BEFORE THE NEBRASKA PUBLIC SERVICE COMMISSION

In the Matter of the Application of SourceGas Distribution LLC, Lakewood, Colorado, seeking approval of a general rate increase.	)	Application No. NG-0067
	)	ORDER GRANTING APPLICATION, IN PART
	)	Entered: May 22, 2012

BY THE COMMISSION:

On September 30, 2011, SourceGas Distribution LLC (SourceGas) filed an application seeking approval of a general rate increase (Application). Pursuant to the planning conference order entered on November 8, 2012, the hearing officer released the staff list of disputed issues, and the parties were asked to provide comment and corrections.[1] Based upon the comments and corrections received, a revised list of issues was released on March 16, 2012.[2] Hearing on this matter was held from March 19 through March 21, 2012.

On May 1, 2012, the Commission entered an interlocutory order releasing assumptions for the purpose of calculating rates.[3] Subsequently, the Hearing Officer entered an order amending the assumptions.

On May 8, 2012, SourceGas filed proposed rates pursuant to the May 1, 2012 order. A technical conference was held on May 10, 2012. Hearing on the revised rates was held on May 15, 2012.

E V I D E N C E

In its Application, SourceGas sought a revenue increase of approximately $8.279 million based upon a test year of twelve months ending March 31, 2011.[4] SourceGas proposed a return on equity of 11 percent and an overall return of 8.4 percent.[5]

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[1] *In the Matter of the Application of SourceGas Distribution LLC, Lakewood, Colorado, seeking approval of a general rate increase*, Application No. NG-0067, Hearing Officer Order Releasing List of Issues and Seeking Comment (Mar. 9, 2012).

[2] *In the Matter of the Application of SourceGas Distribution LLC, Lakewood, Colorado, seeking approval of a general rate increase*, Application No. NG-0067, Hearing Officer Order on Prehearing Motions and Releasing Revised List of Issues (Mar. 16, 2012). (Hereafter “Order Releasing Revised Issues”)

[3] *In the Matter of the Application of SourceGas Distribution LLC, Lakewood, Colorado, seeking approval of a general rate increase*, Application No. NG-0067, Interlocutory Order Releasing Assumptions for the Purposes of Calculating Proposed Rates (May 1, 2012). (Hereafter “Interlocutory Order”)

[4] SourceGas Distribution LLC Application for General Rate Increase, Ex. 10 at 4.

[5] *Id.*

The Public Advocate filed testimony on January 31, 2012, asserting that no revenue deficiency existed and therefore no rate increase was required.[6]

SourceGas significantly reduced the increase sought in its rebuttal case. It updated the rate base, cost of capital, expenses, and revenues filed in its direct case using actualized data through January 31, 2012, adjusted for known and measurable changes.[7] Based upon its rebuttal filing, SourceGas now seeks an annual revenue increase of $6.086 million.[8] The Company further proposes a return on common equity of 10.62 percent.[9] Based upon its rebuttal filing, SourceGas seeks an increase in fixed monthly charges to $15.00 for residential customers, $25.00 for small commercial customers, and $60.00 for large commercial customers.[10] Furthermore, SourceGas proposes a declining block rate design with a two-tiered distribution rate schedule which includes a monthly volumetric rate of $.4818 for the first 20 therms used by residential and small commercial rate payers and for the first 40 therms used by large commercial rate payers. Both would be subject to a rate of $.1378 for remaining volumes.

During the hearing on the application, live testimony was provided in support of the Application by Mr. Lewis Binswanger, Ms. Lynn Norsworthy, Mr. Stephen Rocheleau, Mr. Jason Pickett, Mr. Jerrad Hammer, and Mr. Verlyn Engler. Mr. Michael Arndt provided live testimony on behalf of the Public Advocate. In addition to live testimony, prefiled written and rebuttal testimony on behalf of the witnesses listed above and that of Dr. Roger A. Morin, Dr. Robert Livezey, Mr. Larry Loos, and Mr. Thomas Sullivan was filed on behalf of SourceGas and entered into the record. In addition to prefiled testimony of Mr. Arndt, that of Dr. David Dismukes and Dr. J. Randall Woolridge was filed on behalf of the Public Advocate and entered into the record. Various other documents were also entered into the record in this matter and will be specifically referenced when appropriate.

On May 15, 2012, Mr. Hammer testified at the hearing on proposed rates regarding the various rate design options and sponsored the schedules required by the Commission’s interlocutory order.

Throughout the Order, references made to numbered issues, each of which corresponds to the Revised Commission Staff List of Disputed Issues[11] and the Interlocutory Order Releasing Assumptions for Purposes of Calculating Proposed Rates[12].

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[6] Pre-Filed Direct Testimony and Exhibits of Public Advocate Witness Michael L. Arndt, Ex. 352 at 5:25-27.
[7] Prefiled Rebuttal Testimony and Exhibits of Lewis M. Binswanger, Ex. 37 at 8:8-22.
[8] *Id.* at 9:16-17.
[9] *Id.* at 9:22.
[10] See Ex. 10.
[11] Order Issuing Revised Issues*, supra*.
[12] Interlocutory Order, *supra*.

O P I N I O N A N D F I N D I N G S

"Every rate made, demanded, or received by any natural gas public utility shall be just and reasonable. Rates shall not be unreasonably preferential or discriminatory and shall be reasonably consistent in application to a class of ratepayers."[13]

> The commission, in the exercise of its power and duty to determine just and reasonable rates for natural gas public utilities, shall give due consideration to the public need for adequate, efficient, and reasonable natural gas service and to the need of the jurisdictional utility for revenue sufficient to enable it to meet the cost of furnishing the service, including adequate provisions for depreciation of its utility property used and useful in rendering service to the public, and to earn a fair and reasonable return upon the investment in such property.[14]

"Cost of service shall include operating expenses and a fair and reasonable return on rate base, less appropriate credits."[15]

Items reflected in issues 10, 15, 17, 18, 23, and 24 were removed by SourceGas' rebuttal testimony and are, therefore, no longer at issue. Any adjustments necessary as a result of their removal have been made including the adjustment to net utility plant by $477,641 and the $68,235 in accumulated reserve for depreciation and amortization (ARDA) reflected in the rebuttal testimony.

With the exception of the items specifically addressed herein, the Commission grants SourceGas' Application as reflected in its rebuttal filing subject to the adjustments and limitations discussed below.

MOTIONS TO DISMISS AND UPDATES IN REBUTTAL TESTIMONY

The Public Advocate filed a Motion to Dismiss Application or to Otherwise Deny Relief (Motion to Dismiss) and a Motion to Dismiss Application with Respect to Past Rate Case Expense Issue, Alternative Objections and Motion to Strike, and Alternative Motion in Limine (Rate Case Expense Motion). SourceGas filed a Motion to Strike and Written Objections to the Public Advocate's Prefiled Testimony.

The Hearing Officer entered an order resolving all issues with the exception of the Motion to Dismiss and the issues related to the Rate Case Expense in the Rate Case Expense Motion.

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[13] *Neb. Rev. Stat*. § 66-1825(1) (Reissue 2009).
[14] § 66-1825(3).
[15] § 66-1825(4).

Motion to Dismiss and Use of Rebuttal Testimony

SourceGas, in its rebuttal testimony, updated the rate base, cost of capital, expenses and revenues filed in its direct case using actualized data through January 31, 2012, adjusted for known and measurable changes.[16] The update reduces its requested revenue increase significantly.[17] In his Motion to Dismiss, the Public Advocate argues that SourceGas' rebuttal testimony and the attendant updates demonstrate that the original revenue deficiency was overstated and cannot provide a reliable basis upon which to proceed with the Application. He also contends the rebuttal submission constitutes a new rate case with a new test year. The Public Advocate states that the rate payers have been denied due process as he has not had sufficient notice or time to conduct discovery or otherwise analyze the rebuttal data.

The use of an historical test year for the purposes of establishing rates represents a snapshot in time that may or may not precisely reflect the rate base, revenues, cost of service in place at the time that revised rates will take effect. Therefore, to account for this inherent imprecision, the Act allows for adjustments for known and measurable changes as well as the inclusion of construction work in progress (CWIP). Utilizing updated data based upon actuals rather than estimates allows the Commission to set rates based upon data that will most closely match the time period during with rates will take effect.

The Commission has previously relied upon updated information in rate cases and such reliance has been affirmed on appeal.[18]

Additionally in direct testimony, the Public Advocate's witnesses criticize the accuracy of the estimates made by SourceGas and as having not been updated through March 31, 2012. With respect to CWIP, Mr. Arndt testifies:

> the Company has not updated corresponding customer contributed capital balances such as accumulated depreciation, accumulated deferred income taxes (ADIT) through March 31, 2012. The Company's failure to update customer contributed capital through March 31, 2012, creates a major matching problem and greatly overstates rate base.[19]

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[16] Ex. 37 at 8:8-22.
[17] Ex. 37 at 8:8-22.
[18] *See In the Matter of Black Hills/Nebraska Gas Utility Company, LLC, d/b/a Black Hills Energy, Omaha, seeking a General Rate Increase for Black Hills Energy's Rate Areas One, Two and Three (Consolidated),* Application No. NG-0061, Order Granting Application in Part, (Aug. 17, 2010)(Hereafter "Black Hills Order"); *In the Matter of SourceGas Distribution, L.L.C.,* Application No. NG-0060, Order Granting Application, In Part (Mar. 9, 2010)(Hereafter "NG-0060 Order"); *Nebraska Public advocate v. Nebraska Public Service Commission*, District Court Case No. 07-3542, Order dated March 3, 2008.
[19] Ex. 352 at 14:21-15:3

He further recommends that "If the Commission accepts the inclusion of CWIP projects in rate base through March 31, 2012, the accumulated depreciation and ADIT balances should be updated to March 31, 2012 levels and any excess costs and projects scheduled to be in service after March 31, 2012, should be removed."[20] Many of the Public Advocate's other objections to the direct case relate to whether the particular adjustment constituted a known and measurable change.[21]

The Public Advocate had an opportunity to review the accounts and processes employed by SourceGas in maintaining its accounting records during his 3-day audit conducted during the pendency of this case.[22] Additionally, he could cross-examine SourceGas witnesses on the rebuttal testimony.

The schedule imposed by statute and the inherently imprecise nature of the rate-making process present challenges for both the Public Advocate and the Commission. However, the end-goal for all parties and the Commission is to reach just and reasonable rates. Using the updated data will best satisfy this purpose. The Commission finds that unless otherwise stated herein, that the amounts reflected in SourceGas' rebuttal testimony should be used for purposes of determining just and reasonable rates and that the Public Advocate's Motion to Dismiss should be denied. However, recognizing the challenges presented by updates being filed shortly before the hearing, the Commission intends to initiate an investigation to establish a process for providing updates during the pendency of a rate case.

RATE BASE

Rate base is defined by the Act.

> The rate base of the jurisdictional utility shall consist of the utility's property, used and useful in providing utility service, including the applicable investment in utility plant, less accumulated depreciation and amortization, allowance for working capital, such other items as may be reasonably included and reasonable allocations of common property, less such investment as may be reasonably attributed to other than investor-supplied capital unless such deduction is otherwise prohibited by law.[23]

"The rate base shall ordinarily consist of those items which are used and useful in providing service to the public."[24]

> Post test year adjustments are permitted for known and measurable rate base adjustments to test year where the utility accounts for any related impacts on all aspects of the jurisdictional utility's operations. Related impacts are

[20] *Id.* at 19:36-20:3.
[21] See e.g. Ex. 352 at 42:12-14, 47:15-17, and 60:10-14.
[22] Ex. 37 at 14:1-4.
[23] § 66-1825(6).
[24] § 005.06D

> those that reasonably follow as a consequence of the post test year adjustment being proposed, including a related impact of another post test year adjustment.[25]

Capital Additions and Construction Work In Progress

In its rebuttal testimony, SourceGas proposes adjustments to rate base in the amount of $6,960,680 related to CWIP as well as additional adjustments to ARDA and ADIT balances related to changes in the Cost Assignment and Allocation Manual (CAAM).[26] The Public Advocate recommends that no CWIP be included as it is not a known and measurable change.[27]

Neb. Rev. Stat. § 66-1817 states, in part

> (1) Any jurisdictional utility property may be deemed to be completed and dedicated to commercial service if construction of the property will be commenced and completed in one year or less.
>
> (2) The Commission may determine that property of a jurisdictional utility which has not been completed and dedicated to commercial service may be deemed used and useful in the utility's service to the public.

Post-test year adjustments related to capital additions and construction work in progress are entirely within the Commission's discretion.[28] The Commission has previously provided guidance regarding the nature of direct testimony that utilities should provide in support of adjustments for construction work in progress including but not limited to:

> a discussion of each project; why the utility has determined that the project is necessary to the provision of safe and reliable gas service; and how the project costs are being financed, whether through debt or internally generated cash. Additionally, the utility should describe why it is necessary for the project to be included in rates before it is complete and in service.[29]

The Commission further suggested that evidence should include:

> a list of all construction projects the utility is requesting to include in plant in service which should

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[25] § 005.06F
[26] Issues 8, 9, and 11; Ex. 14 at 1; Prefiled Rebuttal Testimony and Exhibits of Jerrad S. Hammer, Ex. 120 at 20:22-21:2.
[27] Ex. 352 at 14:20.
[28] § 66-1817.
[29] *In the Matter of Aquila, Inc. d/b/a Aquila Networks (Aquila), Omaha, seeking individual rate increases for Aquila's Rate Area One, Rate Area Two, and Rate Area Three.,* Application No. NG-0041, Order Granting Application in Part, pg. 5 (July 24, 2007).

> include a description of the project; location of the project; purpose of the project; date construction was begun; expected completion date; actual costs incurred as of the last day of the test year; and finally total expected cost of the project at completion.[30]

Mr. Arndt testifies “CWIP balances are based on budgets and are not known and measurable. In addition, the Company has not updated corresponding customer contributed capital balances such as accumulated depreciation, accumulated deferred income taxes (ADIT) through March 31, 2012. The Company’s failure to update customer contributed capital through March 31, 2012, creates a major matching problem and greatly overstates rate base.”[31] Mr. Arndt further states that “The Company’s CWIP proposal is based on forecasted completion dates which are not known and measurable.”[32] He also testifies that another reason to disallow CWIP as proposed is that the balance is based upon budgets and that the actual costs may be significantly less.[33]

In its rebuttal testimony, SourceGas provides a listing of all CWIP projects which includes project descriptions, locations, budgets and costs, and scheduled completion dates.[34] At the hearing, Mr. Pickett testified “[a]lmost all of the CWIP projects now are in service or being in the process of being booked to plant by our accounting folks.”[35] He further provides specific testimony regarding the status of three Nebraska specific projects: the McCook low-pressure system project, the Alliance town border station project, and the bare steel pipeline replacement project in Neligh. With respect to the McCook project, Mr. Pickett testified

> “SourceGas Distribution has completed about 70 percent of the McCook low-pressure system project. Natural gas is flowing through that project, through that system, and is being in use. The remaining 30 percent of that project will be completed in mid 2012. It was put off last year due to frozen ground and the snow flying.”[36]

Regarding the Alliance project, Mr. Pickett stated, “SourceGas Distribution has resolved the right-of-way issues that we ran into with landowners affecting the alliance town border station project. That project will be completed by mid 2012 as well.”[37] Finally, he testified that the remaining 5 percent of the bare steel pipeline replacement project in Neligh will be completed during 2012.[38] He

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[30] *Id.*; See Also, Neb. Admin. Code, Title 291, Ch.9 § 4.03C (2012).
[31] Ex. 352 at 14:20-15:3.
[32] *Id.* at 17:1-2.
[33] See *Id.* at 17:18-20.
[34] Ex. 14 pp. 7-16.
[35] Trans. at 290:16-18.
[36] Trans. at 291:4-12.
[37] Trans. at 291:13-17.
[38] See Trans. at 291:18-24.

noted that "gas is flowing in the pipe, and it is serving the end-use customers as of the end of 2011."[39]

Mr. Pickett also discussed the Mobile Data Solutions Incorporated (MDSI) replacement software project which is expected to be completely operational by the second half of 2012.[40]

Mr. Hammer also provided testimony regarding two projects, the new corporate headquarters and the implementation of the COGNOS analytics software, which remained open at the time of the filing of rebuttal testimony.[41] Mr. Hammer stated, "Effective March 19, 2012, SourceGas will occupy its new corporate headquarters in Golden, Colorado."[42] He further testified the COGNOS project would "be completed by April 30, 2012."[43]

The "open" projects that are expected to be completed subsequent to the twelve months after the close of the test year are to be completed within a sufficiently short period or are substantially completed so that it would not be reasonable to deny recovery on the entirety of the project. SourceGas has provided sufficient information regarding their progress and expenditures for the Commission to deem these projects as used and useful and allow them to be included in rate base.

The Commission finds the CWIP balance set forth in its rebuttal testimony in the amount of $6,960,680.00 are approved. Additionally, SourceGas should include updated balances of ARDA in the amount of $99,080,552[44], which includes adjustments related to changes in the CAAM and the inclusion of CWIP as set forth in its rebuttal testimony. Also, updated balances of accumulated deferred income tax are approved in the amount of $9,313,676[45] which includes adjustments related to changes in the CAAM and the inclusion of CWIP.

<u>Working Capital and Prepaid Expenses</u>

With respect to working capital allowance, SourceGas, as proposed in its rebuttal testimony, removes prepaid expenses from rate base and in order to recover its interest expense associated with prepaid expenses, applies its short-term debt interest rate for the twelve months ending January 31, 2012, 1.74 percent to prepaid expenses resulting in a total working capital sought of $483,200 including a per books thirteen month average ending January 31, 2012, for materials and supplies.[46] The Public Advocate opposes any return on

[39] Trans. at 291:25-292:2.
[40] Trans. at 292:25-294:3.
[41] Ex. 120 at 20:4-21
[42] *Id.* at 20:7-8.
[43] *Id.* at 20:20-21.
[44] Ex. 216 at 5:4.
[45] *Id.* at 5:7.
[46] Ex. 120 at 28:10-16.

prepaid expenses as no cash working capital study had been performed and postpaid expenses were not included.[47]

Working capital allowance includes: prudent inventories of materials and supplies, held specifically for purposes of permitting efficient operation of the utility in providing normal utility service; prudent prepayments for operating expenses; and a prudent allowance for cash working capital.[48]

Prepaid expenses are specifically delineated in the rule as a component of working capital. In this case, rather than including the item in rate base, the Company seeks to limit its recovery of capital costs for this item to the short-term debt interest rate, as short-term debt is used to finance prepaid expenses (per the testimony of Binswanger - cite should be in cap structure section). As discussed below, we find that this is a fair treatment of the capital costs associated with this item.

Customer Advances and Deposits

In its rebuttal testimony, SourceGas seeks to include the actual per books thirteen-month average of customer deposits as of January 31, 2012, of $2,212,701[49] and the actual per books non-refundable portion of customer advances as of January 31, 2012, in the amount of $75,957.[50] The Public Advocate argues that the average over the test year should be used.[51] In response to the Commission's Interlocutory Order, SourceGas calculated the actual per books thirteen month average for customer advances in the amount of $95,552.[52] The Commission finds that the amount calculated by SourceGas should be used.

The Commission finds that SourceGas should include in rate base the actual per books thirteen-month average as of January 31, 2012, of $2,212,701 for customer deposits and the actual per books thirteen month average as of January 31, 2012, for customer advances.

Call Center and Billing Systems

SourceGas seeks to include in rate base costs in the amount of $975,980 associated with SourceGas' call center; $4,774,997 related to the SAP billing system and $2,450,891 for the PEACE billing system and the associated depreciation expense in the amount of $245,089.[53]

The Public Advocate argues that SourceGas has failed to provide sufficient evidence to support the costs associated with the call center and the SAP billing system. He further argues that the costs of the PEACE billing system should be eliminated from rate base as the

[47] Public Advocate Post Hearing Brief at 48.
[48] See § 005.06B.
[49] Ex. 120 at 27:4-5.
[50] *Id.* at 24:21-22.
[51] Ex. 352 at 29:1-4.
[52] Ex. 215 at 4:15
[53] Ex. 37 at 36:3-12, Rebuttal Table 2, Ex. 48 and Ex. 137.

system is not currently used and useful. In the alternative, he contends that any return on this portion of rate base should be limited to the Company's short-term debt interest rate.

During the hearing, Mr. Hammer testified that SourceGas currently utilizes the PEACE billing system to gain access to historical billing data that predates the current SAP billing system.[54] This data includes "not only the total amount billed to customers…but it also contains all of the individual line items, like, customer charges, taxes, distribution charges, consumption, all of that type of information related to the billings."[55] The SAP billing system replaced the PEACE billing system in approximately late 2009.[56] Mr. Hammer testified that they often look at historical billing data from about three to five years back in order to determine classification of commercial and agricultural customers.[57] The cost of the billing system is being amortized over a ten (10) year period, and the Company is approximately five years into that period.[58] SourceGas also provided information regarding how frequently the data from the PEACE billing system is accessed.[59]

The Commission finds that based upon the evidence provided, the Company will no longer need to gain access to PEACE billing system information once the SAP billing system has accumulated 3-5 years worth of data. Because the SAP billing system was installed in 2009, the need to gain access to the PEACE billing system data will become almost non-existent prior to the costs being fully depreciated.

Therefore, the Commission finds that costs of the call center and the SAP billing system are approved and should be included in rate base. With respect to the PEACE billing system, the Commission finds that based upon the fact that it will cease to be used and useful within a year and a half, SourceGas may include one-third (1/3) of the Peace Billing System-related jurisdictional plant balances as shown in Exhibit 137 in rate base, in the amount of $451,375, along with related adjustments.

Rate Case Expense: Docket No. NG-0060

SourceGas is seeking recovery of expenses totaling $294,295.70, assessed by the Commission for costs of the Commission and the Public Advocate in Docket No. NG-0060. The Public Advocate seeks to dismiss all portions of SourceGas' application relating to the recovery of rate case expenses from NG-0060 on the basis of res judicata. SourceGas contends this amount was not recovered through rates prior to the filing of the present matter.

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[54] See Trans. at 344:16-20.
[55] Trans. at 346:9-14.
[56] See Trans. at 347:1-7.
[57] See Trans. at 349:15-22.
[58] See Trans. at 354:10-15.
[59] See Ex. 136.

> On and after June 1, 2007, the commission by general rule and regulation ***shall*** authorize the recovery of the amount of any assessments or charges paid to the commission pursuant to this section and section 66-1840 in a general rate filing or through a special surcharge which may be billed on the monthly statements for up to a twelve-month period immediately following their payment by the jurisdictional utility.[60]

The Commission has previously denied a request to recover past rate case expenses.[61] However, the request included both assessed costs and the utility's internal costs. SourceGas is not seeking recovery of its internal expenses, but only those assessed by the Commission. Such amounts are beyond the control of the Company and result from the actions of the Commission and the Public Advocate. Further costs assessed by the Commission under the Act are distinguishable from other costs recovered through the rate making process. Pursuant to the Act, the utility is entitled to recovery of assessed amounts. Therefore, the uncollected rate case expenses from Docket No. NG-0060 totaling $294,295.70 may be collected, amortized over a three (3) year period.

COST OF SERVICE

"Operating expenses shall consist of expenses prudently incurred to provide natural gas service including (a) a reasonable allocation of common expenses as authorized and limited by section 66-1819 and (b) the quantity and type of purchased services regulated by the Federal Energy Regulatory Commission."[62]

Affiliate Costs

SourceGas filed its application to be "consistent with and organized as set forth in the Commission's second set of proposed rules in Rule and Regulation No. 179."[63] The proposed rules were later adopted by the Commission on November 8, 2011.[64] The rules and regulations were filed with the Secretary of State on March 28, 2012, and became effective April 2, 2012.

Transactions between a utility and its affiliates are typically subject to close scrutiny due to the potential for overpayment for goods or services inherent in the relationship. Such transactions do not enjoy the same presumption of prudency available to a utility with

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[60] § 66-1841(6)(b).
[61] Black Hills Order, *supra.*
[62] § 66-1825(7).
[63] Prefiled Direct Testimony and Exhibits of Lewis M. Binswanger, Ex. 29 at 15:20-22.
[64] *In the Matter of the Commission, on its own motion, seeking to amend Title 291, Chapter 9, Natural Gas and Pipeline Rules and Regulations, to adopt rules regarding General Rate Filings; Rate Principles; Affiliate Transactions and Tariff Filings.*, Rule and Regulation No. 179, "Order Issuing Certificate of Adoption" (Nov. 8, 2011).

respect to arms length transactions. The rule and regulation in place prior to March 2012 stated:

> The jurisdictional utility has the burden to demonstrate that any cost paid to an affiliate for any goods or services are prudent. The jurisdictional utility has the burden to demonstrate all of the following before any amount paid to an affiliate either, as a capital cost or an expense, is included in rates except as provided in *Neb. Rev. Stat*. § 66-1825(8):
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> > 005.07A Each payment is prudently incurred for each item or class of items at the time incurred.
> >
> > 005.07B The costs charged by an affiliate reasonably approximate the market value of service to it. [65]

Currently, the rules state:

> 001.01A Affiliate: A person or entity that directly, or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with a jurisdictional utility or competitive natural gas provider. A voting interest of 10 percent or more creates a rebuttable presumption of control.
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> > 001.01A1 Shared Resources Affiliate: A person or entity whose primary purpose is to share employees, departments or other physical assets used by the jurisdictional utility.
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> > 001.01A2 Affiliate Transaction: The purchase, sale, trade or lease of a good, service, or tangible or intangible asset from the regulated utility to an affiliate, regulated or unregulated other than a shared resources affiliate, or from an affiliate other than a shared resources affiliate to the regulated utility.

Under the current rules, transactions with a shared resource affiliate enjoy the same presumption of prudence as other non-affiliate transactions.[66]

The information provided by SourceGas is similar to that previously provided in Docket No. NG-0060.[67] Mr. Binswanger testified

[65] § 005.07.

[66] See § 005.04 stating: “Only those expenses which are prudent may be included in allowable expenses. Expenses incurred by a jurisdictional utility or a shared resources affiliate shall be presumed to be prudent, unless the contrary is shown.”

"SourceGas's base salaries on average are slightly below the midpoint of our range driven by market data." Ms. Norsworthy testified as to how the costs in question are allocated to the various affiliates pursuant to the CAAM answering questions previously posed by the Commission to Black Hills in Docket No. NG-0061.[68] Ms. Norsworthy specifically testifies:

> The Company assignments and allocations are at actual costs. There are no adders of any sort…shared resources activities involve economies of scale under which, essentially by definition, costs are lower to each participant than they would be if they purchased the service from a third party.[69]

She provides further explanation in her rebuttal testimony describing the costs at issue as allocations rather than affiliate transactions.[70]

The Commission does not reach the question of whether the former affiliate rule or the current affiliate rule controls in this case. Further, we find SourceGas has met its burden of proof regarding the transactions in question under either rule.

Cost Allocation

SourceGas filed a Class Cost of Service Study and CAAM.[71] The Company provided an updated CAAM in its rebuttal testimony.[72] The Public Advocate objects to the use of the three-factor allocator as over-allocating shared costs to the regulated entities as compared to unregulated enterprises.

SourceGas' CAAM and methods for allocation, including the three-factor allocator, are similar to those previously approved by the Commission and widely used across regulatory jurisdictions.[73]

The Commission is satisfied, based upon the information provided in direct and rebuttal testimony, that the methodology for allocating common expenses is reasonable for purposes of this application.

Weather Normalization

SourceGas proposes a 12-year average for weather normalization based on Optimum Climate Normals (OCN) provided and supported by Dr. Robert Livezey, a climatologist, former chief of the National Weather

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[67] *Nebraska Public Advocate v. Nebraska Public Service Commission*, 19 Neb. App. 596 (2012) and Black Hills Order, *supra*.
[68] Ex. 78 at 23-28.
[69] Prefiled Direct Testimony and Exhibits of M. Lynn Norsworthy, Ex. 78 at 28:11-12 and 17-19.
[70] Prefiled Rebuttal Testimony and Exhibits of M. Lynn Norsworthy, Ex. 81 at 4:8-6:21.
[71] See Ex. 78.
[72] See Ex. 81 and Trans. at 201:25-248:17.
[73] Black Hills Order, *supra*; Ex. 78 at 27:8-15.

Service's climate services, and expert in climate variability, climate change, and climate prediction. Dr. Livezey testifies regarding his conclusions that the predictive value of 30-year normals has decreased due to a weather warming trend recorded since the mid 1970's. Further, Dr. Livezey testifies that a 30-year normal is no longer the best indicator of normal weather conditions.[74] The National Oceanographic and Atmospheric (NOAA) is no longer using 30-year normals in forecasting weather[75] and the World Meteorological Organization (WMO) recommends that 30-year normals be updated every 10 years. The WMO's recommendation has been adopted in the United States.[76] Dr. Livezey recommends, based on the data from Nebraska, the OCN method, with a 12-year running average, as a considerably more accurate and reliable method to determine normal weather for normalization purposes.[77]

The Public Advocate urges the Commission to use a 30-year rolling average for weather normalization and reject the Company's proposal to use the OCN method of a 12-year running average.[78] Through the testimony of Dr. David Dismukes, the Public Advocate cites the following reasons for rejecting the Company's proposed weather normalization adjustment: the empirical data utilized by the Company is not publically available; the proposed normalization adjustment is based upon selective and subjective statistical methodologies used in a statistically-inappropriate way; the proposed methodology is opportunistically used by the Company for its own benefit and inconsistent with past SourceGas positions in rate cases; and finally, the OCN method advocated by the Company is inconsistent with traditional ratemaking practices.[79]

Proposed rates are based on gas usage to calculate the revenue generated for the test year. Gas usage figures are then adjusted to reflect a "normal" year of usage. In prior rate cases the Commission has approved a 30-year average of the NOAA normals.[80] However, in the most recent rate case proceeding, the Commission approved use of the OCN methodology with a 10-year rolling average.[81] The Commission finds, after analysis of the evidence provided by Dr. Livezey, that SourceGas has presented sufficient evidence to support its weather normalization adjustment. Therefore, the Commission finds, for purposes of this rate case proceeding, use of the OCN 12-year rolling average is reasonable and should be adopted.

The Commission is satisfied with the normalization adjustment and methodology utilized by the Company in this rate case proceeding. However, the Commission finds jurisdictional utilities should be mindful in future proceedings, of the methods and procedures utilized

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[74] Prefiled Direct Testimony of Robert Livezey, Ex. 92 at 10:3-24.
[75] *Id.* at 8:10-13.
[76] *Id.* at 7:21 - 8:3.
[77] *Id.* at 34:14-20.
[78] Prefiled Direct Testimony of Dr. David Dismukes, Ex. 301 at 100:10-11 and 101:4-13.
[79] *Id.* at 100:10 – 101:3.
[80] *See* NG-0060 Order, *supra*; NG-0041 Order, *supra* note 21.
[81] *See* NG-0061 Order, *supra* at 13-15.

by a company to select and apply weather data, especially when data from some weather stations in the service area are missing or incomplete. The technical process of selection and application of weather data has the potential bias, particularly when matching regional weather to load data for weather normalization. Utilities should consider providing sensitivity analyses of different alternatives that match weather station data and area-specific energy consumption.

Labor Costs

In its Application, SourceGas included $1,298,826 in labor costs[82] which include (i) a 2.5 percent increase for non-union employees to become effective during the first quarter of 2012; (ii) the effect of the 2.5 percent union wage increase effective, May 1, 2011; and (iii) increases in benefits costs between 2.25 percent and 8 percent.[83]

The Public Advocate proposes these costs be disallowed, including the 2.5 percent increase for union employees effective May 1, 2012, and the 2.5 percent non-union increase effective in 2012.[84]

In rebuttal, SourceGas reduces labor costs by $247,367. The adjustment (i) replaces the estimated 2.5 percent increase for non-union employees with the actual annual 2012 pay rates for 967 active employees as of February 5, 2012 (which excludes 26 vacant positions); (ii) includes labor and benefits costs for six vacant positions that are part of the 26 vacant positions that will be filled by active employees on or before March 19, 2012; (iii) reflects the effect of the 3 percent union wage increase that will be effective, pursuant to contract approximately 1 month after the end of the test year; (iv) corresponds employee benefits with the change in level of salaries and wages as well as the change in the number of employees identified above; (v) includes the effect of applying the 2012 CAAM factors; and (vi) reflects lower labor and benefit expenses attributable to lower operating expenses for 2012 with 2011. [85]

The Commission finds that based upon the information provided the costs are known and measurable and should be approved.

Pipeline Integrity Position

In its Application, SourceGas included costs in the amount of $135,846 for the addition of two new positions related to pipeline integrity.[86]

The Public Advocate contends that this amount should be eliminated as it is not known and measurable. At the time of the filing the two positions had not yet been filled and Mr. Arndt testifies that the adjustment “represents a piecemeal adjustment given the constant

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[82] Prefiled Direct Testimony of Stephen L. Rocheleau, Ex. 83 at 30:23-25.
[83] *Id.* at 29:14-18.
[84] Ex. 352 at 42:12-14.
[85] Prefiled Rebuttal Testimony of Stephen L. Rocheleau, Ex. 87 at 8:17-9:15.
[86] Ex. 83 at 32:7-10.

change in employee levels”.[87] In rebuttal, SourceGas reduces the expense to $78,567 for costs related to one new position and has indicated that the position has been filled.[88]

The Commission finds that costs for the additional position are known and measurable and should be approved.

Variable Compensation

In its rebuttal testimony, SourceGas includes $684,815 in actual variable compensation paid pursuant to the Company’s STIP plan.[89] This amount does not include approximately $157,000 of executive long-term incentive plan payments.[90]

The Public Advocate contends that these amounts should be disallowed as not supported by direct testimony.[91]

The Commission finds that SourceGas has provided sufficient evidence to support the expense and therefore it should be approved.

Dues

SourceGas seeks to include $18,321 in Energy Association dues and $11,000 in Chamber of Commerce Dues.[92] These amounts do not include any lobbying costs or political contributions.[93]

The Public Advocate argues that SourceGas has failed to provide sufficient evidence to demonstrate that the expenses are necessary for the provision of safe and reliable gas service and should be removed.[94]

The Commission finds that expenses for dues paid to trade associations and chambers of commerce should be approved.

Rate Case Expenses

In its Application, SourceGas sought rate case expenses estimated at $1,160,000, amortized over two (2) years. SourceGas also sought to collect assessed amounts through a surcharge rather than in rates. The Public Advocate argued that the Commission should use the rate case expense from the prior rate case in the amount of $529,059 as a proxy for the expense in this case.[95]

At the hearing, Mr. Binswanger testified, “Our actual expenses up – up through this week are estimated to be $704,012. Although, in

[87] Ex. 352 at 47:12-17.
[88] Ex. 87 at 11:6-7 and 19.
[89] Ex. 37 at 39:17-43:9; Trans. At 87:13-14; See also Ex. 29 at 34:15-38:13.
[90] Ex. 84 at 18 and Ex. 37 at 42:1-4.
[91] Ex. 352 at 44:21-45:14.
[92] Ex. 83 at 23:1-7; Ex. 84 at 15 and 17; and Ex. 87 at 15:18-17:8.
[93] Ex. 83 at 16:3-13, 20:21-23, and 24:25-25:4.
[94] Ex. 352 at 53:17-54:22.
[95] *Id.*

light of the recent waiving of certain witnesses, we expect that amount to go down approximately 10 to $15,000."[96] SourceGas also provided a late-filed exhibit indicating that their actual rate case expense is $691,303 and estimated expenses for the remainder of the present case of $109,147.[97]

The Act[98] allows for the costs of the Public Advocate and the Commission to be recovered through an assessment on the utility recovered from ratepayers through a surcharge. The pertinent statute reads:

> On and after June 1, 2007, the commission by general rule and regulation shall authorize the recovery of the amount of any assessments or charges paid to the commission pursuant to this section and section 66-1840 in a general rate filing or through a special surcharge which may be billed on the monthly statements for up to a twelve-month period immediately following their payment by the jurisdictional utility.[99]

Previously, SourceGas has recovered rate case expenses through its rates. However, the Company proposes to recover its own expenses through rates and assessed costs through the use of a surcharge.

The Commission has only allowed jurisdictional utilities to use surcharges to recover costs when specifically allowed under statute.[100] Every cost incurred by a utility could potentially be directly surcharged to customers, but the appropriate mechanism contemplated by the Act for SourceGas to recover its costs, including rate case expenses, is to recover them through its rates and the assessed costs may be recovered either through rates or through a surcharge. Further, including costs in rates encourages the Company to find efficiencies and economies when operating its business, policy goals the Commission promotes.

The Company proposed a two-year amortization period of its estimated rate case expenses. Although the present case was filed within two years of the last rate case, a more typical time frame between rate cases for utilities is three years.

It is true if the Company initiates a general rate case in less than three years from this current proceeding, it will not recover the entire amount of the cost it estimates for this rate case proceeding; however, a two year amortization period would be more likely to cause the Company to over-recover from ratepayers. Consistent with the history of rate filings for utilities before the Commission, a three year amortization period for rate case expenses is appropriate in this case.

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[96] Trans. at 85:21-86:1.
[97] Ex. 212.
[98] *See* § 66-1801 et seq.
[99] § 66-1841(6)(b).
[100] *See* § 66-1854; § 66-1865.

SourceGas has estimated its costs for the current proceeding as $800,450.[101] In making its estimate, the Company included costs for any potential appeals. The Public Advocate argues that should no appeal be filed, that portion of the estimate attributable to appeal costs will never be spent and the Company will over-recover.

The fact that the Company includes in its estimate some allowance for possible appeals is entirely reasonable in light of the history of rate proceedings before the Commission. Whether an appeal will be taken is not solely within the company’s control but is also within the discretion of the Public Advocate.

The Commission finds that the $800,450 estimate should be approved and directs that the Company shall amortize that cost over three years. The Commission further finds that with respect to assessed costs, SourceGas may institute a surcharge consistent with the Act.

<u>Income Taxes</u>

SourceGas seeks to utilize the “stand alone” method of calculating income taxes for recovery. SourceGas figures taxes based on what SourceGas would pay if they paid income taxes directly. SourceGas calculations utilize the federal corporate income tax rate of 34 percent and the Nebraska state corporate income tax rate of 7.81 percent.[102]

The Public Advocate argues SourceGas does not pay federal or state income taxes, but instead SourceGas’ earnings and liabilities for taxation purposes are passed through to its parent corporation, SourceGas Holdings, LLC, and ultimately onto the partnership that owns SourceGas Holdings, LLC and all its subsidiaries.[103] The Public Advocate sought financial information from the ownership partnership that owns SourceGas Holdings, LLC and its subsidiaries, including SourceGas, but did not receive such information from SourceGas. The Company stated in response, “SourceGas Distribution is not privy to the records of [its owners], and therefore does not have possession of annual reports that may have been prepared for those entities.”[104] The Public Advocate recommends that the Commission not allow any recovery for federal or state income taxes, and would require the Company to demonstrate that the partnership that owns SourceGas incurs actual or potential income tax liability.[105]

SourceGas generates income and that income for taxation purposes is considered income for its ultimate owners. Whether income taxes are directly paid by a subsidiary or by another entity within the ownership structure of a Company, income tax liability is created by a

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[101] Ex. 212.
[102] *See* Interlocutory Exhibit III, Interlocutory Schedule B.
[103] Ex. 352 at 61:20–62:6.
[104] Id. at 65:1-23.
[105] Id. at 68:4-11.

utility, and costs of such liability are prudent and should be included in rates.

The Commission has previously found that imputing income tax liability for a subsidiary company serving Nebraska as if the company paid income taxes directly, or the "stand-alone" method, is a reasonable method to determine income tax expense.[106] We find the stand-alone method again to be the most reasonable method to determine the tax expenses for a wholly-owned subsidiary that does not directly pay income taxes on its own.

Therefore, the Commission approves including the estimated taxable income the Company would report if it filed federal and state income taxes in the revenue requirement, as proposed by SourceGas.[107]

<u>Operating and Depreciation Expense</u>

SourceGas includes in its cost of service expenses related to its SAP billing system including $990,814 in operating expenses and $477,500 in depreciation expenses and expenses related to its call center including $1,203,582 in operating expenses and $92,578 in depreciation expenses.[108]

The Commission has approved the inclusion of these rate base items and therefore finds that the attendant operation and depreciation expenses as proposed in rebuttal should be included as well.

HEAT PROGRAM

SourceGas operates a High-Efficiency Assistance Tool (HEAT) program which provides rebates to customers who purchase and install certain natural gas furnaces and water heaters. The Company seeks the following enhancements to the program: creating an energy audit incentive for customers by offering a credit toward an energy efficiency audit by a qualified energy auditor; directing additional funding to the Nebraska Energy Office (NEO) to provide weatherization services for income-qualified residential customers participating in the Low-Income Weatherization Assistance Program administered by NEO; and increasing the rebate for appliances rated at 90 percent efficiency or higher.[109] These enhancements would be funded through the existing HEAT program, which is a surcharge on customer bills, while retaining the program's existing cap of $1 Million for each program year.[110] Additionally, SourceGas proposes eliminating expiration of the program as expressed by sunset dates in the Company's tariff and providing for annual reconciliation of eligible expenses and revenues.[111]

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[106] *See* NG-0060 Order, *supra* at 14-16; NG-0061 Order, *supra* at 28-29.
[107] *See* Interlocutory Exhibit III, Interlocutory Schedule B.
[108] Ex. 37 at 36:3-12, Rebuttal Table 2.
[109] Ex. 37 at 22:13-25:22.
[110] *Id.* at 24:13-17.
[111] *Id.* at 25:7-11.

The Public Advocate recommends that the HEAT program modifications be rejected and the program be discontinued. Dr. Dismukes testifies that in his analysis, the program is not cost-effective, also citing low participation rates and a lack of verifiable energy efficiency savings on behalf of customers.[112]

The Commission finds that SourceGas should be permitted to increase rebates for higher efficiency appliances as proposed, that sunset dates should be eliminated and that annual reconciliation should be permitted as proposed. Offering a rebate program to assist the Company in retaining customers is important in light of evidence regarding customer loss in SourceGas' service area. However, the Commission remains concerned about the long-term cost effectiveness of the HEAT program, and similar programs of Nebraska gas distribution utilities. The Commission will thus continue to monitor the expenditures, effectiveness, and participation of customers within end-use rebate programs of all types.

We decline to adopt any of the remaining modifications to the program. While weatherization efforts for low-income individuals are certainly worthwhile, SourceGas customers should not be required to bear additional costs of weatherization to supplement an existing government program. Regarding the energy audit incentive, SourceGas provides no evidence that providing customer incentives for energy audits will encourage customers to remain on the Company's distribution system.

USE PER CUSTOMER AND NUMBER OF CUSTOMER RIDERS

SourceGas has proposed two decoupling mechanisms, a Customer Adjustment (CA) Rider and a Use per Customer Adjustment (UPCA) Rider.[113] The CA Rider is intended to "return excess revenue or recover the revenue deficiency that results from a change in the number of customers served from those levels underlying the determination of base rates in this proceeding."[114] Mr. Sullivan testified, "Over the twelve year period 2000-2011, the Company has incurred a net loss of 12,047 Residential customers, 1,411 Small Commercial customers, and 211 Large Commercial customers."[115]

The UPCA Rider is intended "to calculate the revenue excess or deficiency that results from a change in the weather normalized use per customer from those levels underlying the determination of base volumetric rates."[116] Mr. Sullivan testified "Over the twelve year period 2000-2011, the Company has incurred an actual net decline of over 100 therms per customer for Residential customers."[117]

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[112] Ex. 301 at 45:6-69:12.
[113] Prefiled Direct Testimony and Exhibits of Thomas J. Sullivan Ex. 138 at 25:2-4.
[114] *Id.* at 28:21-24.
[115] *Id.* at 28:9-11.
[116] *Id.* at 33:22-24.
[117] *Id.* at 33:8-10.

The Public Advocate recommends that the Commission reject both of the Riders.[118]

The Commission recognizes the decline in numbers of customers and usage per customer experienced by SourceGas. However, we remain concerned regarding the accuracy of the method used for implementation of decoupling riders and, in particular, the strength of the incentives facing utilities for continued cost efficiency in the provision of natural gas service, under decoupling mechanisms. Therefore, the Commission finds that the UPCA Rider and CA Rider are not approved.

RATE OF RETURN

"In determining a fair and reasonable return on the rate base of a jurisdictional utility, a rate-of-return percentage shall be employed that is representative of the utility's weighted average cost of capital including, but not limited to, long-term debt, preferred stock, and common equity capital."[119]

"The Commission must allow each utility a reasonable opportunity to earn a reasonable rate of return, which is expressed as a percentage of invested capital, and must fix the rate of return in accordance with *Neb. Rev. Stat*. §§ 66-1825(3) and (5)."[120] In evaluating each case, the Commission "must consider the utility's cost of capital, which is the weighted average of the cost of the various classes of capital used by the utility."[121]

The classes of capital include debt and equity. "The cost of debt capital is the actual cost of debt."[122] "The cost of equity capital must be based upon a fair return on its value."[123]

<u>Capital Structure</u>

SourceGas proposes a capital structure of 48.84 percent long-term debt and 51.16 percent common equity, as of January 31, 2012.[124]

The Public Advocate recommends use of the Company's capital structure as of March 31, 2011, at 50.44 percent long-term debt and 49.56 percent common equity.[125] The Public Advocate also recommends including a provision for short-term debt in the amount of 4.21 percent, based upon an average of $42.3 million in short-term debt used by the Company each month during the test year, as calculated by

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[118] Ex. 301 at 131:3-19 and 132:4-133:2.
[119] § 66-1825(5).
[120] § 005.05A.
[121] § 005.05A2.
[122] § 005.05A2(a).
[123] § 005.05A2(b).
[124] Ex. 37 at 18:10-12. In the Company's initial filing, SourceGas had proposed a capital structure of 48.57 percent long-term debt and 51.43 percent common equity, as of March 31, 2011. <u>See</u>, Ex. 29 at 18:17-18.
[125] Prefiled Testimony of J.R. Woolridge, Ex. 363 at 12:3-9.

Dr. J.R. Woolridge.[126] The Public Advocate cites decisions from Arizona and Arkansas where the state commission required a utility to include short-term debt in capital structure.[127]

SourceGas responds to the Public Advocate's position regarding short-term debt through testimony from Mr. Binswanger, who states that SourceGas' assets are long-lived and thus financed with long-term debt.[128] Mr. Binswanger further testifies that the two components of SourceGas' rate base financed by short-term debt are prepaid expense and unamortized rate case expense. The Company has removed prepaid expense from its rate base and has not applied the unamortized rate case expense to its rate base, but rather, applied its short-term debt interest rate of 1.74 percent to both items.[129] Additionally, Mr. Binswanger testifies that short-term debt would mainly be used for financing gas purchases, and that SourceGas does not purchase gas in Nebraska due to its operation of a customer choice program.[130]

The Commission finds that SourceGas' capital structure of 48.84 percent long-term debt and 51.16 percent common equity, as of January 31, 2012, should be approved and that no provision in the capital structure should be made for short-term debt in this rate case, at this time. The Company's approach of excluding prepaid and rate case expenses from rate base and calculating interest on both items at an interest rate of 1.74 percent represents a fair treatment of the capital charges associated with these two items.

Though the Commission is satisfied that SourceGas' capital structure should not include short-term debt at this time, the Commission generally expects jurisdictional utilities to use a prudent mix of short-term debt, long-term debt and equity for the purpose of financing all capital and rate base elements reflected in jurisdictional tariff rates. To this end, either informally or in a docketed proceeding, the Commission intends to take up the following issues regarding a filing requirement related to short term debt, wherein, as a matter of general regulatory policy, jurisdictional utilities (1) set forth short-term debt balances for inclusion in the overall capital structure for the determination of the overall rate of return as applied to the rate base; or 2) justify the conditions that would warrant the exclusion of short-term debt from the capital structure and the calculation of overall return level.

<u>Return on Debt</u>

SourceGas proposes using a weighted average cost of debt at a rate of 5.642 percent, which represents a blended rate of the two long-term debt instruments that the Company holds, a five-year term loan and ten-year senior notes. Mr. Binswanger testifies that the five-year term loan has both fixed and variable components to the in-

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[126] <u>Id</u>. at 12:12-17 and Ex. 369.
[127] Public Advocate's Post Hearing Brief at 28 and 30.
[128] Ex. 37 at 17:17-20.
[129] Ex. 120 at 27:22-28:5.
[130] Trans. at 176:2-11.

terest rate, and that SourceGas has fixed the variable component through low interest rate hedges which will remain in place for the remainder of the term loan.[131] Additionally, SourceGas has refinanced the term loan, resulting in lowering the fixed portion of the interest rate.[132]

The Public Advocate has used the Company's proposed long-term debt rate cost rate of 5.642 percent. The Public Advocate also proposed that an interest rate of 1.59 percent be applied to short-term debt. Because the Commission has declined to include short-term debt in the Company's capital structure, a short-term interest rate does not need to be determined by the Commission.

The Commission finds that the Company's long-term debt cost rate of 5.642 percent represents "actual cost of debt" as required by Commission rules[133] and therefore should be used.

Return on Equity

Both SourceGas and the Public Advocate develop sets of comparable companies and use the discounted cash flow (DCF) model and the capital asset pricing model (CAPM) to estimate a cost of equity capital for SourceGas. SourceGas seeks a return on equity of 10.3 percent.[134] The Public Advocate recommends a rate of 8.2 percent for return on equity.[135]

SourceGas develops three groups of comparable companies: 1) a gas utility proxy group of eight (8) investment-grade natural gas utilities that pay dividends and generate greater than fifty percent of revenues from regulated operations;[136] 2) a combined gas-electric utility proxy group of twenty (20) investment-grade utilities that pay dividends and generate greater than fifty percent of revenue from regulated operations;[137] and 3) twenty (20) utilities rated by the Standard & Poor's Index.[138]

The Public Advocate develops a proxy group of eight (8) natural gas distribution companies that are investment-grade and are listed in two publications identified by Dr. Woolridge.[139] The Public Advocate's proxy group is similar to SourceGas' gas utility proxy group, except that Dr. Woolridge substitutes WGL Holdings, Inc. for Nicor Inc. as a comparable company.[140]

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[131] Ex. 29 at 19:21-20:7.
[132] *Id.* at 20:3-5.
[133] § 005.05A2(a).
[134] Ex. 77 at 54:8.
[135] Ex. 363 at 79:4-5.
[136] Prefiled Direct Testimony of Roger. A. Morin, Ph.D., Ex. 64 at 38:3-7 and 44:8-15; Ex. 66 at 1.
[137] Ex. 64 at 38:4-7 and 45:14-46:2; Ex. 66 at 2.
[138] Ex. 64 at 22:10-12 and Ex. 66 at 3.
[139] Ex. 363 at 10:19-11:2; Ex. 368.
[140] *See* Ex. 66 at 1 and Ex. 368

SourceGas updates its analysis in rebuttal testimony to reflect changes in the capital market that occurred after direct testimony was prepared. Dr. Morin's updates reduce the Company's requested return on equity from 11 percent to 10.3 percent.[141] Dr. Morin states that the average for all of his analyses is 9.7 percent, and testifies, "I stress that no one individual method provides an exclusive foolproof formula for determining a fair return, but each method provides useful evidence so as to facilitate the exercise of an informed judgment."[142]

The Public Advocate's approach produces a DCF-based cost of equity estimate equal to 8.2 percent. The Public Advocate generates a CAPM result of 7.5 percent. Dr. Woolridge uses this information and, relying primarily on his DCF approach, concludes that "an equity cost of 8.2 percent is appropriate" for the return on equity.[143]

The Public Advocate criticizes several aspects of Dr. Morin's analysis. For example, Dr. Woolridge testifies that the values used by Dr. Morin for two components of the CAPM, the risk-free rate and Beta, are higher than is warranted and result in an overstated equity cost rate.[144]

Additions to Return on Equity

In addition to the CAPM and DCF analyses, SourceGas proposes three additions to the return on equity: a flotation cost adjustment; a risk premium; and an additional 32 basis points in the event the Commission declines to adopt the Company's revenue decoupling riders.

Flotation Cost Adjustment. SourceGas proposes adding a flotation cost adjustment of 0.3 percent to return on equity. Flotation costs compensate a) the security underwriter for issuing common equity capital; and b) investors for "the downward pressure on the stock price as a result of the increased supply of stock from the new issue."[145] The Public Advocate responds that the Company has not identified any actual flotation costs and criticizes SourceGas' rationale for an upward flotation adjustment, namely that any flotation cost adjustment should be a reduction; that existing shareholders realize an increase in book value per share, not a decrease; that any underwriting costs should be borne by investors; and that other brokerage fees responsible for increasing stock prices paid by investors are not accounted for in determining cost of equity.[146]

Regarding SourceGas' proposed flotation cost adjustment, the Commission finds, first, that existence of actual flotation costs is not supported by the record; second, that if any actual flotation costs, such as underwriting fees, were to be reflected in a test year, they would be more accurately classified as an expense. Reflecting

[141] Ex. 77 at 54:4-8.
[142] Ex. 77 at 56:3-6.
[143] Ex. 363 at 46:11-46:15.
[144] Ex. 363 at 55:6-55:20
[145] Ex. 64 at 47:10-48:5.
[146] Ex. 363 at 51:12-53-23.

flotation costs within the return on equity would create a perpetual return in relation to a one-time or intermittently-occurring cost. In addition, the Commission is not persuaded that ratepayers should be required to compensate shareholders for any potential, unsubstantiated downward pressure on stock price as a result of a stock issuance.

Risk Premium. SourceGas proposes adding a risk premium of 0.5 percent. Dr. Morin testifies that the additional risk premium is necessary to address SourceGas LLC’s below investment-grade credit ratings, its small size, and its more leveraged capital structure.[147] The Public Advocate responds that “the Company’s credit rating is a function of the parent organization, which has what S&P [Standard & Poor’s] calls a ‘highly leveraged’ financial risk profile”, and therefore a risk adjustment of 0.5 percent is not appropriate.[148]

Additional 32 Basis Point Adjustment. SourceGas requests that if the Commission rejects its revenue decoupling mechanisms, an increase of 32 basis points be added to the return on equity, to compensate the company for one year of declining use per customer and customer loss.[149]

The analyses of SourceGas and the Public Advocate suggest a reasonable range for the estimated cost of equity between 8.2 percent, representing the Public Advocate’s recommendation, and 9.7 percent, representing the average of SourceGas’ updated results. In examining all analyses by the parties and critiques of each approach, the Commission finds that a rate of return on equity of 9.6 percent should be allowed. The Commission does not adopt SourceGas’ flotation cost adjustment, risk premium or 32 basis point adjustment related to denial of revenue decoupling riders, which are discussed further below; however, we note that the allowed return on equity is on the high end of the reasonable range. A return of 9.6 percent should permit SourceGas to fairly compensate its investors, offer a return adequate to attract new capital and maintain its financial integrity.

BASE RATE REVENUE REQUIREMENT

Based upon the above and the proposed rate calculations provided by SourceGas, the Commission finds that SourceGas is entitled to a total revenue requirement of $44,006,943.[150]

ALLOCATED COST OF SERVICE

Determining the cost of serving each customer class is key in setting revenue levels by customer class. To the extent that the Commission approves any cost of service study, such study is used to allocate cost between unregulated or large volume customers and the regulated (residential and commercial) customers and to avoid subsidization between classes. However, the study is not the sole factor

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[147] Ex. 64 at 5:9-12 and 31:1-36:11.
[148] Ex. 363 at 50:16-51:10.
[149] Ex. 37 at 20:6-18; Ex. 77 at 57:12-21.
[150] Ex. 216 at 2:7.

in determining final rates and rate design. Adjustments in rate design between classes of ratepayers may still be necessary.[151]

Cost of service studies can be developed using a variety of methodologies. Some level of subjectivity is inherent in the process. Since the cost of service is the primary consideration in determining customer class revenue levels and rate levels, it is important that the study be as accurate as possible.[152]

The COSS provided uses allocation factors similar to those previously approved by the Commission.[153] We find that the COSS should be approved. However, the Commission finds that a higher distribution of the revenue increase should be made to residential ratepayers to avoid the subsidization of residential costs by commercial ratepayers. The actual distribution between the classes is addressed below with respect to rate design.

RATE DESIGN

At the hearing on recalculation of rates, SourceGas offered several rate design alternatives.[154] The Public Advocate also offered an alternative, reflecting recommendations of Dr. Dismukes.[155] The Commission adopts the proposal labeled Scenario 2A, which produces rates as follows:

Customer Charge	
Residential	14.70
Small Commercial	22.75
Large Commercial	56.15
Volumetric Rates	
First Tier	0.4675
Second Tier	0.1338

Scenario 2A represents a gradual transition of rates toward costs as shown by the Company’s class cost of service study. The cost-shifting transition in Scenario 2A is more gradual than Scenarios 3 or 3A, and brings the revenues associated with the Small Commercial class closer to costs than Scenario 2. Scenario 1 represents an equal application of the rate increase across classes, which would not adequately address shifts in costs warranted by the Company’s class cost of service study. Scenario 4 was an attempt by the Company to reflect the Public Advocate’s recommendations regarding rate design, and Scenario 4A represents the Public Advocate’s calculation of his recommended rate design. Of all the options, Scenario 2A seems to strike a balance between appropriate cost recovery and mitigation of steep rate increases for any single rate class or rate component.

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[151] Black Hills Order, *supra.*
[152] Black Hills Order, *supra.*
[153] *Id.*
[154] Ex. 217 and Rate Ralculation Hrg. Trans. at 13:16-14:22.
[155] Ex. 225.

COMPLIANCE

The Commission finds that final rates set forth in this order shall be **effective June 1, 2012**, and refunds shall be calculated as required by *Neb. Rev. Stat*. § 66-1838(10)(b).

Interim Rate Refund Plan

As permitted by law, SourceGas implemented interim rates pending the consideration of its rate application.[156] SourceGas implemented the rates based upon the filed rate base and cost of service but maintaining its previous rate of return. As a result of the Commission's decision herein, ratepayers are entitled to a refund of any amounts paid over and above the rates approved herein.

SourceGas must file a Refund Plan within thirty (30) days from the date of this order. That Refund Plan shall include a proposal for refunding the difference between the interim rate revenue collected and its final rates and documentation supporting the calculations made. The Commission reserves the right to receive evidence regarding such Refund Plan and to enter a subsequent order regarding such Refund Plan as hereafter provided in this order.

Proration of Rate Changes

The Company shall prorate the application of the final rates to reflect the estimated customer gas usage that occurred before and after the effective date of the new rates. The Compliance Filing shall include detailed description of the proration method utilized by the Company to implement the final rates as contained in this order.

Tariff Sheets

Finally, prior to the effective date of rates, SourceGas shall file any necessary tariffs, schedules, and classifications, and all terms or conditions of service with the Commission as required by *Neb. Rev. Stat*. § 66-1838(16).

O R D E R

IT IS THEREFORE ORDERED by the Nebraska Public Service Commission that the Application for Approval of a General Rate Increase is granted in part as set forth herein.

IT IS FURTHER ORDERED that rates set forth herein shall become effective on June 1, 2012.

[156] § 66-1838(10)(b).

MADE AND ENTERED at Lincoln, Nebraska this 22nd day of May, 2012.

NEBRASKA PUBLIC SERVICE COMMISSION

COMMISSIONERS CONCURRING:

Tim Schram

Gerald L. Vap

//s// Rod Johnson
//s// Frank Landis

Chairman Rod Johnson

ATTEST:

John Burvainis

Deputy Director