meters**
- 4. Average Net Plant**
- 5. Accumulated Deferred Income Taxes**
- 6. Original Cost Determination**
- 7. Cash Working Capital**

B. Contested Issues

Liberty Midstates takes exception to certain conclusions of the PO regarding contested Rate Base issues. For each of the items under contested Rate Base issues, Liberty Midstates argues that the PO does not indicate an understanding of the Company's argument or mischaracterizes the Company's arguments. (Co. BOE, 2-3)

The Company has not raised any new or different arguments than have been previously raised in their Initial Brief ("IB") or Reply Brief ("RB") regarding these issues. Staff has addressed each of these issues in its IB and RB. The PO appropriately considered and found that average net plant should be used in the test year, the use of average net plant as the appropriate method of calculating accumulated income taxes, and Staff's

adjustment to incentive compensation. Accordingly, the PO should maintain its findings and conclusions on these issues.

1. Average Net Plant

2. Accumulated Deferred Income Taxes

3. Incentive Compensation²

C. Recommended Rate Base

III. OPERATING REVENUES AND EXPENSES

A. Resolved Issues

1. Property Taxes – Test Year Expenses

2. Outside Professional Services

3. Rate Case Expense

4. Allocation from Shared Services (“LABS”)

5. Depreciation Expense

B. Contested Issues

Liberty Midstates takes exception to certain conclusions of the PO regarding contested Operating Revenues and Expenses. For each of the items under contested Operating Revenues and Expenses, Liberty Midstates argues that the PO should reflect higher income tax rate although no legislative has been enacted. (Co. BOE, 6) In addition, with respect to incentive compensation, Liberty Midstates continues to argue it has shown clear benefit to ratepayers. (Co. BOE, 7) The Company has not raised any new or different arguments than have been previously raised in their IB or RB regarding these issues. Staff has addressed both of these issues in its IB and RB. The PO appropriately

² Due to the capital component.

considered and found that the evidence best supports a corporate tax rate of 7.75 percent and Staff's adjustment to incentive compensation. Accordingly, the PO should maintain its findings and conclusions on these issues.

1. Gross Revenue Conversion Factor

a. Uncollectible Expense Rate

b. State Income Tax Rate

2. Incentive Compensation

C. Recommended Operating Income / Revenue Requirement

IV. RATE OF RETURN/COST OF CAPITAL

The BOE filed by Liberty Midstates takes issue with the following Rate of Return/Cost of Capital-related issues in the PO: Embedded Cost of Long-Term Debt (Company Technical Exception 1), Common Equity and Long-Term Debt Ratio (Company Exception 8), Cost of Common Equity (Technical Exceptions 2 and 3), and Authorized Rate of Return on Rate Base (Company Exception 9). Staff disagrees with the Company's criticisms of the PO conclusions regarding Embedded Cost of Long-Term Debt and Common Equity and Long-Term Debt Ratio. Below, Staff explains why the PO conclusions are correct on those issues.

A. Resolved Issues

1. Short-Term Debt Ratio

2. Cost of Short-Term Debt

3. Embedded Cost of Long-Term Debt

Embedded Cost of Long-Term Debt (Company Technical Exception 1)

The Company recommends deleting the last sentence from Section IV.A.3. of the PO (Company Technical Exception 1 – Embedded Cost of Long-Term Debt). The

Company argues it “could be read to require the Company to provide supporting documentation for any debt issues for which it is not seeking recovery.” (Co. BOE, 7-8) The Company’s proposal should not be adopted. As noted in Staff testimony, the Company’s supporting documentation for debt costs was lacking in several respects and required more judgment than is typically required for the embedded cost of long-term debt calculation, which is generally straightforward. (Staff Ex. 8.0, 2, fn. 1) Nevertheless, Staff recommends the following changes to the PO, which clarify the directive set forth in Section IV.A.3 of the PO, address the Company’s concern noted in Company Technical Exception 1, and assist the examination of debt costs in future rate cases by specifying the debt information that the Company will need to provide for any debt expenses for which it seeks recovery through rates.

In addition, the Commission concludes that in future cases, the Company should provide invoices and supporting documentation that clearly identify those debt issues that it seeks to include in the embedded cost of long-term debt calculation, specify the expenses incurred for each particular debt issue, the date those expenses were incurred, and the method for amortizing expenses.

B. Contested Issues

1. Common Equity and Long-Term Debt Ratios

Common Equity and Long-Term Debt Ratio (Company Exception 8)

The Company BOE claims that the PO errs in adopting Staff’s proposed capital structure. (Co. BOE, 8) The Company argues that the PO “errs in inferring that [Liberty Utilities Co., or “LUC”]³ has a higher cost of long-term debt than Liberty Midstates.” (Co.

³ This Reply BOE and the PO refer to Liberty Utilities Co. as “LUC,” whereas the Company BOE uses the term “LUCo” to refer to Liberty Utilities Co. To be consistent, this Reply BOE replaces the term “LUCo” with “LUC” throughout this Reply BOE.

BOE, 8) The Company argues further, “The Proposed Order’s conclusion that Liberty Midstates is actually able to obtain a lower stand-alone cost of capital than [LUC] is contrary to the existing Commission decisions granting approval of Liberty Midstates to obtain its debt based on [LUC]’s financing costs because they rely on evidence that Liberty Midstates cannot obtain lower-cost debt on a stand-alone basis.” (Co. BOE, 9-10)

As Staff explained in testimony and briefs, LUC is the parent company of Liberty Midstates, and provides Liberty Midstates all of its debt and equity capital such that Liberty Midstates’ cost of debt equals LUC’s cost of debt. (Staff IB, 20) Before agreeing to a 4.81% cost of debt in order to narrow the issues in this proceeding, the Company proposed a 4.43% cost of debt “based solely on Liberty Midstates issuances.” (Co. RB, 13-14) As noted in the Company BOE, both the 4.43% cost of debt for Liberty Midstates and the 4.81% cost of debt for LUC are based on LUC’s debt costs. (Co. BOE, 9) Thus, there is no proposal for the Commission to consider that is based on Liberty Midstates’ non-existent stand-alone debt costs.

The Company BOE alleges, “Market data also supports the conclusion that the Company’s stand-alone cost of capital would be higher than that of [LUC].”⁴ (Co. BOE, 10) “Market data” refers to the 5.17% average cost of debt Company witness Hevert alleged to have extracted from authorized ROEs and the 5.02% yield for Baa-rated utility bonds on January 29, 2014. (Co. BOE, 10, fn. 30) There is no explanation in Mr. Hevert’s testimony, however, of how he arrived at the 5.17% average cost of debt “implied from authorized ROEs.” (Co. Ex. 4.0, 55) Staff has explained why authorized ROEs in outside

⁴ Although the Company BOE refers to “cost of capital,” the market data it references in this section are debt costs. (Co. BOE, 10)

jurisdictions are not relevant to the Commission's decision in this case. (Staff RB, 16-17) Given the cost of debt for Liberty Midstates is an embedded cost, the 5.02% Baa bond yield during January 2013 is also irrelevant. Further, nothing in the record indicates that Liberty Midstates, with a debt ratio below 40%, would have the same creditworthiness as a Baa-rated company.⁵ Rather, the record shows that lower debt ratios are correlated with higher credit ratings and lower debt costs. (Staff RB, 14) In short, the 4.43% cost of debt for Liberty Midstates and the 4.81% cost of debt for LUC are the only competing proposals in the record and there is no evidence to support the Company's claim that had Liberty Midstates issued its own debt its cost would have been higher than 4.81%.

Second, the Company claims that the existence of an unregulated operation does not automatically create a presumption of a higher business risk. (Co. BOE, 11) Algonquin Power & Utilities Corp. ("APUC") targets a **XXX** credit rating from Standard & Poor's ("S&P") and debt to total capital ratios of **XXXXX** for its mostly regulated subsidiary, LUC, and **XXXX** for its unregulated subsidiary, Algonquin. (Staff Cross Ex. 3) According to S&P, higher debt to capital ratios denote riskier financial risk profiles (i.e., debt to capital ratios of less than 25% are denoted as "Minimal" whereas debt to capital ratios greater than 60% are denoted as "Highly Leveraged." (Co. Cross Ex. 2, p. 3) All else equal, a company with a higher degree of financial risk can have a lower business risk profile and sustain the same rating as a company with less financial risk and more business risk. Thus, given APUC targets a **XXX** rating from S&P, its higher target debt

⁵ Moody's credit rating of Baa is equivalent to Standard & Poor's BBB credit rating.

ratio for the regulated subsidiary (denoting more financial risk) than its unregulated subsidiary, reveals a lower business risk profile for the regulated subsidiary. As such, contrary to the Company's assertions in its BOE, in this case, the existence of an unregulated operation does create a presumption of a higher business risk. (Co. BOE, 11)

The Company errs when it argues the PO "incorrectly concludes that LUC's confidential data could not be utilized." (Co. BOE, 12) The Company cites three cases to support its claim that "the Commission regularly makes findings based on confidential record evidence without disclosing that information." (Co. BOE, 12) Two of the cases are Qualified Solid Waste to Energy Facility cases (Docket Nos. 03-0714 and 98-0572) and one is an affiliate interest agreement case (Docket No. 93-0191). (Co. BOE, 12, fn. 37) Those cases are not relevant because they are not ratemaking proceedings. To the best of Staff's knowledge, the Commission has never issued a rate Order without disclosing publicly the capital structure used for ratemaking purposes in a contested proceeding. (Staff IB, 20) Thus, the PO correctly concludes that LUC's confidential data cannot be utilized to establish an authorized rate of return on rate base.

The Company argues further, "Staff could have proposed a capital structure relying on or even identical to [LUC]'s capital structure without disclosing confidential information." (Co. BOE, 12) It seems the Company is suggesting Staff could propose a capital structure for ratemaking purposes that mirrors the Company's confidential capital structure, but refer to it as an imputed capital structure. This argument is self-serving and ignores the fact that Staff, just like every other party to a proceeding, must have a sound

basis for its recommendations to the Commission. The fact is that Staff repeatedly urged the Company to make LUC's capital structure public but was rebuffed each time.

Finally, the Company BOE argues, Staff's proposed imputed capital structure is not reasonable; the methodology of the proposed imputed capital structure is flawed; and, the Commission must adopt a reasonable capital structure. (Co. BOE, 12-16).

The Company criticizes Staff's imputed capital structure comprising 45.59% common equity because it is below the 50.07% "average authorized equity ratio since January 2013 for BBB-rated natural gas utilities." (Co. BOE, 14) Company witness Mr. Hevert claims that 50.07% to 51.48% would represent a reasonable range for an imputed capital structure, and the Company BOE recommends the Commission adopt an imputed capital structure comprising 51.48% common equity. (Co. BOE, 15)

As Staff explained in briefs, under Section 9-230 of the Public Utilities Act ("Act"), the actual common equity ratio of LUC serves as the upper bound on permissible common equity ratios. (Staff IB, 19-21; Staff RB, 11-12) The Illinois Appellate Court has made clear that the Commission cannot consider a Company's actual capital structure unless it makes a threshold determination that the capital structure in question satisfies Section 9-230 of the Act. Section 9-230 absolutely bars the adoption of a capital structure which, as result of affiliation, results in increased risk or increased cost of capital. (Staff RB, 12)

Putting aside the requirements of Section 9-230 of the Act, capital structures approved in other jurisdictions, subject to different laws and measurement methodologies, are not relevant. (Staff RB, 17) That is, even if the Commission were to consider the equity ratios in other jurisdictions, which it rightly does not, the Company has not provided the information necessary for the Commission to determine whether the facts and

circumstances in any of the decisions Mr. Hevert cites are relevant to the Commission's decision in this case (e.g., whether the authorized rate of return is for gas operations only, ratemaking adjustments such as removal of goodwill and the effect of affiliates that increase the cost of capital, whether authorized rate of return is determined using a formula rather than financial analysis to estimate the investor-required rate of return, models relied upon to estimate the investor-required rate of return). (Staff RB, 16-17)

The Company attempts to call into question the methodology used by Staff witness Ms. Phipps to adjust the common equity ratio of the proxy group so that it would reflect LUC's riskier credit rating.⁶ (Co. BOE, 14-15) Staff's reply brief addresses these allegations. (Staff RB, 18-19) First, nothing in the record suggests the standard credit rating agency adjustments identified by the Company (i.e., Moody's) vary based upon a Company's capital structure. In other words, the distance between the midpoints of the debt to capitalization ratio range for an A rating and Baa rating would remain at 9.5 percentage points regardless of how Moody's calculates the debt ratio for any particular company. (Staff RB, 18-19) Second, recognizing that the Company's ratemaking capital structure differs from how Moody's calculates its benchmark ratios, Ms. Phipps used the proxy group's average common equity ratio as the starting point for the imputed capital structure, rather than the common equity ratio implied by the Moody's benchmark debt to capitalization ratio. (Staff RB, 19)

⁶ Staff's Reply Brief points out that Mr. Hevert first made these arguments in surrebuttal testimony (Co. Ex. 10.0, 7-11), even though those arguments responded to an adjustment Ms. Phipps presented in direct testimony (Staff Ex. 3.0, 5-6). In Staff's view, this constitutes improper surrebuttal because Staff was denied an opportunity to address and expose those arguments as baseless in Staff's rebuttal testimony. (Staff RB, 18)

In addition to satisfying Section 9-230 of the Act and the need for transparency when the Commission authorizes a rate of return for an Illinois public utility, Staff's proposed common equity ratio is only **[**begin confidential**]** XXXXXXXXXXXXXXXXXXXX **[**end confidential**]** lower than LUC's actual common equity ratio. (Staff RB, 19-20) Moreover, Staff's imputed capital structure, comprising a 54.41% debt to capital ratio comports with the LUC's own target debt ratio. (Staff RB, 13) Staff observes that if goodwill is removed from the Company's common equity balance (which typically occurs in Illinois ratemaking proceedings) the common equity ratio falls from 60.10% to 43.98%, which is even lower than Staff's recommended equity ratio of 45.59%. (Staff RB, 14) Staff examined the financial strength implied by its recommended rate of return on rate base and concluded there should not be any negative effect on the financial strength of LUC. (Staff RB, 15-16) Thus, the PO reaches the correct conclusion on capital structure in this case because in addition to satisfying the requirements of Section 9-230 of the Act, the imputed capital structure adopted in the PO is reasonable.

2. Cost of Common Equity

Cost of Common Equity (Technical Exceptions 2 and 3)

Company Technical Exception 2 recommends deleting a paragraph on page 67 of the PO (Cost of Common Equity Analysis and Conclusion), which admonishes the Company brief for mischaracterizing Commission action in Docket No. 13-0192 and for misleading statements regarding the risk-free rate relied upon by Mr. Hevert. (PO, 67; Co. BOE, Attach. A, 67-68) With respect to "mischaracterizing Commission action," the Company argues that it was attempting to describe a trend rather than characterize a single docket in its brief. (Co. BOE, 17) The Company's brief included a footnote that

referenced three prior Commission decisions, and Mr. Hevert was the ROE witness in two of those cases (i.e., Docket Nos. 11-0282 and 13-0192). (Co. IB, 41, fn. 232) The Commission rejected Mr. Hevert's CAPM estimates in each case for which he was the ROE witness. See Ameren Illinois Company d/b/a Ameren Illinois, Order, Docket No. 11-0282, 125 (1/10/2012) and Ameren Illinois Company d/b/a Ameren Illinois, Order, Docket No. 13-0192, 165 (12/18/2013). Therefore, in Staff's view, the PO correctly describes the Company's brief as mischaracterizing prior Commission decisions. Thus, the paragraph in question does not need to be stricken from the Final Order.

Company Technical Exception 3 (Cost of Common Equity) is similar to Staff Technical Exception 3. In the event the Final Order adopts the same rate of return on common equity as the PO, which it should not, Staff recommends the Final Order reflect this technical correction.

C. Recommended Overall Rate of Return

Authorized Rate of Return on Rate Base (Company Exception 9)

The Commission should reject the Company's proposed changes to Section IV.C. of the PO (Company Exception 9 – Authorized Rate of Return on Rate Base) for all the reasons set forth on pages 6-10 of Staff's BOE. Rather than leaving the PO as is or, worse yet, adopting the changes proposed by the Company, Staff recommends the Commission adopt Staff's rate of return on common equity recommendation and Staff's proposed corresponding changes to Section IV.C. of the PO, as set forth on pages 13-14 of the Staff BOE.

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

V. COST OF SERVICE

VI. RATE DESIGN

VII. OTHER

A. Quality of Future Rate Filings and Reports

B. Property Taxes – Request for Deferred Accounting⁷

Liberty Midstates takes exception to the PO's finding that its request for deferred accounting treatment be denied. (Co. BOE, 19-20) The Company does not agree with the PO's characterization that the deferred property taxes will have an insignificant financial impact. Staff believes Liberty Midstates' argument does not present any new facts for the Commission to alter the PO's decision to deny the request for deferred accounting treatment. (PO, 85)

VIII. CONCLUSION

WHEREFORE, for all of the reasons set forth in Staff's Initial Brief, Reply Brief, Brief on Exceptions, and this Reply Brief on Exceptions, Staff respectfully requests that the Commission's Order in this proceeding reflect all of Staff's recommendations regarding the Company's request for a general increase in gas rates.

⁷ No longer an operating expense issue.

Respectfully submitted,

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