ORIGINAL

STATE OF INDIANA

INDIANA UTILITY REGULATORY COMMISSION

VERIFIED PETITION OF WESTFIELD GAS CORPORATION, D/B/A CITIZENS GAS OF WESTFIELD FOR (1) AUTHORITY TO INCREASE RATES AND CHARGES FOR GAS UTILITY SERVICE AND APPROVAL OF A NEW SCHEDULE OF RATES AND CHARGES AND TERMS AND CONDITIONS APPLICABLE TO GAS UTILITY SERVICE, INCLUDING APPROVAL PURSUANT TO RULE 5-1-27(F) OF THE COMMISSION'S RULES OF A FIVE-YEAR NON-GAS REVENUE TEST TO DETERMINE WHEN DEPOSITS ARE REQUIRED FOR FACILITIES EXTENSIONS; (2) APPROVAL PURSUANT TO INDIANA CODE SECTION 8-1-2.5-6 OF AN ALTERNATIVE REGULATORY PLAN AND AUTHORITY TO IMPLEMENT AN ENERGY EFFICIENCY ADJUSTMENT RIDER; (3) APPROVAL TO AMORTIZE AND RECOVER CERTAIN DEFERRED ENERGY EFFICIENCY REBATE COSTS; (4) AUTHORITY TO RECOVER UNACCOUNTED FOR GAS COSTS AND A PORTION OF THE GAS COST COMPONENT OF NET-WRITE OFFS THROUGH PETITIONER'S GAS COST ADJUSTMENT CHARGE; (5) APPROVAL OF NEW DEPRECIATION ACCRUAL RATES; AND (6) APPROVAL OF A SERVICE LEVEL AGREEMENT BETWEEN PETITIONER AND CITIZENS ENERGY GROUP.	)	CAUSE NO. 43624 APPROVED: MAR 10 2010

BY THE COMMISSION:
James D. Atterholt, Commissioner
Aaron A. Schmoll, Administrative Law Judge

On December 31, 2008, Petitioner Westfield Gas Corporation, d/b/a Citizens Gas of Westfield ("Westfield Gas" or "Petitioner") filed with the Indiana Utility Regulatory Commission ("Commission") its Verified Petition requesting authority to increase its rates and charges for gas utility service. Westfield Gas also requested approval of other matters related to its provision of gas utility service identified in the caption to this Cause.

Pursuant to notice and as provided for in 170 IAC 1-1.1-15, a Prehearing Conference in this Cause was commenced on February 18, 2009, at 9:30 a.m. EST in Room 224 of the National City Center, 101 West Washington Street, Indianapolis, Indiana. Proof of publication of the notice of the Prehearing Conference was incorporated into the record and placed in the official files of the Commission. The Petitioner and the Indiana Office of Utility Consumer Counselor ("Public" or "OUCC") appeared and participated at the Prehearing Conference. No members of the general public appeared. On March 4, 2009, the Commission issued a Prehearing

Conference Order, which established procedural and scheduling matters in this Cause. Among other things, the Prehearing Conference Order established March 31, 2008, as the rate base cutoff to reflect used and useful property in this proceeding and the 12 months ending March 31, 2008, as the test year for determining Petitioner's actual and pro forma operating revenues, expenses and operating income under present and proposed rates, adjusted for changes that are fixed, known and measurable for ratemaking purposes and that occur within 12 months following the end of the test year.

Petitioner filed its prepared case-in-chief evidence with its Verified Petition on December 31, 2008. Petitioner's case-in-chief testimony consisted of the testimony and exhibits of Christopher H. Braun, John R. Brehm, Scott A. Miller, C.P.A., Robert F. Miller, P.E., Otto W. Krohn, C.P.A., LaTona S. Prentice, Jill A. Phillips and Donald J. Clayton, P.E. On May 13, 2009, Petitioner filed supplemental and updated exhibits, consisting of Petitioner's Exhibit CHB-2, the legal and customer notices published and distributed by Petitioner in connection with the relief requested in this proceeding, and Petitioner's Exhibit CHB-4, consisting of a revised service agreement substituted for the service agreement that was initially filed with Petitioner's case-in-chief testimony on December 31, 2008. On May 29, 2009, the OUCC filed its prepared case-in-chief evidence consisting of the testimony and exhibits of Mark H. Grosskopf, Bradley E. Lorton, Sherry L. Beaumont and Mitchell Van Cleave. On June 29, 2009, the OUCC filed the testimony of Ray L. Snyder, who adopted the previously filed testimony of Mitchell Van Cleave as his own. On June 22, 2009, Petitioner filed its prepared rebuttal evidence consisting of the rebuttal testimony of John R. Brehm, Aaron D. Johnson, Scott A. Miller, C.P.A., LaTona S. Prentice and Jill A. Phillips. On July 1, 2009, Petitioner filed the verification page executed by John R. Brehm related to his rebuttal testimony.

Pursuant to notice as provided by law, proof of which was incorporated into the record and placed in the Commission's official files, a public evidentiary hearing was commenced on July 7, 2009, at 9:30 a.m. EST in Room 222, National City Center, 101 West Washington Street, Indianapolis, Indiana. The Petitioner and the OUCC appeared and participated in the evidentiary hearing. No members of the general public appeared or otherwise sought to testify. At the hearing, the filed testimony and exhibits described above were admitted into the record without objection. Additionally, at the hearing, the Presiding Officers directed Petitioner to submit certain information regarding the indirect acquisition and ownership of Petitioner's stock by the Board of Directors for Utilities (the "Board") of the Department of Public Utilities of the City of Indianapolis d/b/a Citizens Energy Group ("Citizens Energy Group"), which serves as the successor trustee of a public charitable trust for the benefit of the inhabitants of the City of Indianapolis. On July 15, 2009, Petitioner submitted Petitioner's Exhibit B, consisting of the Affidavit of Aaron D. Johnson and its attachments, which explained the relationship between Citizens Energy Group and Petitioner. Petitioner's Exhibit B was admitted into the record without objection.

On August 27, 2009, the Commission issued a docket entry directing Petitioner to file supplemental testimony addressing a variety of issues, including issues related to the beneficiaries of the public charitable trust for which the Board serves as trustee and whether Petitioner's customers are subsidizing certain of those beneficiaries. Additionally, the docket entry directed Petitioner and the Public to provide a legal brief concerning the applicability of *Indiana Bell Telephone Co. et al. v. Ind. Util. Reg. Comm'n, et al.*, 715 N.E.2d 351 (Ind. 1999) to the transfer of the stock of Westfield Gas to Citizens Energy Services Corporation ("CESCO"), which is an indirect subsidiary of Citizens Energy Group. The parties were also directed to discuss whether changes in operational control at Westfield Gas constitute a de facto transfer of the Westfield Gas franchise, works or system.

Pursuant to the Commission's August 27, 2009 docket entry, Petitioner filed the testimony of Carey B. Lykins on September 24, 2009. Additionally, on September 24, 2009, Petitioner and the Public each filed a brief addressing the legal issues raised in the Commission's August 27, 2009, docket entry. On October 8, 2009, Petitioner and the Public each filed a reply brief responding to the other party's brief that was filed on September 24, 2009. On that same day, Petitioner requested that the Commission, pursuant to 170 I.A.C. 1-1.1-21(i) & (j), take administrative notice of the Commission's final Order and certain materials filed in Cause No. 42874.

Pursuant to notice as provided by law, proof of which was incorporated into the record and placed in the Commission's official files, a public evidentiary hearing was commenced on October 20, 2009, at 1:30 p.m. EST in Room 224, National City Center, 101 West Washington Street, Indianapolis, Indiana. Petitioner and the OUCC appeared and participated in the evidentiary hearing. No members of the general public appeared or otherwise sought to testify. At the hearing, the filed testimony of Mr. Lykins described above was admitted into the record without objection. The Commission also granted without objection Petitioner's request to take administrative notice of the materials it filed on October 8, 2009. Additionally, at the October 20, 2009 hearing, the Public cross examined Mr. Lykins. During that cross examination, the Public offered into evidence a document designated OUCC-CX-1, which was Petitioner's response to a data request propounded by the Public in this proceeding. OUCC-CX-1 was admitted into the record without objection.

Based on the applicable law and the evidence of record, the Commission now finds:

1. <u>Notice and Jurisdiction</u>. Notice of the public evidentiary hearing held on July 7, 2009, was given as required by law. Petitioner Westfield Gas is a public utility and is subject to the jurisdiction of this Commission in the manner and to the extent provided by the laws of the State of Indiana, including certain sections of the Public Service Commission Act, as amended. The Commission has jurisdiction over Petitioner and the subject matter of this proceeding.

2. <u>Petitioner's Characteristics</u>. Westfield Gas is a corporation organized under the laws of the State of Indiana and existing and authorized to transact business in the State of Indiana. Westfield Gas provides gas service to approximately 3,000 retail customers in and around Westfield, Indiana. Petitioner owns, operates and maintains a variety of plant and equipment that is used and useful for the provision of gas utility service, including 95 miles of distribution mains, 40 miles of services and four regulator stations.

3. <u>Current Rates and Relief Requested</u>. Petitioner's current base rates and charges were approved by the Commission in Cause No. 40793 in an Order issued on September 25, 1997. Westfield Gas' current authorized revenue requirement was established pursuant to the Commission's Order dated February 27, 2002, in Cause No. 42095-U; however, Petitioner did not seek and the Commission did not authorize in that Cause a change of the rates and charges established in Cause No. 40793. Petitioner's rates and charges for residential and commercial customers are subject to a normal temperature adjustment, which the Commission approved in Cause No. 43202 on February 28, 2007. On April 11, 2007, Petitioner placed into effect rates and charges for School Transportation Service and School Pooling Service, which the Commission approved pursuant to its thirty-day filing procedure.

In its case-in-chief testimony, Petitioner requested the Commission approve an increase to its rates and charges in order to produce annual pro forma operating revenues of $6,339,020. After updates reflected in Petitioner's rebuttal testimony, Petitioner's requested increase would produce operating revenues of $6,337,827 and reflects an increase of $1,010,443 or 18.98% to its normalized test year operating revenues of $5,327,384. Petitioner proposes an across-the-board increase to produce the additional operating revenues.

In addition to the requested rate relief, Petitioner requested approval of the following matters related to its provision of gas utility service: (a) authority, pursuant to Indiana Code Sections 8-1-2.5-1 et seq., to create an Energy Efficiency Portfolio and implement an Energy Efficiency Adjustment Rider similar to other energy efficiency programs and decoupling mechanisms previously approved by the Commission and designed through collaborative efforts by other gas utilities, the OUCC and other interested stakeholders; (b) approval to amortize and recover over a three-year period certain energy efficiency rebate costs that Petitioner was authorized by the Commission to defer in Cause No. 43600; (c) authority to recover through its gas cost adjustment charge the actual unaccounted for gas costs and the gas cost component of net write-offs it incurs, which currently are reflected in Petitioner's base rates and charges; (d) approval of depreciation accrual rates for gas utility plant in accordance with the depreciation study presented as part of Petitioner's case-in-chief testimony; (e) approval of a Service Agreement between Petitioner and Citizens Energy Group, pursuant to which Citizens Energy Group provides certain managerial, administrative, marketing, technical, operational and other services to Petitioner; and (f) approval of a new schedule of rates and charges reflecting the proposed increase and terms and conditions applicable to gas utility service, including, pursuant to Rule 5-1-27(F) of the Commission's rules, 170 IAC 5-1-27(F), a five and one-half year non-gas revenue test to determine when deposits are required for extensions to serve new customers.

4. <u>Fair Return on Fair Value of Utility Property</u>.

A. <u>Fair Value Based on Original Cost of Utility Plant</u>. Petitioner's case-in-chief testimony showed the net original cost of Petitioner's plant in service as of March 31, 2008, was $5,482,373. (Pet. Exh. JRB-2). The OUCC also calculated the net original cost of Petitioner's utility plant as $5,482,373. Thus, the parties are in agreement regarding the net original cost of Petitioner's used and useful utility property at issue in this proceeding.

B. <u>Nature of Petitioner's Request for Relief</u>. Petitioner is a wholly-owned subsidiary of Citizens Energy Services Corporation ("CESCO"), which is an indirect subsidiary of Citizens Energy Group. (Pet. Exh. CHB at 1). CESCO acquired the common stock of Petitioner on September 1, 2004. (<u>Id</u>. at 4). In Petitioner's case-in-chief testimony, Petitioner's witness Brehm testified that, in accordance with the Federal Energy Regulatory Commission Uniform System of Accounts, Petitioner recorded the difference between the acquisition cost of the gas plant acquired and its net original cost as a gas plant acquisition adjustment. (Pet. Exh. JRB at 10). One major point of contention that was raised in this proceeding is whether Petitioner's request for an opportunity to earn a fair return on the fair value of its utility property is a "de facto" request for a return on and of the acquisition adjustment accounting entry Petitioner recorded.

C. Alternative Fair Value Methodologies and Acquisition Adjustment.

(1) Petitioner's Case-in-Chief. In his case-in-chief testimony, Mr. Brehm testified that Petitioner was not seeking to include an acquisition adjustment in its rate base in this case. Mr. Brehm testified that Petitioner was seeking to have its property valued for ratemaking purposes at its fair value in accordance with the provisions of Indiana Code Section 8-1-2-6. (Pet. Exh. JRB at 10).

Mr. Scott A. Miller, Certified Public Accountant and principal in the firm of H.J. Umbaugh & Associates ("Umbaugh"), testified on the fair value of Petitioner's utility property in service as of March 31, 2008. Mr. Miller stated that the three most commonly used approaches to valuing business property are the cost-based, market, and income approaches. He explained those methodologies as follows. The cost-based approach to valuation requires a comprehensive analysis of a company's property to establish the current cost of acquiring or constructing the property to provide the same function as a firm's existing property, adjusted for the current condition of the current property. The market approach to valuation uses actual market transaction data between willing buyers and sellers to establish the value of the property. Mr. Miller testified that it is not appropriate to determine the fair value of the property of a public utility using the income approach, because one of the purposes of a utility rate case is to establish the proper level of the utility's income (the fair return) and, consequently, use of the income approach in this context would be circular. (Pet. Exh. SAM at 5 – 6; see also Pet. Exh. JRB at 31 – 32).

In order to value Petitioner's utility property using the cost-based approach, Umbaugh subcontracted with Mr. Robert F. Miller,[1] a professional engineer specializing in the valuation of utility properties, to conduct the actual plant appraisal. Mr. Robert Miller also testified in this case and explained that the appraisal he conducted consisted of three steps: (1) analysis of Petitioner's fixed asset records; (2) the development of current replacement costs of the properties; and (3) an evaluation of the physical and functional status of the utility's above-ground assets via a field inspection. He testified that he found the above-ground assets of the utility to be in "good to excellent" condition for a utility of Petitioner's size. (Pet. Exh. RFM at 3 - 4).

The results of Mr. Robert Miller's appraisal analysis are summarized in Petitioner's Exhibit RFM-1. That exhibit shows Petitioner's assets summarized by asset class (e.g., mains, services, meters, etc.). The exhibit also shows the date the assets were placed in service, the historical cost of the assets as well as cost index values that were used to determine the replacement cost of the assets as of January 1, 2008. Mr. Robert Miller stated that he used the Handy Whitman Index for determining changes in the cost of constructing utility property, as the basis for the cost indices shown in Petitioner's Exhibit RFM-1. He explained that the Handy Whitman Index, which is composed of index numbers presented for various accounts prescribed by the Uniform System of Accounts as well as for construction, material and labor, is generated

[1] Petitioner's witness Robert F. Miller is referred to hereinafter as Mr. Robert Miller. Petitioner's witness Scott A. Miller is referred to hereinafter as Mr. Miller.

by comparing current prices for material, equipment and labor with a base year. He said the index values are updated each year as of January 1 and July 1, and that he used the January 1, 2008, figures for his study, because they are the closest to the March 31, 2008 rate base cutoff date. Based on his analysis, Mr. Robert Miller concluded that the total reproduction cost value of Petitioner's assets as of January 1, 2008, was $8,998,814. (Pet. Exh. RFM at 5 – 6).

Mr. Miller testified that the historical and reproduction cost figures shown on Petitioner's Exhibit RFM-1 formed the basis of his fair value analysis. His first methodology for determining the fair value of the utility's property used Mr. Robert Miller's results to calculate the Reproduction Cost New Depreciated ("RCND") value of Petitioner's assets. He began by determining the weighted average years of service for each asset class. He then divided that figure by the estimated useful life of the particular asset category as contained in the depreciation study presented by Petitioner's witness Donald Clayton. That information was then used to determine the percentage condition, or remaining useful life, of each asset class. Finally, Mr. Miller multiplied the reproduction cost values (as determined by Mr. Robert Miller's analysis) by the percentage condition to determine the current value of the assets on a RCND basis. The RCND value of Petitioner's utility property is $7,329,167, which according to Mr. Miller, represents the first and lowest of the three outcomes he derived to determine the fair value of Petitioner's utility property. He noted his professional opinion, however, that it is not the preferred methodology because it fails to take into account actual arms-length market transaction information between a willing buyer and seller. (Pet. Exh. SAM at 6 – 8).

Mr. Miller's second method of determining the fair value is based on a hybrid of the cost-based approach and market based approach of calculating the current worth of utility property. He testified that this approach is his preferred methodology and incorporates his belief that there is no better representation of the current worth of an asset than the actual price between a willing buyer and a willing seller in an arms-length transaction. He explained that the methodology involves separate calculations to determine the value of the assets that existed at the time of the acquisition and the assets that have been added subsequent to the acquisition. For the original assets, he used the value of the actual market transaction adjusted for the change in condition of the assets since the transaction was consummated. For the newer assets, he used the replacement cost adjusted for the change in condition of the assets. The end result of this methodology, which is summarized on Petitioner's Exhibit SAM-7, establishes the fair value of Petitioner's utility property as $9,248,151. Mr. Miller testified that he believes this methodology produces the best and most appropriate assessment of the true current worth of Petitioner's utility property. (Id. at 8 – 10).

Mr. Miller's final fair value calculation is similar to the second methodology. He explained that the only significant difference between the second and third calculations is that in the third methodology, the assets acquired have been indexed based on the Handy Whitman Index to reflect the estimated replacement cost of those assets at the appraisal date of March 31, 2008. The result of indexing the value of those assets produces a fair value of $10,398,682. While Mr. Miller stated this is a reasonable assessment of the fair value of Petitioner's utility plant, he conceded it may include value that was already reflected in the purchase price of the assets. (Id. at 10 – 11).

Mr. Miller summarized his three fair value calculations as follows:

Methodology	Fair Value
RCND of All Assets (methodology 1)	$7,329,167
Depreciated Purchase Cost and DRC of New Assets (methodology 2)	$9,248,151
DRC of Purchase Price and New Assets (methodology 3)	$10,398,682

Mr. Miller then compared his fair value determinations for Westfield Gas against the fair value that Lawrenceburg Gas Company, Inc. ("Lawrenceburg") presented to the Commission in its most recent rate case. Mr. Miller testified that, based on the $15,165,199 purchase price Lawrenceburg's owners paid for the utility and plant additions subsequent to the acquisition, Lawrenceburg's fair value at the time of its rate case filing was $16,804,760. Mr. Miller concluded by testifying that in his opinion the most appropriate estimate of the current worth and therefore, fair value, of Petitioner's utility assets is $9,248,151. (Id. at 13).

(2) OUCC's Case-in-Chief. OUCC witness Lorton testified that because Petitioner's proposed fair value rate base reflects the amount of the purchase price CESCO paid to acquire Westfield Gas, Petitioner has requested "both a return on and return (recovery) of the acquisition adjustment associated with the 2004 purchase of Westfield Gas." (Pub. Exh. BEL-1 at 4). On this point, witness Lorton testified as follows:

> Q: Mr. Lorton, does Petitioner effectively propose to earn a return on and return (recovery) of an acquisition adjustment based on the purchase price paid by CESCO in September 2004?
>
> A: Yes. Line 2 Petitioner's Exhibit JRB-2 enters a "Gas Plant Acquisition Adjustment" of $3,629,021. Petitioner's Witness Brehm defines this adjustment as "the difference between the acquisition cost of the gas plant and its net original cost," (Petitioner's Exhibit JRB, p. 10, lines 9 – 10). However, Mr. Brehm quickly argues that Petitioner is not including this acquisition adjustment in its proposed rate base in this proceeding. Rather, he states that, "Petitioner is seeking to have its property valued for ratemaking purposes at its fair value. . ." (Id., lines 14 – 15). According to Mr. Brehm, Petitioner records an acquisition adjustment, but does not use it for ratemaking purposes.

(Id. at 5).

Mr. Lorton's Exhibit BEL-3 establishes the Net Utility Plant per books of Petitioner at the time of the acquisition was $2,367,766. This was the book value that Mr. Brehm used to calculate the acquisition adjustment. Mr. Lorton testified that the price CESCO paid for Westfield Gas was 2.48 times the book value.

Mr. Lorton testified that the Commission's historical position has allowed acquisition adjustments only under limited circumstances. He cited to the Commission's Order in Indiana-American Water Company, Inc., Cause No. 42029, which stated:

It is the established policy of this Commission to allow an acquisition adjustment in rates in only two events, namely:

1. As a result of the acquisition, are there significant and demonstrable benefits flowing to the ratepayers, e.g. better service and/or lower rates?
2. Does the acquisition result in correction or salvage of an entity identified by this Commission as a "troubled" utility"? (Cause No. 42029, Order of November 6, 2002, p. 5).

(Id. at 7-8).

Mr. Lorton testified that Petitioner's witness Braun's estimate of the commodity savings realized by Petitioner's customers of more than $1.6 million over the period 2005 through 2008 is erroneous. This conclusion is borne out by the method he used in Petitioner's Exhibit CHB-3 in reaching such estimate. He observed that the figure of $1.6 million of "savings in reduced gas commodity costs as a result of Citizens' gas procurement practices" was referenced in a letter from Mr. Lindsay Lindgren of Citizens Gas of Westfield to the utility's customers. This letter was filed as the "customer notice" in this case, on May 13, 2009 (see Public's Exhibit BEL-4).

Mr. Lorton testified that Mr. Braun used the Commission's annually published residential gas bill comparisons as the source data for his calculations. He stated that those are not comparisons of commodity costs, but are total bill comparisons. He also testified that Mr. Braun's estimates of the so-called "commodity savings" are measured against the "industry average." He said that this "industry average" is simply an overall average of gas utilities listed in the Commission's annual bill comparisons. He stated that these savings are not estimated by comparing the utility's own performance before and after the acquisition, or against actual natural gas market data. Consequently, the only claim that can be made is that Petitioner has improved its ranking compared to other Indiana gas utilities. He stated that merely improving this ranking does not establish the existence of any measurable benefits to Petitioner's customers. He also testified that since the data Mr. Braun presents includes the total bill, rather than commodity cost only, it is possible that the only reason for this improvement is that most of the other utilities have had one or more rate cases since Petitioner's current rates went into effect. He noted that this relative improvement will likely be watered-down or eliminated by increases resulting from this case.

Mr. Lorton testified that the Commission comparisons Mr. Braun used are based on a level of consumption of 200 therms for one monthly bill. Mr. Braun's estimates are based on an annual consumption of 850 therms, or roughly an average of 71 therms per monthly bill. He said that Mr. Braun's calculation on Petitioner's Exhibit CHB-3 ignores the fact that the fixed monthly charge and distribution charge is a higher percentage of the total monthly bill in warmer, lower usage months. He testified that Mr. Braun's claim of "gas commodity savings" is skewed when he uses a commodity cost/distribution charge bill ratio from a winter month as being representative of an entire year's estimated usage. He further stated that Mr. Braun's calculation of "gas cost savings" is also flawed by including the fixed monthly charge and distribution charges in the calculation. He observed that even Mr. Braun's own calculations show that Petitioner's average bill at 200 therms consumption rose from $192.63 in the 2001-04 timeframe to $227.95 in 2005-08. (See Petitioner's Exhibit CHB-3). He said that ratepayers have not seen their bills drop, and that the comparisons used by Mr. Braun do not imply any improvement in commodity cost performance by Petitioner.

Mr. Lorton said he does not believe Petitioner has demonstrated any significant or measurable benefit to its customers that would justify a de facto acquisition adjustment for ratemaking purposes. Mr. Lorton also stated that Petitioner presented no evidence of "troubled utility" status in its case-in-chief, nor even made such a contention.

Mr. Lorton testified that the market-to-book ratio associated with the acquisition of 2.48:1 does not appear reasonable. He stated that in Cause No. 41968, Aqua Source was allowed an acquisition adjustment on its purchase of Utility Center water utility. Further, Utility Center was found to be a "troubled utility" but the Commission held that the acquisition adjustment should allow a market-to-book ration of no more than 2.09:1. He said that without convincing evidence as to the benefits to ratepayers resulting from the acquisition of Westfield Gas, and no evidence presented (nor even the contention raised) that Westfield Gas was a "troubled utility," treating Petitioner *as if* a 2.48:1 market-to-book ratio is reasonable for rate making purposes is both unrealistic and excessive.

Mr. Lorton testified that acquisition premiums have historically not been included in rate base or given above-the-line treatment for ratemaking purposes. He said the basis for this historical treatment relates back to abuses from the 1920's and 1930's that created the need to adopt the "original cost" concept in setting rates. He stated that in the 1920's and 1930's, utilities were acquiring other utility properties for amounts in excess of net book value. As a result, inflated rate bases were created through transactions that lacked any economic substance. When included for ratemaking treatment, customers pay a premium through higher rates for the same property that had been providing them utility service. Regulators noticed that if utilities were allowed to earn a return on investment in excess of original cost, investors would realize unreasonably high profits. Accordingly, regulators determined that it was not reasonable to charge customers higher rates for the same utility property simply because the utility providing service was acquired by another company. (Hahne & Aliff, Accounting for Public Utilities (Matthew Bender) 4.04[2], p. 4-9, 4-10.)

Mr. Lorton testified that it is not reasonable to charge customers higher rates for the same utility property since regulators have granted public utilities a monopoly for their services. Under this status, a regulatory compact was formed providing public utility companies certain privileges in exchange for certain obligations, which are not afforded to non-regulated, competitive businesses. The utility's obligations include the provision of safe and reliable utility service at non-discriminatory, reasonable rates. Privileges given to the public utility include exclusive service territory and the opportunity to recover all reasonably and prudently incurred costs and to receive a fair return on prudent investment. In return for this protection, utilities have generally been prohibited from earning unreasonably high profits.

Mr. Lorton stated that he found other cases in which acquisition adjustments were denied on similar bases. In Cause No. 42029, Indiana-American Water Company requested acquisition adjustments for ratemaking purposes on three smaller utilities, (Northwest Indiana Water Company, United Water West Lafayette Inc., and United Water Indiana, Inc.) that Indiana-American had acquired since its last rate case. The market-to-book ratios on these utilities were 1.69, 1.71 and 2.20. However, the Commission denied the requested adjustments because Indiana-American had not presented evidence that the acquired utilities were troubled, nor that significant benefits were received by ratepayers as a result of the acquisition.

Mr. Lorton disagrees with Petitioner's witness Miller that the Lawrenceburg Gas rate case (Cause No. 43090) "provides a compelling argument" for the fair value methodology that Petitioner has employed in this case. He stated that he was involved in the Lawrenceburg Gas rate case as an analyst and witness and that there were several issues, most notably in Lawrenceburg's capital structure, that made it an unusual case, and not a good comparison. He observed that Mr. Miller cited an opinion stated by Lawrenceburg Gas witness Duane Mercer that the fair value of that utility was $16,804,760. However, Mr. Lorton testified that the Lawrenceburg final order did not address fair value, and that the words "fair value" are not to be found in that final order. Mr. Mercer proposed an original cost rate base of $15,239,260, (Cause No. 43090, Order, p. 7). The Commission accepted a rate base very close to that proposed by Public's witness Mark Grosskopf in that case, and determined a rate base of $15,224,621 (Id., p. 8).

Mr. Lorton also testified that the purchase price of Lawrenceburg Gas in 2004 was very close to book value. The current owners purchased Lawrenceburg for $15,165,199 (Cause No. 43090, Petitioner's Exhibit DCM, p.11) on February 27, 2004. An examination of Lawrenceburg's "Class A-B Private Gas Utility Annual Report" for the year ending December 31, 2003 reveals a book value of $15,141,111 (Net Utility Plant in Service less Property Held for Future Use and Construction Work in Progress). Mr. Lorton also testified that Lawrenceburg did not seek a return on or of an acquisition adjustment in its rates.

Mr. Lorton disagreed with Mr. Miller's contention that the dollars per foot of mains in the Lawrenceburg "fair value" estimate "shows the price CESCO paid to acquire Petitioner was reasonable given the market forces in effect since both acquisitions were conducted as arms-length transactions between unaffiliated parties at approximately the same time and yielded very comparable results." (Petitioner's Exhibit SAM, p. 12, lines 12-15). Mr. Lorton noted that Mr. Miller's calculation of the Lawrenceburg "dollars per foot of mains" is based on a *fair value estimate* that the Commission never approved, and that was not even addressed in the final order. Mr. Lorton stated that Mr. Miller's calculation did not constitute a convincing argument for the reasonableness of the price CESCO paid for Westfield Gas.

Mr. Lorton testified that Petitioner's fair value rate base recommendation of over $9.75 million is far too high. He said that in order to reach that level, Petitioner must include a de facto $3.6 million acquisition adjustment, that Petitioner otherwise seems to disavow. As a result, Petitioner asks for a rate base $3.76 million higher than the original cost rate base. Mr. Lorton recommended that Petitioner's fair value rate base should be $5,989,306 (see Public's Exhibit MHG-1, Schedule 4, page 1), which is calculated without the *de facto* acquisition adjustment.

(3) Petitioner's Rebuttal Testimony. In his rebuttal testimony, Petitioner's witness Brehm testified that Petitioner recorded the difference between the acquisition cost of the gas plant acquired and its net original cost as a gas plant acquisition adjustment because it was the correct accounting entry, not for the purpose of ultimately seeking rate recognition of the acquisition adjustment. (Pet. Exh. JRB-R at 18). Mr. Brehm stated that an acquisition adjustment (like original cost) is a historical accounting entry. He explained that because the date of valuing the utility property acquired for this rate case is only three and one-half years after the acquisition, it is not surprising that such valuation is similar (though not identical) to its value on the date of acquisition. He testified, however, that it is wrong to

interpret such similarity in value as an indirect attempt to seek rate recognition of the historical acquisition adjustment accounting entry that was booked to record the acquisition. Mr. Brehm emphasized that Petitioner is not seeking to have its property valued for ratemaking purposes in accordance with historical accounting entries. Rather, he stated, it is seeking to have its property valued at its present fair value in accordance with Indiana law. (Id. at 11 – 12).

Mr. Brehm further testified that over time a return on original cost rate base for installed plant combined with a return on and of an acquisition adjustment for acquired plant does not produce the same result as a return on the fair value of utility property. He explained that this is so because an acquisition adjustment, like original cost, is an historical accounting entry that is typically never adjusted for book accounting purposes in spite of inflation and other factors affecting the property's subsequent fair value other than to allocate the acquisition adjustment over the estimated useful life of the property through amortization accruals. (Pet. Exh. 18 – 19).

Mr. Brehm observed that OUCC witness Lorton testified that "Petitioner's fair value should be $5,989,306 while OUCC witness Grosskopf testified that "the OUCC proposes an original cost rate base of $5,989,306." (Pet. Exh. JRB-R at 5).

Mr. Brehm testified that the OUCC's position that the fair value of Petitioner's property should be established at the property's net original cost is unreasonable, because Petitioner's property has been placed in service over a time spanning multiple decades. Consequently, he stated, the fact of inflation alone occurring since each element of Petitioner's existing property was first placed in service would mean that the fair value of such property is substantially different and greater than its net original cost. He also opined that the OUCC's position that net original cost equals fair value in this case is inconsistent with guidance the Commission and the Indiana Courts have provided regarding the meaning of the term "fair value" as it applies to utility ratemaking in Indiana. In support of that opinion, Mr. Brehm quoted our Order in Cause No. 39314, in which we stated, "we believe that the fair value of a utility's property is most analogous to the true current worth of that property, perhaps what a willing buyer would pay a willing seller." He also pointed out that the Commission and Indiana Courts have repeatedly stated that the Commission cannot ignore the commonly known and recognized fact of inflation in its determination of fair value. (Pet. Exh. JRB-R at 5 – 6).

Mr. Brehm then explained his understanding of the how the OUCC attempts to justify its position that the fair value of Petitioner's property is identical to its net original cost. He pointed to the OUCC's stated belief that the Commission has "wide latitude" for arriving at a fair value determination and stated that the OUCC appears to reject the Commission's determination that its duty with respect to fair value in a utility rate case is to determine the "true current worth" of the property. Rather, Mr. Brehm testified, the OUCC appears to believe that the Commission has "wide latitude" to ignore the reality of inflation, actual transaction information between a willing buyer and seller and reproduction cost new less depreciation in order to decide that fair value equals original cost. (Id. at 6 – 7).

Mr. Brehm described other cases where the OUCC has taken the position that net original cost equals fair value and the Commission has rejected that position. He then explained his understanding of the phrase in Indiana Code Section 8-1-2-6 that directs the Commission to "give[] such consideration as it deems appropriate in each case to all bases of valuation which may be presented or which the commission is authorized to consider." He stated that giving each base of valuation the consideration that is "appropriate" necessarily requires reference to the specific circumstances pertaining to the property being valued at the time of the valuation. He once again cited our decision in Cause No. 39314, in which we explained how our consideration of various bases of valuation under the fair value statute is to be applied by quoting a decision of the United States Supreme Court that states, "[b]ut this does not mean that the original cost or the present cost or some figure arbitrarily chosen between these two is to be taken as the measure. The weight to be given to such cost figures and other items or classes of evidence is to be determined in the light of the facts of the case in hand." Thus, Mr. Brehm said that original cost should be considered when and so far as appropriate in light of the facts, for example, with respect to relatively new property or as the beginning point for a reproduction cost new valuation where the property is older. (Id. at 9 – 10).

Mr. Brehm also addressed OUCC witness Lorton's suggestion that it is an "abuse" to seek to value utility property at its true current worth for ratemaking purposes when such property was acquired from a prior owner. Mr. Brehm rejected the notion that such ratemaking treatment is an abuse. Rather, he testified it is merely following the law in Indiana and corresponding guidance from the Commission. He noted that in its Order in Cause No. 39314, the Commission stated "the book net original cost of that property would make little difference to a willing buyer attempting to make a fair assessment of a reasonable purchase price" and "[a]s [a] potential, willing buyer examines the property he can scarcely argue that the effects of past inflation should be calculated and removed from the potential purchase price." Consequently, Mr. Brehm stated that the Commission has observed it is logical and reasonable to expect that utility property will change hands between a prior owner and current owner at a negotiated price reflecting the parties' determination of the property's value, that such value could be substantially greater than the property's net original cost and that such value is most analogous to the property's true current worth or fair value. Mr. Brehm pointed out that, in fact, the prior owner was entitled to have the property valued for ratemaking purposes at its true current worth rather than its original cost and, therefore, the fact of an acquisition does not change the present fair value of a utility's property as much as it reveals it. (Id. at 14 - 15).

Finally, Petitioner's witness Scott A. Miller testified in response to the OUCC's position on fair value. Mr. Miller reiterated that the result of a true arm's length transaction, meaning two independent parties acting in their own interests, is the fair value to each party taking into account all of the issues relative to the transaction. Thus, he stated his use of the negotiated purchase price to determine the fair value he described in his case-in-chief testimony as "methodology 2" is reasonable. In contrast, Mr. Miller testified, the OUCC's reliance on net original cost and complete disregard for an arm's length transaction involving the purchase and sale of the property less than four years earlier is inherently unreasonable. (Pet. Exh. SAM-R at 2 – 3).

Mr. Miller then noted that the OUCC summarily dismissed the other two methodologies of calculating fair value that Mr. Miller presented. He explained that while his other two methodologies may not represent his preferred methodology, the determination of fair value rate base is generally the result of an analysis of a variety of different bases, and his other calculations should be considered when determining the fair value of Petitioner's rate base. (Id. at 3 - 4).

Mr. Miller next addressed the OUCC's valuation proposal, noting Mr. Lorton's apparent belief that Petitioner's fair value rate base is equivalent to its original cost. He stated that while book value can provide useful insight into what something cost originally, the amounts recorded and carried in the accounting books and records are generally not very useful in determining what something is currently worth, particularly business property. He quoted a textbook, *Ross et al., Corporate Finance* (Irwin 4th ed. 1996), which states:

> The accounting value of a firm's assets is frequently referred to as the carrying value or book value of the assets. Under generally accepted accounting principles (GAAP), audited financial statements of firms in the United States carry the assets at cost. Thus, the terms carrying value and book value are unfortunate. They specifically say "value," when in fact the accounting numbers are based on cost. This misleads many readers of financial statements to think that the firm's assets are recorded at true market values. Market value is the price at which willing buyers and sellers trade the assets. It would be only a coincidence if accounting value and market value were the same.

In addition, Mr. Miller explained that differences in capitalization policies, allowances for funds used during construction, treatment of contributions and other matters could result in different carrying costs between utilities. For these reasons, he stated that he does not believe the original cost of property reflects the true value of Petitioner's plant assets in this case. (Id. at 4 – 5).

Mr. Miller next discussed the OUCC's contention that the market-to-book ratio that resulted from CESCO's acquisition of Petitioner was too high. He stated that the only evidence OUCC witness Lorton provided to support his claim that a ratio of 2.48 is unreasonable were comparisons to acquisitions of dissimilar water and sewer utilities by other entities. Mr. Miller explained that some of these utilities have treatment facilities and all of them may have had some form of storage facilities, which could introduce variables into the cost structure that a gas distributor such as Petitioner does not have. He also observed that it is undisclosed if or when the prior owners of Mr. Lorton's comparison utilities made major investments in new plant shortly before the acquisitions, which Mr. Miller stated would influence the outcome of Mr. Lorton's analysis. Mr. Miller stated the present case is a perfect example of that and noted that since CESCO's acquisition of Petitioner in 2004, Petitioner has added a significant amount of gas main to its system, which has reduced its market-to-book ratio from 2.48 at the time of the acquisition to 1.69 as of the rate base cutoff date. He noted that the present market-to-book ratio is well within the bounds subscribed to by Mr. Lorton. (Id. at 6 – 7).

Mr. Miller also addressed OUCC witness Lorton's contention that an analysis of Petitioner's proposed valuation of Westfield Gas's utility property vis-à-vis the fair value presented by Lawrenceburg Gas in its most recent rate case was not a good comparison. He pointed out that based on the purchase prices of the two utilities, the Lawrenceburg price per foot of main was $18.83 while the Westfield Gas price per foot of main was $18.44. He stated that this suggests that the fair value of a natural gas distributor in the Indiana marketplace in 2004 was approximately $18.44 to $18.83 per foot of main. (Id. at 10 - 11).

Mr. Miller then discussed Mr. Lorton's argument that the comparison is flawed because it is based on a fair value for Lawrenceburg that was not approved by the Commission. Mr. Miller first noted that the fact the rate bases proposed by the parties in the Lawrenceburg case were not based on fair value does not change the fact that Lawrenceburg's owners paid $15,165,199 and subsequently installed plant with an original cost of $1,639,561 resulting in a total property value of $16,804,760 at the time of its rate case. Furthermore, Mr. Miller stated that even if Mr. Lorton's position on that point is accepted, Lawrenceburg still compares favorably to Petitioner's proposed fair value calculations and provides corroborative evidence that the price CESCO paid was reasonable. Mr. Miller explained that taking the Lawrenceburg rate base of $15,224,621 that was accepted by the Commission and dividing it by the 892,320 feet of main in service at that time derives a price per foot of main of $17.06. He then demonstrated that multiplying that same $17.06 per foot of main amount by Petitioner's 501,600 feet of main in service results in a fair value for Petitioner of $8,557,296, which is significantly more than the net original cost proposed by the OUCC and is also more than Petitioner's methodology 1 calculation of fair value based on the reproduction cost new depreciated value of Petitioner's utility property. (Id. at 11 – 12).

Mr. Miller concluded by reiterating his professional opinion that the most appropriate estimate of the current worth and therefore, fair value, of Petitioner's utility assets is $9,248,151, which when combined with the inventory amount of $506,933 set forth in Petitioner's Exhibit JRB-13 results in a total fair value rate base of $9,755,084. (Id. at 12).

Petitioner's witness Aaron D. Johnson also testified in response to the OUCC's position that the fair value of Petitioner's utility property is identical to its net original cost as well as its suggestion that the price CESCO paid to acquire Petitioner was excessive. Mr. Johnson stated that the OUCC apparently believes the payment of any amount above book value would have been "unrealistic and excessive," as it ultimately concluded that the rate base on which Petitioner should be allowed an opportunity to earn a return is equal to the net original cost (or book value) of the utility's plant in service. He rejected that position, stating that book value, or some multiple thereof, as that term is used by OUCC witness Lorton, is simply not an accurate way to measure the fair value of an asset. Mr. Johnson then briefly explained the principles governing the accounting for and depreciation of the book value of an asset and concluded that Mr. Lorton's attempt to judge the reasonableness of a purchase as a multiple of book value becomes very problematic insofar as applying a multiple to book value can result in dramatic variations depending upon a variety of factors related to depreciation, such as useful life, depreciation method and salvage value estimates. Mr. Johnson also pointed out that the timing of plant investment can cause a significant variation in the fair value-to-book ratio. Mr. Johnson then presented a calculation showing that he agrees with Mr. Lorton's calculated ratio of 2.48 at the time of CESCO's purchase of Westfield Gas, but also showing that due to a significant increase in capital investment since the acquisition, that ratio has decreased to 1.69. (Pet. Exh. ADJ-R at 3 – 6).

Mr. Johnson next described the manner in which the parties involved in CESCO's acquisition of Westfield Gas determined the fair value of the utility property acquired. He testified that the book value of Westfield Gas's assets played no part in that determination. In fact, Mr. Johnson stated, the initial offer CESCO made to purchase the assets of Petitioner was well above the book value of the assets, and that offer was rejected by Petitioner's prior owners. He explained that because book value is simply the historical cost of an asset less depreciation on any given date, it does not reflect changes (either increases or decreases) in the value of the asset subsequent to the date that historical cost is established and is, therefore, generally not helpful in determining the current worth or fair value of the asset. (Id. at 7 – 8).

Mr. Johnson summarized the process pursuant to which CESCO acquired Petitioner as follows. He became aware in mid-2003 that Petitioner's former owners were interested in selling the utility. He was aware that they had received an offer several years prior from another company to purchase Petitioner for $4,000,000 of that company's stock and that Petitioner's former owners rejected that amount as insufficient. Mr. Johnson learned that the same company and others were once again making offers to purchase Petitioner. Based on CESCO's analysis of the competing buyer's price/earnings ratio and Petitioner's estimated 2003 earnings, as well as recent utility acquisition prices, CESCO estimated the competing buyer would be willing to offer between $4,800,000 and $6,000,000 for the assets of Petitioner. Thereafter, CESCO offered Petitioner's prior owners $5,500,000 to purchase Petitioner's public utility assets, excluding liabilities other than current liabilities. Petitioner's prior owners rejected that offer, informing CESCO they had received superior offers. CESCO then presented a stock purchase offer that equated to a net utility plant purchase price of $5,882,593, after adjusting for current assets and assumed liabilities. That offer was accepted and formed the basis of the transaction that resulted in CESCO's acquisition of Westfield Gas. (Id. at 9 – 10).

Mr. Johnson concluded by stating his disagreement with the OUCC's contention that the price CESCO paid to acquire Petitioner has resulted in a valuation that is unrealistic and excessive. He emphasized that there were other interested buyers and CESCO's initial offer to purchase the assets with no financing contingency for an amount well above book value was summarily rejected by Petitioner's prior owners. Consequently, Mr. Johnson testified, an offer to pay no more than net original cost for Petitioner's assets would not have been taken seriously. (Id. at 12 – 13).

(4) Discussion and Findings. Indiana Code 8-1-2-6(a) states:

> The commission shall value all property of every public utility actually used and useful for the convenience of the public at its fair value, giving such consideration as it deems appropriate in each case to all bases of valuation which may be presented or which the commission is authorized to consider by the following provisions of this section.

The Indiana Supreme Court has stated that "'[f]air value' is a conclusion or final figure, drawn from all the various 'values' or factors to be weighed in accordance with the statute by the Commission." Public Service Commission v. City of Indianapolis, 131 N.E.2d 308, 318 (1956). The Court further explained that the Commission is not limited to "any one or more methods of valuation, be it prudent investment, original cost, present value or cost of reproduction." Id.

In this Cause, Petitioner requested a determination of the fair value of its utility property, without an explicit acquisition adjustment request. The OUCC appears to have viewed Petitioner's request for a fair value determination as an attempt by Petitioner to obtain a return on and a return of an acquisition adjustment it contends CESCO paid in acquiring Westfield stock in 2004.

The OUCC presented evidence of Petitioner's 2004 balance sheets showing that the original cost of utility plant was approximately $2.3 million, and that Petitioner recorded an acquisition adjustment of approximately $3.7 million. Petitioner paid approximately $5.9

million to acquire the Westfield stock, or nearly $3.6 million more than the original cost of the utility plant at the time. Here, Petitioner has proposed a fair value of over $9.2 million, which is more than $3.7 million more than the original cost minus depreciation at the end of the test year.

As we found in *Petition of Indiana-American Water Co.*, Cause No. 42029, acquisition adjustments are only allowed in cases of demonstrated benefits subsequent to the acquisition, or the improvements to a troubled utility. Order, Cause 42029, at 5 (Nov. 6. 2002). In this Cause, Westfield was not a troubled utility, and given Petitioner's express statement that it was not seeking an acquisition adjustment, we will disregard the proffered testimony of both parties concerning any benefits Westfield customers may recognize subsequent to the acquisition, as that evidence is not relevant to our fair value determination.

While there was much disagreement over what fair value should be as compared to original cost, neither party recognized in testimony that whether the Commission determines fair value and uses a fair return, versus determining original cost and an appropriate cost of capital, the resulting net operating income should, in theory, be comparable. Fair value takes inflation into account in valuing the plant, but deducts inflation from the cost of capital, whereas original cost methodology includes inflation in the cost of capital.

Petitioner presented three different fair value calculations, none of which was original cost. The first of those calculations, which Petitioner's witness Scott Miller refers to as the Reproduction Cost New Depreciated ("RCND") fair value of Petitioner's property, is based on a reproduction cost new study completed by Petitioner's witness Robert Miller, as adjusted by Petitioner's Scott Miller for the effects of depreciation on Petitioner's utility property. In determining the weight we should give the RCND analysis, we make several observations. First, Indiana's fair value statute explicitly authorizes us to "take into account reproduction costs at current prices, less depreciation." Ind. Code § 8-1-2-6(b). Moreover, the Indiana Courts have instructed us that "reproduction cost new less depreciation cannot be disregarded in fixing a valuation for rate making purposes." Indianapolis Water Co., 484 N.E.2d at 640. Finally, other than summarily dismissing it in favor of the OUCC's net original cost valuation, the OUCC presented no evidence challenging the RCND analysis completed by Petitioner's witnesses Robert Miller and Scott Miller.

Petitioner also presented two additional methodologies to determine the fair value of its utility property separately calculates the value of the assets that existed at the time of the acquisition and the assets that have been added subsequent to the acquisition and then sums those values to arrive at a total fair value determination.[2] The question posed, of course, is whether we should give this evidence any consideration in light of the lower RCND fair value calculated by Petitioner. For the reasons discussed below, we conclude that we should not.

Here, Petitioner's witness Mr. Miller explained that methodology 2 is his preferred methodology because it incorporates his belief that there is no better representation of the true current worth of an asset than the actual price between a willing buyer and a willing seller in an arms-length transaction. (Pet. Exh. SAM at 8). However, Mr. Miller's analysis with respect to

[2] Petitioner's third fair value calculation is similar to methodology 2, however, in the third methodology the assets acquired have been indexed based on the Handy Whitman Index to reflect the estimated replacement cost of those assets as of March 31, 2008.

the two proferred market-based methodologies fails to differentiate a stock purchase from the purchase of the utility plant. Indeed, Mr. Miller allocated 100 percent of the $5.9 million dollar stock purchase price to utility plant. With the purchase of all of the Westfield stock, Petitioner gained control of more than simply the utility plant of Westfield. Indeed, CESCO became the sole stockholder and thus, fully in charge of utility operations. By virtue of the stock purchase, CESCO obtained a utility entitled to provide gas service in its non-exclusive service territory to the existing customer base captive to Westfield. None of the myriad elements inclusive in the stock purchase, such as goodwill, were evaluated by Mr. Miller, and Petitioner presented no evidence as to the allocation of the purchase price to anything other than the utility plant. As such, we reject the market-based methodologies presented by Scott Miller.

Given that no other evidence was presented challenging Petitioner's RCND study, the Commission finds Petitioner's RCND calculation of $7,329,167 to be a reasonable estimate of the fair value of Petitioner's utility property as of March 31, 2008. Based on the evidence presented, the Commission finds that the total fair value of Petitioner's utility property used and useful for the convenience of the public is $7,836,100, computed as follows:

Fair Value of Utility Plant	$7,329,167
13 Month Average Inventory	$ 506,933
Total Fair Value of Property	$7,836,100

D. Cost of Capital.

(1) Petitioner's Case-in-Chief. Petitioner's witness Brehm testified on the cost of capital Petitioner proposed in this proceeding. He stated that formulas inherent in widely used models for determining cost of capital, such as the Discounted Cash Flow ("DCF") model or the Capital Asset Pricing Model ("CAPM"), are forward looking and measure the return investors expect going forward not an amount investors should receive to catch them up for the inflation of the past. (Pet. Exh. JRB at 12).

Mr. Brehm discussed how he determined cost of equity in this case. He stated that he relied upon the CAPM, which he described as a widely used and generally accepted method of determining cost of equity. He then provided his perspective of the CAPM, which can be summarized as follows. The principal insight of the CAPM is that the expected return on an asset is related to its risk; that is, risk-taking is rewarded. The model assumes there is a riskless rate of return that can be earned on a hypothetical investment with returns that do not vary. The CAPM breaks up the total risk (the variability of returns) of an investment into two parts: systematic risk and unsystematic risk. Systematic risk is unavoidable and pervades (to a greater or lesser degree) every asset in the real economy and every claim (such as a stock) on those assets. In contrast, unsystematic risk is that portion of total risk that can be avoided through diversification. The CAPM describes the cost of equity for any particular company as equal to the riskless rate plus an amount proportionate to the systematic risk an investor assumes. The CAPM is expressed mathematically as:

$$k_s = r_f + (\beta_s \times ERP)$$

where:

k_s = the cost of equity for company **s**;

r_f = the expected return of the riskless asset;

β_s = the beta of the stock of company **s**; and

ERP = the expected equity risk premium, or the amount by which investors expect the future return on equities to exceed that on the riskless asset.

(Id. at 13 – 15).

Mr. Brehm stated that since the CAPM has only three variables—the expected return on the riskless asset, the beta of the stock, and the expected equity risk premium, it is one of the easiest models to implement in practice. Mr. Brehm used 4.86% as the risk free rate in his CAPM analysis of the cost of equity for Petitioner, based on an analysis of the average yield on Treasury bonds with 20-year maturities during the most recent full cycle of economic expansion and contraction experienced in the U.S. economy. He stated his belief that this is the best information available representative of the full spectrum of macroeconomic conditions that may be experienced while the rates and charges established in this case are in effect. (Id. at 15 - 19).

Mr. Brehm next discussed his derivation of beta, which measures a security's sensitivity to the market as a whole, and is otherwise known as systematic risk. Because Petitioner does not have publicly traded common stock, Mr. Brehm estimated Petitioner's beta using an average of the betas of a representative comparison group of eight publicly traded gas distribution companies. According to Mr. Brehm, the average beta for those eight companies is 0.81, which is the measure of beta Mr. Brehm used in his CAPM analysis for Petitioner. (Id. at 19 – 20).

Finally, Mr. Brehm described his derivation of the expected equity risk premium, which he defined as the additional return an investor expects to receive to compensate for the additional risk associated with investing in equities as opposed to riskless assets. He used Ibbotson, which calculates the equity risk premium by taking the average total stock market return for the S&P 500 and subtracting the average yield on Treasury bonds with 20-years to maturity for the time period 1926 – 2007, as the source for the equity risk premium. The equity risk premium reported by Ibbotson is 7.05%, which is what Mr. Brehm used in his CAPM determination of Petitioner's cost of equity. Mr. Brehm's CAPM computation is presented in Petitioner's Exhibit JRB-5, which shows the CAPM results in a cost of equity for Petitioner of 10.57%. (Id. at 21 – 22).

Mr. Brehm also used the DCF model to form his opinion regarding Petitioner's cost of equity; however, after considering the data requirements necessary to compute the cost of equity using the DCF model, he concluded it is substantially less reliable than the CAPM. Mr. Brehm explained that when using the DCF model to compute cost of equity, reference is typically made to consensus analyst expectations of growth for both the firm in question and a relevant peer group of firms. Mr. Brehm stated that consensus analyst expectations do not exist for Petitioner since it is not a public company and the fact that Petitioner does not currently pay a dividend renders peer group analysis of publicly traded companies problematic, because the publicly traded gas distribution companies that would be included in the peer group generally pay out a meaningful portion of earnings in dividends. Mr. Brehm nevertheless computed a cost of equity for Petitioner using the DCF model of 13.61%. (Id. at 24 - 26).

Using the 10.57% cost of equity derived from the unmodified CAPM analysis, Mr. Brehm then computed Petitioner's overall cost of capital. The other two components of Petitioner's cost of capital are customer deposits and deferred income taxes. Mr. Brehm used the customer deposit interest rate of 3.5% published by the Commission and included deferred income taxes at zero cost. Petitioner's proposed overall cost of capital is 10.46%, based on its actual capitalization ratios as of March 31, 2008, as shown on Petitioner's Exhibit JRB-8. (Id. at 26)

(2) OUCC Testimony. Mr. Lorton testified that Petitioner's current authorized return on equity (ROE) is 12.0% This ROE resulted from the Westfield Gas rate case in 2002, (Cause No. 42095-U) in which the revenue requirement was changed from its 1997 rate case (Cause No. 40793), but not the rate schedules. However, the final order in Cause No. 42095-U approved a 9.31% weighted cost of capital which included a 12.0% ROE. Mr. Lorton recommended reducing the current authorized ROE, because (1) the Normal Temperature Adjustment mechanism (NTA), approved on February 28, 2007 in Cause No. 43202 has considerably reduced Petitioner's risk. The NTA was not in place at the time of Petitioner's last rate case. And (2) common equity accounted for only about 50% of the approved capital structure in Cause No. 42095-U, while the capital structure proposed in this Cause includes no debt. He said that with less risk, ROE should be reduced. He testified that with interest rates in a relatively low range, Petitioner's low risk due to the NTA and 100% equity financing, demonstrate that an authorized ROE in the range of 12.0% is too high.

Mr. Lorton testified that he relied primarily on the DCF and CAPM models to estimate the cost of equity. He stated that while he could not apply the DCF and CAPM models directly to Petitioner, because Petitioner's stock is not publicly traded, (and consequently much of the data that would be available for publicly traded companies is not available for Petitioner) he calculated cost of equity for Petitioner using the established approach of a proxy group of publicly traded companies. He stated that he used the same eight (8) company proxy group Mr. Brehm did in his CAPM calculation chosen from the Standard edition of Value Line.

(a) DCF. Mr. Lorton, disagreed with Mr. Brehm's Discounted Cash Flow (DCF) result of 13.61% cost of equity for Petitioner. Mr. Lorton disagreed with Mr. Brehm's contention that a DCF peer group analysis is problematic for this utility. He testified that proxy group dividend yields and growth rates are key information used by investors to develop expectations on return on equity (ROE). A proxy group provides an approximation of such expectations. Mr. Lorton said that Mr. Brehm's CAPM analysis selected a proxy group which he felt applicable for comparison to Petitioner. He said that Mr. Brehm's DCF methodology is unique at best, and highly questionable. Further he stated that 13.61% is not a reasonable ROE, as it is out of line with findings in recent rate cases, and even Mr. Brehm backs away from using it as his final recommendation

Mr. Lorton said that the DCF model is relatively simple in that it states cost of equity in terms of just two components, and only one of these involves any significant controversy. The calculation of dividend yield generally involves few disputes. Most of the controversy in DCF calculations focuses on the growth rate *g*. He said that this should not be surprising since the growth rate projects into the future, and disagreements will always arise regarding such projections.

However, he stated that a reasonable estimate for *g* can be developed by evaluating variables such as dividends, earnings, and book value per share.

Mr. Lorton testified that his calculations resulted in a 4.2% forward dividend yield for the Gas Utility Proxy Group. He said this calculation applies the "half year method" to the average current yield calculated from *AUS Utility Reports* data. However, he said that he did not use this calculation as his final dividend yield recommendation, as recent Value Line data produced a result more favorable to the utility. He testified that he compared the results to an average of the Value Line dividend yields for the Gas Utility Proxy Group. Value Line publishes forward dividend yield estimates that reflect anticipated dividend growth in the coming year. He said that for purposes of this DCF analysis, he would use the Value Line forward yield of 4.8% for the Gas Utility Proxy Group. He stated that this was both reasonable and more favorable to Petitioner.

Mr. Lorton testified that he relied on Value Line growth rates in EPS, DPS and BPS for companies in the Gas Utility Proxy Group to estimate the growth term *"g"* he used in this DCF analysis. He concluded that 5.1% is a very reasonable growth rate for the Gas Utility Proxy Group. As a result of his DCF calculations Mr. Lorton estimated a cost of equity for Petitioner of 9.9%. This combines the 4.8% forward yield and the 5.1% growth rate.

(b) CAPM. Mr. Lorton disagreed with Petitioner's Capital Asset Pricing Model (CAPM) result of 14.22% cost of equity. He stated that Mr. Brehm's calculation depends on the addition of a small company premium of 365 basis points, along with a much larger risk-free rate and beta than current data can reasonably justify. He testified that an additional premium for company size is a questionable adjustment when analyzing public utilities. He cited Annie Wong of Western Connecticut State University, who wrote:

> . . . given firm size, utility stocks are consistently less risky than industrial stocks. Second, industrial betas tend to decrease with firm size but utility betas do not. These findings may be attributed to the fact that all public utilities operate in an environment with regional monopolistic power and regulated finance structure. As a result, the business and financial risks are very similar among the utilities regardless of their sizes.

(Annie Wong, "Utility Stock and the Size Effect: An Empirical Analysis," Journal of the Midwest Finance Association, 1993, p. 98).

Mr. Lorton also quoted Michael Paschall and George B. Hawkins:

> A size premium does not automatically apply in every case. Each privately held company should be analyzed to determine if a size premium is appropriate in its particular case. There can be unusual circumstances where a small company has risk characteristics that make it far less risky than the average company, warranting the use of a very low risk premium. One possible example of this is a private water utility (monopoly situation, very low risk, near-guarantee of payments).

(Paschall and Hawkins, Do Smaller Companies Warrant a Higher Discount Rate for Risk?: The "Size Effect" Debate, CCH Business Valuation Alert, December, 1999).

Mr. Lorton said that the underlying assumption of CAPM is that the stock market compensates investors for risk that cannot be eliminated by means of a diversified stock portfolio. In CAPM, the required return on a stock equals the sum of a risk free rate of return (R_f) plus a risk premium [β*(R_m- R_f)] which is proportional to the level of "market risk," which cannot be eliminated through diversification.

Mr. Lorton said the "beta" is considered the measure of risk most relevant in CAPM. A stock with a beta below 1.0 is considered less volatile and less risky than the stock market. Above a 1.0 beta the stock is considered more volatile and more risky than the stock market. By definition, the stock market has a beta of 1.0. The market is usually represented by a large and highly diversified portfolio of stocks such as the Standard & Poor's 500. Mr. Lorton stated that as Petitioner's stock is not publicly traded, the necessary data does not exist to perform CAPM analysis directly for Petitioner. Therefore, he used the Gas Utility Proxy Group to perform a CAPM analysis.

Mr. Lorton used betas from the Value Line Investment Survey, Standard Edition for the companies in the Gas Utility Proxy Group. However, he also considered betas from Smart Money, Yahoo Finance, NASDAQ and Zack's. For this analysis he used the average of the Value Line adjusted betas. The Value Line adjusted betas calculated to the highest average of the data series that he considered. Therefore, he utilized 0.65 as the beta estimate in his CAPM analysis. Mr. Lorton said that he used 4.8% for his risk free rate 4.8% because it is near the top of his reasonable range.

Mr. Lorton calculated long term market risk premiums based on historical data from <u>Stocks, Bonds, Bills and Inflation, 2009 Classic Yearbook</u>, by Morningstar, Inc. (formerly Ibbotson Associates). The Morningstar database covers the period 1926 to 2008. He testified there are two methods of calculating historical holding period returns: the geometric mean (or compound annual return) and the arithmetic mean, which is a simple average of one-year holding period returns. The geometric mean return measures the average compound annual rate of return from an investment over a period of more than one year. The arithmetic mean measures the average of one-year holding period returns. He said the arithmetic mean rate of return *always* exceeds the geometric mean rate of return unless the investment provides a constant return year after year. The arithmetic mean approach also produces higher estimates of the market risk premium, and higher overall CAPM results.

As the Commission has expressed its preference for considering both the geometric mean and arithmetic mean approaches, the market risk premiums he calculated gave equal weight to both the geometric and arithmetic mean approaches. This consideration yielded a 4.75% risk premium. (Public's Exhibit BEL-7, page 4 of 4).

Mr. Lorton emphasized that his analysis provides a "conservatively high estimate." He used only the upwardly adjusted betas from Value Line and a risk free rate higher than recent performance of 20-year Treasury bonds might otherwise indicate. He also balanced the weight given to the geometric mean and arithmetic mean approaches. This results in a CAPM estimate of 7.9% for the Gas Utility Proxy Group.

Mr. Lorton compared his CAPM and DCF cost of equity estimates, noting that his CAPM was well below his 9.9% DCF result. He recommended a cost of equity for Petitioner of 9.75%, toward the upper end of the range between his DCF and CAPM models. He made the recommendation in order to afford Petitioner as reasonable a rate of return as his analysis justified. He also testified that he made no downward adjustment related to the fact that Petitioner has zero long-term debt in the capital structure. However, he stated that such an adjustment could be justified. He observed that the proxy group companies employ very substantial amounts of debt, which increase risks to shareholders. However, in light of Petitioner's small size he made no adjustments to reflect the absence of any risk associated with debt capital.

(c) Macroeconomic trends. Mr. Lorton testified that macroeconomic factors and trends influence the cost of equity, specifically interest rates, economic growth, and inflation. He stated that economic forecast data supported 9.75% as a reasonable ROE for Petitioner. He said an indication of the reasonable nature of his recommendation comes from the March 2009, *CFO Magazine Business Outlook Survey*, from Duke University (*See* Public's Exhibit BEL-8). This survey of Chief Financial Officers from major corporations noted: "On February 16, 2009 the annual yield on 10-yr treasury bonds was 2.9%" and posed the question, "Over the next 10 years, I expect the average annual S&P 500 return will be: . . ." The mean expected return on the S&P 500 was 8.77% with a 95% Confidence Interval between 7.89% and 9.65%. He stated that this placed his recommended ROE, of 9.75% for Petitioner, above the upper limit of the *CFO Magazine* survey's 95% Confidence Interval. He contrasted the CFO Survey rate of return of 8.77% for S&P 500 companies, to Mr. Brehm recommendation that an 10.57% cost of equity should apply to a regulated public utility with zero debt. Mr. Lorton said that in today's capital market, Petitioner's proposal is too high and not realistic.

Mr. Lorton said that yields on U.S. Treasury Bonds are commonly used to establish the risk-free rate of return in many analyses, and that changes in interest rates have an impact on investor expectations. Mr. Lorton stated that recent years have been described as a period of "low cost capital." Lower interest rates and bond yields have been the main indicator of this trend. The trend toward low cost capital has taken place over two decades; it is a long run phenomenon. He said that the most important influence that economic growth has on cost of equity is its potential impact on interest rates, noting that a booming, high growth economy tends to put upward pressure on interest rates, while a lackluster or recessionary economy tends to lead to stagnant or falling interest rates.

Mr. Lorton said the economic expansion that began in late 2001 proved somewhat less robust than earlier decades. He testified that prior to the 1990's economic expansion periods included at least one or more years above 5% real growth. He observed that the U.S. economy has not experienced that level of real GDP growth on an annual basis since 1984. He pointed to Congressional Budget Office (CBO) forecasts of a 3.0% decline in real GDP in 2009, and only 2.9% growth in 2010. The long term CBO forecasts 3.6% growth annually in the period 2012-2015, and 2.3% in 2016-2019. (Congressional Budget Office, *A Preliminary Analysis of the President's Budget and an Update of CBO's Budget and Economic Outlook*, Table 2-1, March, 2009, http://www.cbo.gov/doc.cfm?index=10014). Recent data reveals the impact of the current recession. The third quarter of 2008 saw a negative real growth rate of 0.6%. The recession then intensified with the GDP declining in both the fourth quarter of 2008 and the first quarter of 2009 at -6.3% and -6.1% respectively. (U.S. Department of Commerce, Bureau of Economic

Analysis, http://www.bea.gov/national/index.htm). The current projections from the CBO and BEA continue to suggest somewhat restrained growth in the long term.

Mr. Lorton testified that he took current and projected inflationary trends into account in his analysis. Mr. Lorton testified that current CBO estimates indicate the Consumer Price Index (CPI) in 2009 will decline by 0.7%, and increase to only 1.4% in 2010 and 1.2% in 2011. The CBO also estimates that the "Core Consumer Price Index" (which excludes the volatile prices in food and energy) will increase by 1.5% in 2009, and moderate to 1.1% in 2010 and 0.9% in 2011 (http://www.cbo.gov/doc.cfm?index=10014).

Mr. Lorton also examined data from the Federal Reserve Bank of Philadelphia's *Survey of Professional Forecasters, First Quarter 2009,* which projects core inflation at 1.2% in 2009, and 1.6% in 2010. This survey projects the overall CPI at 0.2% this year and 1.9% in 2010 with long run expectations of 2.4% during the period 2009 through 2018. (Federal Reserve Bank of Philadelphia Survey of Professional Forecasters, First Quarter, 2009, http://www.phil.frb.org/research-and-data/real-time-center/survey-of-professional-forecasters/2009/survq109.cfm). Mr. Lorton observed that low inflation rates tend to support lower interest rates and lower costs of financing capital investment, including investments in utility plant.

Mr. Lorton testified that recent trends in interest rates, inflation and economic growth do not reveal an over-heating economy, nor one in which the cost of capital trends toward significant increases. He said that the *CFO Magazine* survey demonstrates that Petitioner's proposed 10.57% cost of equity is well above market expectations, even for a much more risky stock portfolio like the S&P 500 containing many industrial companies. Consequently, he recommended a ROE for Petitioner of 9.75%, as much more in line with current economic conditions and very reasonable.

Mr. Grosskopf used Mr. Lorton's conclusion on Petitioner's cost of equity and calculated a 9.65% overall weighted cost of capital for Petitioner (Pub. Exh. MHG-2, Schedule 8).

(3) Petitioner's Rebuttal Testimony. Mr. Brehm discussed Mr. Lorton's DCF analysis. He stated that Mr. Lorton's computation of Petitioner's cost of common equity using the DCF model did not address several specific problems and, in spite of such problems, ignores the fact that Petitioner does not pay a dividend and uses a peer group comprised entirely of utilities that pay dividends to establish Petitioner's dividend yield and expected growth rate. Mr. Brehm observed that the Introduction to Discounted Cash Flow portion of the Investing Classroom feature that appears on the Morningstar website states:

> One question that must be asked of any discounted cash-flow model is exactly what kind of cash flows are you going to be discounting? In the old days, investors used something similar to a dividend discount model, which essentially sums up all the future dividend payments a company is expected to make and expresses them in terms of today's dollars. However, discounting dividends is of little help for valuing companies that pay no dividends, which includes many firms today.

(Pet. Exh. JRB-R at 28 – 29).

Mr. Brehm responded to the OUCC's claims that he used the expected future rate of inflation in his DCF analysis as a substitute dividend yield and the growth rate for the number of residential services as a proxy for constant growth in stock prices. Mr. Brehm stated that the OUCC was incorrect on both points. With respect to the former OUCC claim, Mr. Brehm indicated his direct testimony states that the future rate of inflation was used as part of a computation "to determine the nominal expected growth rate [of the Utility's] cash flow." With respect to the latter claim Mr. Brehm indicated his direct testimony states that the growth rate for the number of residential services was used as part of a computation "to determine the nominal expected growth rate [of the Utility's] cash flow." (Id. at 30).

Mr. Brehm questioned Mr. Lorton's use of the DCF model. Mr. Brehm said that Mr. Lorton ignored the fact Petitioner does not pay a dividend as well as Morningstar's scholarly guidance that discounting dividends is of little help in seeking to measure the cost of equity for companies that pay no dividends.

Mr. Brehm took issue with Mr. Lorton's claim that Mr. Brehm's application of the CAPM resulted in a 14.22% cost of equity for Petitioner. Mr. Brehm said his case-in-chief testimony states that his application of the CAPM results in a cost of equity for the Utility of 10.57%. Moreover, Mr. Brehm stated the 10.57% rate is what he used as the cost of equity input in determining the dollar amount of operating income or fair return Petitioner should be authorized to earn. Mr. Brehm noted that Mr. Lorton acknowledged on page 17 of his testimony that Mr. Brehm proposed using a 10.57% cost of equity in this case. Mr. Brehm explained that the 14.22% cost of equity the OUCC referenced was an adjustment that could be made to the CAPM so the Commission could give such weight as it chooses to a theoretically correct adjustment to the CAPM due to the small size of the Petitioner.

Mr. Brehm discussed Mr. Lorton's computation of the equity risk premium in his CAPM analysis. Mr. Brehm stated that Mr. Lorton made an error in computing the risk premium. He said the information Mr. Lorton used for the long-term bond portion of the risk premium computation was the total return on long-term bonds. Mr. Brehm said the total return on long-term bonds includes the income return plus capital appreciation plus the reinvestment return. He also said only the income return portion should be used in determining the risk premium for application to the CAPM because that is the only part of the long-term bond rate that is truly risk-free.

Mr. Brehm also commented on Mr. Lorton's estimated beta. He noted that he and Mr. Lorton used the same peer group and the same source of betas for the peer group (The Value Line Investment Survey) to derive estimated betas for the Petitioner. He stated that the difference in result between his beta of 0.81 and Mr. Lorton's of 0.65 is due to the date of pulling data from Value Line. Mr. Brehm said he analyzed the peer group betas using the September 12, 2008 Value Line data while Mr. Lorton used the March 13, 2009 Value Line data. Mr. Brehm testified that, although the peer group betas have declined since September 12, 2008, he believes that is likely an anomaly resulting from the extreme stock market volatility that occurred after September 12, 2008. Mr. Brehm stated he reviewed two other historical observations of the average beta for the peer group to be certain no anomalies were present on September 12, 2008. He said he found the average beta of the peer group on December 15, 2006 to be 0.82 and the average beta of the peer group on March 17, 2006 to be 0.76, both such observations nearly the same as he found on September 12, 2008. Consequently, Mr. Brehm said he believes that as the stock market returns to a more normal level of volatility the beta of the peer group will likely revert to around the 0.81 level seen in the past and that 0.81 should be the estimate of beta used in the CAPM. (Id. at 38 – 39).

Mr. Brehm discussed Mr. Lorton's criticism of his use of historical 20-year bond yields to determine the risk free rate for use in the CAPM model as well as Mr. Lorton's testimony regarding projections of future macroeconomic conditions. Initially, Mr. Brehm responded that it is common to use historical measures to make forward-looking estimates under the assumption that what has happened in the past is representative of what might happen in the future. He explained that is what he did to determine the 4.86% risk free rate to use in applying the CAPM model in this case and also to determine the expected rate of future inflation of 2.54% that is subtracted from the cost of common equity in order to apply step 1 of the two-step process he described to compute the correct dollar amount of fair return in this case. Mr. Brehm said he believes using historical measures to make forward-looking estimates under the assumption that what has happened in the past is representative of what might happen in the future may well be a better technique than relying on economic forecasts as the OUCC favors because economic forecasts are so frequently proven wrong.

Mr. Brehm observed that the OUCC included in its testimony various economic forecasts. Mr. Brehm said that to the extent the Commission gives any weight to such economic forecasts in concluding that the appropriate cost of common equity for Petitioner is less than the 10.57% cost of common equity that he proposed, particularly with respect to the OUCC testimony regarding trends in the rate of inflation, it would be theoretically consistent for the Commission to also conclude that the rate of expected future inflation should be less than the 2.54% Mr. Brehm subtracted from the cost of common equity in order to apply step 1 of the two-step process he described to compute the correct dollar amount of fair return in this case. (Id. at 41).

(4) Discussion and Findings. Petitioner and the OUCC agree as to the components of Petitioner's actual capital structure in both dollar amount and percent of total. Petitioner and the OUCC each have presented extensive evidence regarding an appropriate cost of equity for Petitioner based on CAPM and DCF analyses. Through their respective analyses, Petitioner and the OUCC recommended a cost of equity of 10.57% and 9.75%, respectively. Based on our review of the evidence presented, we find Petitioner's weighted cost of capital for purposes of establishing rates as follows:

	Actual March 31, 2008	Percent of Total	Cost of Capital	Weighted Cost
Common Equity	$9,190,293	98.56%	10.10%	9.96%
Customer Deposits	116,606	1.25%	3.50%	0.04%
Deferred Income Taxes	17,228	0.18%	0.00%	0.00%
Total Capitalization	$9,324,127	100.00%		10.00%

E. Fair Return on Fair Value. Having determined Petitioner's weighted cost of capital, we now must decide the actual return Petitioner will be permitted an opportunity to earn.

(1) Petitioner's Case-in-Chief. Mr. Brehm explained his understanding of the relationship between the fair value of a utility's property and the fair return it is allowed to earn on that fair value. He quoted the Commission's Order in Cause No. 39314, including a passage in which the Commission stated "a ratemaking agency's rate of return formula must be methodically consistent with its rate base development." (Id. at 30) (quoting Indiana Michigan Power Co., Cause No. 39314 at 42 (Nov. 12, 1993)).

Mr. Brehm then discussed his view of the proper conceptual framework for establishing the fair return in a manner that is methodically consistent with a fair value rate base determination. He explained that while the use of the income approach to establish the fair value of a utility's property would be circular (because the purpose of a rate case is to establish the proper level of a utility's income), once the fair value of a utility's property has been determined using the cost-based and/or market approach to valuation, rates must be established that will allow the utility a fair opportunity to produce a level of earnings (the fair return) that would result in the income approach to valuation producing such fair value under a reasonable set of assumptions. Mr. Brehm stated his belief that this is the proper conceptual framework for establishing the fair return in a manner that is methodically consistent with the fair value rate base determination. (Pet. Exh. JRB at 31 – 32).

He then explained that the first step in the calculation of the correct fair return is to subtract the expected future rate of inflation from the cost of capital. This rate is then multiplied by the actual current value (or fair value) of the utility's property to determine what Mr. Brehm refers to as the "step 1 computation." He then stated that the result of the step 1 computation is adjusted by the difference between the amount of economic depreciation and the amount of book depreciation (what he labeled the "step 2 computation") to determine the dollar amount of the correct fair return. (Id. at 34 – 35).

Mr. Brehm explained that economic depreciation measures the actual or current value of property consumed in a time period. By contrast, he stated, book depreciation is an accounting mechanism to allocate the original or historical cost of property (adjusted for net salvage) over the estimated life of such property. Mr. Brehm testified that economic depreciation recognizes that in an inflationary or deflationary environment, the return must be sufficient to recover the value of the property consumed in current dollars rather than historical dollars. (Id. at 33).

Mr. Brehm then discussed why both the step 1 and step 2 computations are necessary in order to be consistent with the rate base development. He explained that when the rate base is established based on actual current property value, investors are compensated for inflation through periodic subsequent rate cases that update the rate base for, among other things, the impact of inflation on the then current actual property value. Consequently, he stated, determination of the fair return must take that into consideration. However, he explained, the single step of reducing the cost of capital rate in a current rate case by the rate of expected future inflation in order to multiply the result by the current value of the property (the step 1 computation) overstates the adjustment required to account for the fact that subsequent rate cases will update the rate base for inflation. He said that this is why the step 1 computation must be adjusted by the difference between the amount of economic depreciation and the amount of book depreciation (the step 2 computation). He stated that the step 1 and step 2 computations are both necessary to give proper effect mathematically to the fact that when the rate base is consistently determined based on actual current property value, investors are compensated for inflation through periodic subsequent rate cases. (Id. at 37).

Mr. Brehm emphasized that the methodology he presented for determining the correct fair return does not provide the utility with an incremental allowance for economic depreciation. Rather, he explained, it merely takes into consideration the two mathematical steps that are required to correctly determine the fair return when the rate base is established based on its actual current value. Mr. Brehm testified that to argue that the methodology he presented provides an allowance for economic depreciation, one would also have to argue that the methodology provides a return that is less than the cost of capital, since the step 1 computation reduces the cost of capital rate by the expected rate of future inflation. He said neither argument is true. Mr. Brehm testified that the fact is that both the step 1 and step 2 computations are mutually dependent to accurately compute the dollar amount of return required to enable a utility to earn its cost of capital when the rate base is established consistently from rate case to rate case based on actual property value. (Id. at 38).

Mr. Brehm stated that in the present case, his testimony demonstrates the necessary interplay between adjusting the cost of capital for the rate of inflation and recognizing the impact of inflation on depreciation cost and the resulting measurement of profit in order to produce the correct measure of fair return. He testified that the hypothetical he presented in Petitioner's Exhibit JRB-9, page 2, demonstrates mathematically that the determination of the correct dollar amount of fair return requires both an adjustment to remove the rate of expected future inflation from the cost of capital rate as well as a further adjustment to recognize the impact of inflation on depreciation cost and the resulting measurement of profit. He emphasized that this mathematical proof demonstrates that both the step 1 and step 2 computations are required for the determination of the fair return to be methodologically consistent with the rate base development. (Id. at 40 – 41).

Mr. Brehm next described how he applied the return methodology he proposed to the specifics of Petitioner. He explained the analysis he undertook to make a forward-looking estimate of expected future inflation. Based on that analysis, Mr. Brehm used 2.54% as the expected rate of future inflation in the methodology for determining the correct fair return for Petitioner. He explained that when the 2.54% estimated future rate of inflation is removed from the cost of investor-supplied capital, Petitioner's overall weighted cost of capital is reduced from 10.46%t to 7.96%. Mr. Brehm stated that the 7.96% rate is the rate to be applied to the fair value of Petitioner's property in performing the "step 1 computation" to determine the correct fair return for Petitioner. (Id. at 41 – 44).

He then described the "step 2 computation" of economic depreciation less book depreciation for Petitioner. He explained that the economic depreciation less book depreciation adjustment is computed by first adjusting the current replacement cost value of property (before adjustment for percent condition) to its end-of-year value and then subtracting the original cost of the property from such amount. He said that result is then divided by the estimated useful life of each category of property. Mr. Brehm noted that he used the replacement cost values and estimated useful lives determined by Petitioner's witness Scott A. Miller. He stated that the result is that the economic depreciation less book depreciation adjustment for Petitioner is $79,753. (Id. at 45).

Mr. Brehm presented Petitioner's Exhibit JRB-13 to show the calculation of the correct fair return for Petitioner by applying the methodology he described. Mr. Brehm summarized the computation as follows. The total fair value of Petitioner's property is determined by adding the 13-month average inventory balance of $506,933 to the fair value of utility plant of $9,248,151 determined by witness Scott A. Miller. The result is a total fair value of property amount of $9,755,084. Such fair value of property is first multiplied by the rate for the "step 1 computation" of 7.96% (the 7.96% rate reflects the removal of expected future inflation from the cost of investor-supplied capital and is therefore 2.50% less than the overall cost of capital of 10.46%). The resulting product of $776,505 is adjusted by the difference between economic and book depreciation, the "step 2 computation," of $79,753. The resulting total of $856,258 is the fair return amount. The computation as demonstrated in Petitioner's Exhibit JRB-13 is set forth below.

Fair Value of Utility Plant	$9,248,151
13 Month Average Inventory	506,933
Total Fair Value of Property	$9,755,084
Rate for Step 1 Computation	7.96%
Step 1 Computation	$776,505
Step 2 Computation (Economic less Book Depreciation)	79,753
Fair Return	$856,258

(Id. at 45.).

(2) OUCC Testimony. OUCC witness Lorton testified regarding Petitioner's proposed fair return amount. He stated that Mr. Brehm's fair return proposal suffers from three distinct problems. First, Mr. Lorton said that Petitioner's fair return includes $79,753 for economic less book depreciation, which, according to Mr. Lorton, would allow Petitioner to collect a return on the unrealized gain in the value of assets. Second, Mr. Lorton stated that the fair return is calculated against a proposed fair value rate base of $9,755,084, which is far too high. Third, Mr. Lorton asserted that Mr. Brehm failed to apply Petitioner's actual data to the fair return model he elaborated on. (Pub. Exh. BEL-1 at 15).

Mr. Lorton then noted that the fair dollar return proposed by Mr. Brehm would produce a 14.30% cost of capital (an implied return on equity of 14.46%) against the net original cost of Petitioner's utility property. Mr. Lorton recommended that Petitioner's fair return should be established as $578,197. (Id. at 16).

(3) Petitioner's Rebuttal Testimony. Petitioner's witness Brehm responded to the OUCC's fair return testimony. Initially, he stated that the OUCC is incorrect when it asserts that Petitioner's proposed fair return methodology would allow Petitioner to collect economic depreciation. Mr. Brehm observed that the OUCC fails to mention anywhere in its testimony that in computing the dollar amount of net operating income (synonymously referred to as the "fair return amount") that Mr. Brehm first reduced the cost of equity rate by the rate of expected inflation and multiplied that result times the fair value rate base. Mr. Brehm emphasized that the step 1 and step 2 computations are mutually dependent to accurately compute the dollar amount of return required to enable a utility to earn its cost of capital when

the rate base is established consistently from rate case to rate case based on actual property value. He explained that if the OUCC position that the methodology Mr. Brehm presented provides an allowance for economic depreciation were true, it would also have to be true that the methodology provides a return that is less than the cost of capital since the step 1 computation reduces the cost of capital rate by the expected rate of future inflation. He stated that neither argument is true, because the mutually dependent step 1 and 2 computations are, in fact, a single continuous computation that merely contains two steps. (Pet. Exh. JRB-R at 19 – 20).

Mr. Brehm testified that in every fair value rate case over the past two decades of which he is aware, the Commission has reduced the cost of capital rate by the rate of inflation and applied the net rate after such reduction to the fair value rate base in order to determine the dollar amount of allowed net operating income (also called "return"). He stated that the reason consistently given in Commission Orders for reducing the cost of capital rate by the rate of inflation in order to apply the net amount to the fair value rate base is to avoid "reflecting inflation twice". He said he agrees with the goal of reflecting inflation once but avoiding reflecting inflation twice. However, he explained that he has not seen in any summary of the evidence presented in a case that the premise that such a computation would achieve the Commission's stated goal of reflecting inflation once while avoiding counting inflation twice was actually tested and proven mathematically. Consequently, he stated that he endeavored to test that premise mathematically. (Id. at 20 – 21).

Finally, Mr. Brehm responded to the OUCC's claims that he did not apply Petitioner's actual data to the "model" he presented in Petitioner's Exhibit JRB-9. He noted that the OUCC's assertion appears to stem from a misunderstanding regarding his response to a data request asking about the hypothetical utility example Mr. Brehm provided. He pointed out that in his case-in-chief testimony he described in detail how he applied the methodology for determining the correct fair return to the specifics of Petitioner. (Id. at 27).

(4) Discussion and Findings. In the past, the Commission has emphasized the importance of ensuring our fair return determination gives actual effect to Indiana's fair value statute. For example, we have explained:

> It is increasingly clear that a ratemaking agency's rate of return formula must be methodically consistent with its rate base development. Otherwise, the result will be insupportably arbitrary and unlawful since the ratemaking agency has a duty to ensure that the method of selecting the appropriate rate of return is reasonably related to the method of calculating the rate base. When the two methods lack consistency the combination of rate base and rate of return methodology does not produce an acceptable end result.

Indiana Michigan Power Co., Cause No. 39314 (Nov. 12, 1993 Order at 42). We further stated, "the Commission must find the current fair value of Petitioner's used and useful property dedicated to service of the public in Indiana, and give actual effect to that fair value finding in determining allowed return." Id. at 46.

In the present case, we have been presented with a methodology that Petitioner proposes results in a return calculation that is methodically consistent with and gives actual effect to the fair value rate base amount. Petitioner's witness Brehm has demonstrated mathematically that the formula of simply subtracting inflation from the cost of capital and multiplying that result by the fair value rate base amount results in an understated return amount that is not methodically consistent with and does not give actual effect to the rate base amount. In other words, that method, if consistently applied from rate case to rate case would produce going-forward operating income resulting in future cash flow that when appropriately discounted at the cost of capital results in a present value materially less than the present fair value rate base amount. This would mean that inflation would not be properly reflected even once; an impermissible result under Indiana's fair value statute as it has been interpreted by the Indiana courts.

Petitioner presented a return formula that addresses the methodical inconsistency created when the only adjustment for inflation that is made is to reduce the cost of capital. Petitioner's formula indeed reduces the cost of capital rate by the expected rate of future inflation and multiplies the net rate by the fair value rate base amount, but it also proposes to add to such result the difference between economic and book depreciation.

With respect to the first step of Petitioner's calculation, we note that the fair value we have determined was calculated inclusive of inflation. Petitioner has proposed reducing cost of capital by an inflation amount of 2.54%, and the OUCC did not challenge the amount, instead proposing its original cost methodology. Accordingly, using the 10.1% cost of equity determined above in consideration of an inflation factor of 2.54%, we find that the fair rate of return is 7.49%, as shown in the following table:

	Actual March 31, 2008	Percent of Total	Cost of Capital	Expected Inflation	Inflation Adjusted Cost	Inflation Adjusted Weighted Cost
Common Equity	$9,190,293	98.56%	10.10%	2.54%	7.56%	7.45%
Customer Deposits	116,606	1.25%	3.50%		3.50%	0.04%
Deferred Income Taxes	17,228	0.18%	0.00%		0.00%	0.00%
Total Capitalization	$9,324,127	100.00%				7.49%

However, we disagree with Petitioner's proposed Step 2 calculation. In this Cause, Petitioner agreed to a rate base cutoff of March 31, 2008, which the Commission recognized in its Prehearing Conference Order. Accordingly, no adjustments to rate base shall be made based on changes in rate base occurring after that date. Petitioner's Step 2 calculation attempts to recover the increment between economic and book value by increasing replacement cost as of March 31, 2008 by the cost of inflation. However, since replacement cost is current as of the end of the test year, any change to that value based on future inflation would appear to attempt to address a change in rate base occurring after the cutoff date, contrary to the scheduling order in this Cause.[3] This Commission uses historical data in determining test year costs and values. In order for Petitioner to recover the incremental change in rate base due to inflation, occurring after the cutoff date, Petitioner is required to seek future rate relief.

For all the foregoing reasons, we find Petitioner's authorized return should be computed as follows:

[3] We further note that Mr. Brehm's replacement cost value of $10,076,716 was not supported by any other witness and does not comport with the replacement value calculated by Mr. Robert Miller of $8,998,814.

Fair Value of Utility Plant	$7,329,167
13 Month Average Inventory	506,933
Total Fair Value of Property	$7,836,100
Fair Rate of Return	7.49%
Fair Return	$586,924

5. Operating Revenues at Present Rates. Petitioner's witness Braun testified that "Petitioner's currently authorized revenue requirement and existing rates and charges are inadequate and do not allow the utility an opportunity to earn a fair return on the fair value of its utility property." (Pet. Exh. CHB at 12). Petitioner's witness Krohn stated that Westfield Gas' normalized test year operating revenues amount to $5,327,384. Mr. Krohn further testified that annual operating revenues of $6,339,020 are necessary to cover Petitioner's pro forma revenue requirements, including the proposed fair return supported by Petitioner's witness Brehm. Mr. Krohn's recommendation results in proposed additional operating revenues of $1,011,636. (Pet. Exh. OWK at 4 – 6). The OUCC proposed certain adjustments to the pro forma operating expenses reflected in Petitioner's proposed revenue requirement, which we discuss below.

A. Utility Receipts Tax. OUCC witness Grosskopf recommended a ($14) adjustment to Petitioner's proposed Indiana Utility Receipts Tax. Petitioner's witness Prentice agreed with the OUCC's proposed adjustment, explaining that Petitioner inadvertently excluded a $1,000 exemption from its calculation of the tax. The Commission finds that the OUCC's proposed adjustment to Petitioner's Indiana Utility Receipts Tax should be accepted.

B. Regulatory Commission Expense and Rate Case Expense. Mr. Grosskopf proposed an adjustment of ($2,681) to correct a mathematical error in Petitioner's test year regulatory commission expense adjustment shown on Petitioner's Exhibit OWK-9. (Pub. Exh. MHG-1 at 8). Petitioner did not dispute Mr. Grosskopf's proposed adjustment. However, Ms. Prentice's rebuttal testimony clarified that the correction does not impact Petitioner's proposed operating expenses as the pro forma at present rates regulatory commission expense was correct, only the adjustment amount was incorrect. (Pet. Exh. LSP-R at 17 – 18).

Additionally, OUCC witness Beaumont proposed to remove $3,292 from rate case expense for two rate case consultant invoices that she stated were inadvertently booked to the test year regulatory commission expense account. Ms. Beaumont testified the last rate order for Westfield Gas was issued over seven years ago on February 27, 2002 in Cause No. 42095-U. The previous rate order for Westfield Gas was nearly five years prior to that on September 25, 1997 in Cause No. 40793. Westfield Gas was purchased by Citizens Energy Service Corporation in 2004, and filed the current rate case nearly five years after the purchase. In recent history, Westfield Gas' rate case orders have occurred, on average, every six years. Ms. Beaumont testified, given this fact, that a six-year rate case amortization period is reasonable and supported by the evidence. However, she recommended a five-year amortization period because she understands Petitioner is adding infrastructure and new customers. Therefore, Petitioner may file a new rate case in a time frame that is more in line with the five-year time period since its purchase in 2004. The two adjustments proposed by Ms. Beaumont would result in a combined reduction of $21,184 to Petitioner's pro forma operating expenses. (Pub. Exh. SLB-1 at 3-4).

Ms. Prentice explained that the first adjustment Ms. Beaumont proposed was reflected in Petitioner's pro forma regulatory commission charge (Pet. Exh. LSP-R at 9 – 10). As a result, the invoices in question had been removed from Petitioner's proposed pro forma regulatory commission expense as illustrated in Petitioner's Exhibit LSP-R3. Ms. Prentice testified that the rate case expenses reflected in the two invoices pointed out by Ms. Beaumont were not included in Petitioner's pro forma rate case deferred asset, and as a result were not included in Petitioner's pro forma rate case expense adjustment. However, Ms. Prentice stated that Petitioner would not propose an adjustment to add those amounts to its rate case expense. (Pet. Exh. LSP-R at 9 – 11).

Ms. Prentice took issue with Ms. Beaumont's recommendation to amortize Petitioner's deferred rate case expenses over five years, rather than Petitioner's proposed three-year amortization period. Ms. Prentice explained that Westfield Gas' history of filing general rate cases is not an accurate indicator of the timing of future general rate cases. Rather, Ms. Prentice testified that Westfield Gas, like its sister utilities Citizens Gas and Citizens Thermal, intends to file a general rate case every three years, provided the need for such an increase justifies the cost and burden of initiating such a proceeding. (Id. at 11).

The Commission finds that Mr. Grosskopf's proposed correction of ($2,681) to Petitioner's proposed pro forma regulatory commission expense adjustment should be accepted. We further find that the ($3,292) adjustment proposed by Ms. Beaumont, has been clarified by Ms. Prentice, and is apparently reflected in Petitioner's pro forma regulatory commission charge. Therefore, that adjustment is unnecessary. Finally, we find that Petitioner's rate case expense shall be amortized over four years, resulting in a $38,487 adjustment to Petitioner's rate case expense.

C. Event Sponsorships. Ms. Beaumont proposed adjustments totaling ($1,110) for expenditures she characterized as "charitable contributions"; including golf outings and sign sponsorships. (Pub. Exh. SLB-1 at 2 – 3). Ms. Prentice disagreed that the expenditures should be categorized as "charitable contributions"; however, she explained that Petitioner's current practice is not to sponsor such events and the expenditures must have occurred during the test year prior to Petitioner establishing its current practice. Petitioner agreed to Ms. Beaumont's proposed adjustment. (Pet. Exh. LSP-R at 12). The Commission finds that the OUCC's proposed adjustment related to these expenditures should be accepted.

6. Revenue Deficiency. Based on the foregoing findings, the Commission finds that Petitioner's pro forma net operating income under present rates, adjusted to a level that represents its current operations, is $260,712, as summarized below:

Operating Revenues	$5,327,384
Total Operating Expenses	$4,818,821
Depreciation and Amortization	$ 247,851
Net Operating Income	$ 260,712

In Finding No. 4.E above, we determined that $586,924 is a fair return on the fair value of Petitioner's used and useful utility property. Consequently, we find that Petitioner's current rates and charges are insufficient to allow Petitioner an opportunity to earn a fair return on the fair value of its used and useful utility property and that Petitioner should be authorized to increase its rates and charges in order to produce an additional $326,212 of net operating income. After applying the appropriate revenue conversion factor, the authorized increase to net operating income results in an increase to Petitioner's total annual operating revenues of $551,001 or 10.34%.

7. **Method of Implementing Revised Rates.** In its case-in-chief testimony, Petitioner proposed that the requested increase to operating revenues be achieved by implementing an equal percentage, across-the-board change to the rates and charges in its various rate schedules. The OUCC did not oppose Petitioner's proposal to implement the revenue increase in an across-the-board manner. We find the position of the parties acceptable and order the increase authorized in this Order to be implemented by applying an across-the-board 10.34% increase to all rate schedules and subtracting the pro forma cost of gas, as illustrated in Petitioner's Exhibit LSP-R7.

8. **Energy Efficiency Adjustment Rider and Portfolio.**

A. Proposed Energy Efficiency Adjustment Rider. In its Verified Petition, Petitioner requested authority to implement an Energy Efficiency Adjustment Rider. Petitioner's witness Prentice discussed the purpose of the proposed rider, explaining that it is designed to support efforts by Westfield Gas, working in collaboration with an Oversight Board composed of interested stakeholders, to provide programs comprising an Energy Efficiency Portfolio. The Energy Efficiency Portfolio will be designed to reduce customer bills—both by reducing individual customer gas usage and, on a wider scale, reducing demand and thereby placing downward pressure on gas prices. The proposed rider, which will allow Westfield Gas to recover its non-gas costs even if customer usage declines, will align the utility's interests with the interest of its customers and allow the utility to become a proponent of reduced gas usage. (Pet. Exh. LSP at 3 – 4). Ms. Prentice explained that as part of its proposed energy efficiency efforts, Petitioner will implement an Energy Efficiency Portfolio, which will include programs designed to encourage conservation and efficient gas usage by Petitioner's customers. (Id. at 3).

Ms. Prentice testified that Petitioner's proposed Energy Efficiency Rider is modeled after similar tariff mechanisms the Commission has approved for Citizens Gas in Cause No. 42767 and Vectren Energy in Consolidated Cause Nos. 42943 and 43046. She further pointed out that Petitioner's proposed rider is consistent with Indiana's Homegrown Energy Plan's goals of (i) improving energy efficiency by supporting pricing mechanisms that encourage utilities to promote efficiency and conservation by their customers without incurring negative financial results; and (ii) encouraging creative pricing mechanisms to ensure a reliable and reasonably priced energy supply, including restructuring of fixed and variable charges. (Id. at 4 - 13). Ms. Prentice recommended that the Energy Efficiency Portfolio extend through August 31, 2012, which coincides with the expiration of the energy efficiency portfolio for Citizens Gas.

Ms. Prentice described in detail the governance, oversight and mechanics of Petitioner's proposed Energy Efficiency Adjustment Rider and Energy Efficiency Portfolio. Ms. Prentice emphasized the efforts Petitioner will make to coordinate its energy efficiency efforts with those of Citizens Gas and the cost savings and synergies that can be realized as a result of such coordination. (Id. at 13 – 22).

The OUCC supports Petitioner's proposal to implement an Energy Efficiency Adjustment Rider and Portfolio stating that the rate mechanism proposed by Petitioner "makes the utility a neutral party on the issue of energy conservation, and the OUCC has supported this model and is continuing to work with these utilities to make these energy efficiency programs effective." (Pub. Exh. MVC-1 at 6). The OUCC also supports Petitioner's proposal to integrate Petitioner's proposed Energy Efficiency Portfolio into the Citizens Gas energy efficiency Oversight Board and use the same third party administrator. The OUCC's testimony states that "[u]sing the same administrator and combining the Westfield Gas EE programs into the existing Citizens Gas EE Oversight Board will result in efficient and well-run programs." (Id.).

We have in numerous orders expressed our support for pricing mechanisms and programs that encourage customers to conserve energy and use it more efficiently. For example, in our December 2006 Order initiating an investigation into rate design alternatives and energy efficiency measures for natural gas utilities, we expressed our anticipation that "decoupling mechanisms will be an important element in promoting utility stability and benefits to customers." *In re the Investigation on the Commission's Own Motion into Rate Design Alternatives and Energy Efficiency Measures for Natural Gas Utilities*, Cause No. 43180 (Dec. 1, 2006 Order). Petitioner's proposed Energy Efficiency Adjustment Rider aligns Westfield Gas' and its customers' interests in energy efficiency, and it will be complemented by a portfolio of energy efficiency programs. Consequently, we find that the proposed Energy Efficiency Adjustment Rider is reasonable, in the public interest and should be approved and implemented in accordance with Petitioner's Exhibit LSP. We also find Petitioner's proposal, to integrate its Energy Efficiency Portfolio into the Citizens Gas Energy Efficiency Oversight Board and use the same third party administrator, is reasonable, in the public interest, and should be approved.

B. Energy Efficiency Funding. Petitioner proposed $33,800 as an appropriate funding level for the first year of its Energy Efficiency Portfolio. If successful, Petitioner suggested that the funding level for the Portfolio could increase by 15% increments each year over the term of the program. Ms. Prentice testified that the "proposed funding level will allow Westfield to make a meaningful and significant impact on energy conservation within its service area." (Pet. Exh. LSP at 13). Ms. Prentice explained that at the proposed funding level, Petitioner's energy efficiency efforts would be approximately proportionate to Citizens Gas' funding on both a per customer and a per therm basis. (Id.).

As discussed above, the OUCC supports Petitioner's desire to offer energy efficiency programs to its customers; however, the OUCC recommended a reduction in the funding suggested by Petitioner for its proposed Energy Efficiency Funding Portfolio. OUCC witness Snyder stated that Petitioner's proposed funding level would result in an average charge per customer per year of $11.27, assuming 3,000 customers pay for the cost of the program. Mr. Snyder testified that such an amount exceeds the initial average funding per customer of $9.40 per year for Citizens Gas customers and $7.90 per year for Vectren customers. Accordingly, the OUCC recommended an initial year funding of $23,700. (Public Exh. MVC-1 at 7).

In her rebuttal testimony, Ms. Prentice said that, as a threshold matter, $23,700 will not give Westfield Gas much funding to work with and that the program will need to be properly funded in order to provide meaningful benefits to customers. Ms. Prentice testified that there are other ways to measure and compare the energy efficiency program funding among various utilities including: (1) the ratio of Energy Program funds to total revenues; and (2) estimated customer participation in the program, based on Citizens Gas data and Westfield Gas customer growth. Ms. Prentice explained that the ratio of funding to total revenues is an often-discussed measure of the appropriate level of energy efficiency program funding. She testified that the ratio of Petitioner's proposed energy efficiency program funding to its pro forma total revenues is 0.5%, while Citizens Gas' ratio is 0.6% and Vectren North's ratio is 0.6%. (Pet. Exh. LSP-R at 14; Pet. Exh. LSP-R5, page 1). Ms. Prentice indicated that adjusting Petitioner's funding ratio to 0.6% (consistent with Citizens Gas' and Vectren North's funding ratios) would result in program funding of $38,034, approximately $4,200 more than Petitioner's proposed funding level. In contrast, the OUCC's proposed funding level of $23,700 would result in a funding ratio of only 0.4%, or less than the Citizens Gas and Vectren North ratios. (Pet. Exh. LSP-R at 14 – 15).

Ms. Prentice said that Petitioner's proposed energy efficiency funding level was supported by estimated customer participation in the program, based on Citizens Gas data and Westfield Gas customer growth. She stated that, based on participation data developed for Citizens Gas' energy efficiency programs and historic customer growth in Petitioner's service territory, approximately 60 existing and 80 new customers are expected to participate in Petitioner's proposed Energy Efficiency Program. Ms. Prentice testified that the cost of combined residential and commercial prescriptive programs amounts to $21,700, plus $12,100 for administration and outreach, resulting in total program funding of $33,800. (Id. at 15 – 16).

Having considered the testimony presented regarding an appropriate level of funding for Petitioner's proposed energy efficiency programs, the Commission finds that Petitioner's initial year level of funding for its proposed Energy Efficiency Programs should be $23,700.

9. Other Relief Requested.

A. Terms and Conditions and Rate Schedules. Petitioner requested approval of a new set of terms and conditions and rate schedules in this proceeding. Petitioner's witness Phillips sponsored and described the majority of Petitioner's proposed terms and conditions and rate schedules. (*See* Pet. Exh. JAP, JAP-1, JAP-2, JAP-3). Additionally, however, pursuant to Rule 5-1-27(F) of the Commission's rules, which allows gas utilities to request an alternative to the Commission's main extension rule, Petitioner's witness Prentice described a proposed alternative to the main extension rule, which requires gas utilities to make "free of charge an extension necessary to give service when the estimated total revenue, for a period of three (3) years, from the prospective customers, is at least equal to the estimated cost of such extension." 170 IAC 5-1-27(B). Petitioner proposed to substitute a five and one-half year non-gas revenue test in place of the main extension rule's three-year total revenue test. Ms. Prentice testified that the inclusion of gas commodity costs in the revenue test has become increasingly unfair, because the test is intended to determine whether a main extension will generate enough margin revenue (i.e., revenue collected to recover costs other than gas commodity purchase costs) such that a deposit should not be required. Subject to the OUCC's recommendation that Petitioner's tariff be amended to include transportation rates for commercial and industrial customers, which we discuss below, the OUCC supports approval of Petitioner's proposed terms and conditions and rate schedules, including Petitioner's proposed modification to the main extension rule. The Commission finds that Petitioner's proposed terms and conditions and rate schedules, including its proposed modification to the main extension rule, are reasonable and should be approved.

B. Recovery of Deferred Energy Efficiency Rebate Costs. In Cause No. 43600, the Commission approved Petitioner's request to create a regulatory asset in accordance with FAS71 for potential future recovery of the amortized costs associated with granting residential and commercial energy efficiency rebates that were incurred prior to the issuance of a final order in this proceeding. In the final Order in Cause No. 43600, we "directed [Petitioner] to demonstrate in its pending rate case, Cause No. 43624, based on the benefits realized as a result of the energy efficiency rebates, whether such deferred costs (including carrying costs) should be recovered through its rates and charges." Westfield Gas Corporation, Cause No. 43600, Order at 7 (Apr. 1, 2009). In Petitioner's Exhibit LSP-1, Ms. Prentice demonstrated the significant net savings to a customer who has implemented energy efficiency measures and the minimal impact of allowing Petitioner to recover the costs of achieving those savings upon a customer who has not made any energy efficiency efforts. The exhibit demonstrates that the reduced commodity costs achieved by customers who implement energy efficiency measures outweigh the costs that will be recovered from customers in connection with the energy efficiency programs that make the commodity cost savings possible. (Pet. Exh. LSP at 8; Pet. Exh. LSP-1). Ms. Prentice also discussed the manner in which Petitioner proposed to amortize and recover the regulatory asset authorized in Cause No. 43600. She explained that Petitioner would create an "Appendix F" to its tariff that would amortize over a three-year period any energy efficiency rebate costs accumulated up to the date of the Commission's Order in this Cause. At the conclusion of the three-year period, Petitioner would cancel Appendix F and roll any over- or under-collected amounts into its GCA for final reconciliation. (Pet. Exh. LSP at 23).

The OUCC agreed that Petitioner's request to recover the regulatory asset authorized in Cause No. 43600 "should be approved as set forth in Petitioner's testimony." (Pub. Exh. MHG-1 at 5). Based on the evidence presented, the Commission finds that Petitioner's recovery of the regulatory asset authorized in Cause No. 43600 is appropriate and approves Petitioner's request to recover through its proposed Appendix F energy efficiency rebate costs accumulated up the date of this Order. We direct Petitioner to file as a compliance filing in this Cause, the energy efficiency rebate costs accumulated up to the date of this Order and the resulting Appendix F.

C. Recovery of Unaccounted for Gas Costs Through Gas Cost Adjustment Charge. Petitioner requested approval to recover its unaccounted for gas ("UAFG") costs, up to a maximum of 1.26%, through its GCA rates. Ms. Prentice testified that Petitioner's proposal has three primary benefits for Westfield Gas customers. First, customers will no longer be at risk of overpaying UAFG costs if gas commodity prices decline from prices that have been included in the determination of base rates. Second, to the extent Petitioner's annual UAFG percentage is less than 1.26%, customers will not be at risk for paying the higher, static 1.26%. Third, customers will not be at risk for paying for more UAFG volumes than the maximum level of 1.26%, in the event that Westfield Gas' annual UAFG volume exceeds 1.26%. Although Petitioner will reduce its risk of under-recovery of UAFG costs due to potential gas commodity price increases, it will remain at risk for any UAFG volumes exceeding 1.26%. The OUCC supports approval of Petitioner's proposal to recover unaccounted for gas costs through its GCA rates. (Pub. Exh. MHG-1 at 5). Based on the evidence presented, we approve Petitioner's proposal to recover its UAFG costs, up to a maximum of 1.26%, through its GCA rates.

D. Recovery of Gas Cost Component of Net Write-Offs Through Gas Cost Adjustment Charge. Petitioner requested approval to recover through its GCA rates the net write-off gas costs at a fixed ratio of 0.32% of total gas costs. Ms. Prentice discussed the benefits of its proposal to customers and Petitioner. Because the gas cost component of net write-offs will be recovered through the GCA at a fixed net write-off ratio of 0.32%, and the margin component will continue to be recovered through base rates, Petitioner will remain at risk for the margin component and for the level of the actual net write-off ratio. However, recovering the gas cost component of net write-offs through the GCA will allow Petitioner's net write-off recovery to fluctuate with natural gas prices, which are volatile. In the event natural gas prices drop and potentially become less volatile in the future, customers will benefit from lower GCA rates. If natural gas prices rise, or other factors result in additional net write-offs, the GCA treatment of net write-off gas costs will ensure Westfield Gas will not be financially harmed by its inability to recover gas costs. The OUCC supports approval of Petitioner's proposal to recover the gas cost component of net write-offs through its GCA rates. (Pub. Exh. MHG-1 at 4). Based on the evidence presented, we approve Petitioner's proposal to recover the gas cost component of net write-offs through its GCA rates.

E. Depreciation Accrual Rates. Petitioner's witness Clayton presented the results of a depreciation study performed for Petitioner and the resulting depreciation rates. As a result of the depreciation study, the depreciation rates for Westfield Gas were revised, which resulted in a decrease in Petitioner's annual depreciation expense. Petitioner requested approval of depreciation accrual rates for gas utility plant in accordance with the results of Mr. Clayton's study. The OUCC supports approval of Petitioner's proposed revised depreciation accrual rates. We find Petitioner's depreciation study is reasonable and approve the depreciation accrual rates for Petitioner's gas utility plant in accordance with the results of that study.

F. Service Agreement Between Petitioner and Citizens Energy Group. Petitioner requested approval of a Service Agreement between Petitioner and Citizens Energy Group. Petitioner's witness Braun described the Service Agreement and stated that it governs Citizens Energy Group's provision of certain managerial, administrative, marketing, technical, operational and other services to Petitioner. He testified that Citizens Energy Group's provision of those services facilitates the synergies and efficiencies made possible by CESCO's acquisition of Petitioner. (Pet. Exh. CHB at 13). The OUCC supports approval of the Service Agreement between Petitioner and Citizens Energy Group. Consequently, we find the Service Agreement, which makes that integration possible, is reasonable and should be approved.

G. Transportation Rates for Commercial and Industrial Customers. The OUCC recommended Petitioner adopt commercial and industrial transportation rates as part of its tariff. OUCC witness Snyder explained why the OUCC believes a commercial and industrial transportation rate is important for Petitioner's customers. He stated that Westfield Gas' territory has been characterized as rapidly growing, and he believes commercial (and to a lesser extent, industrial) growth may follow the rapid residential growth in Petitioner's service territory. He testified that present and future commercial and industrial customers should have the opportunity for third-party choice in gas supply, especially since offering such an option is practical for

Petitioner because of the synergies realized as a result of Westfield Gas' relationship with Citizens Gas. (Pub. Exh. MVC-1 at 5).

In its rebuttal testimony, Petitioner indicated its willingness to implement the OUCC's recommendation. However, Petitioner stated that certain issues would need to be analyzed in order to determine the appropriate structure and method for offering transportation rates on Westfield Gas' system. Petitioner's witness Phillips described the various issues that would need to be analyzed, including the impacts of implementing commercial and industrial transportation rates on Petitioner's pipeline capacity requirements, gas storage, balancing procedures and accounting and billing systems. Petitioner proposes to address the issues described by Ms. Phillips and file commercial and industrial transportation tariffs within six months of the issuance of the Commission's Order in this Cause. Petitioner proposes to submit that filing as a compliance filing in this Cause.

We find the OUCC's recommendation that Petitioner implement commercial and industrial rates acceptable. We appreciate Petitioner's need to analyze the issues described by Ms. Phillips prior to implementing such rates. Consequently, we direct Petitioner to file as a compliance filing in this Cause, within six months of the date of this Order, proposed commercial and industrial transportation rates. We further direct the OUCC to file any comments it has to Petitioner's compliance filing within 30 days of the date such filing is made.

10. Commission Review of Stock Purchase. The Commission sought additional information related to the 2004 stock purchase by CESCO. Indeed, this rate case was the first time the Commission has reviewed any aspect of the transfer, as neither Westfield nor CESCO sought Commission review at the time of the transfer. During the July 7, 2009 hearing, the Presiding Officers questioned Petitioner's witness concerning the authority of a subsidiary of a municipal entity taking control of a for-profit utility. The Commission requested additional information subsequent to the July 7 hearing, and Petitioner filed supplemental testimony from the Chief Executive Officer of Citizens Energy Group, Carey Lykins. Mr. Lykins addressed some of the issues the Presiding Officers raised with respect to the operation of Westfield Gas within the corporate structure of a charitable trust. Mr. Lykins acknowledged that "in hindsight, I have come to believe we would have been well served had we sought review of the acquisition and regret that we did not." Pet. Ex. CBL-S at 9.

We agree with Mr. Lykins' assessment that it would have been in the best interests of the parties to seek Commission review of the CESCO/Westfield transaction at the time the transaction took place. As demonstrated by the evidence submitted in this Cause, Petitioner's fair value request ideally would have included some element of market value based on the price paid for the Westfield stock, but the methodology presented to the Commission was not an appropriate one for the Commission to use. Had the Commission been involved earlier in this process, the Commission may have been in a better position to advise the parties on an appropriate methodology for evaluating the value of Petitioner's plant.

Further, the unique nature of the organizational structure in which Petitioner now finds itself, in that it is an indirect subsidiary of a public charitable trust, lends credence to the notion that more involvement with the Commission would benefit the parties and Petitioner's ratepayers. As Petitioner's responses to the Commission's inquiry indicate, the public charitable trust is free from many of the burdens of Indiana law that relate to public utilities, but is also free from many of the burdens of Indiana law that relate to municipal utilities. Thus, the Commission is left with the responsibility of regulating an entity that would face significantly different legal requirements if it were defined as a public utility or even a municipal utility.

The charitable trust includes several regulated entities, such as Petitioner, and other entities that are regulated as municipal utilities for ratemaking purposes, such as Citizens Gas and Citizens Thermal. The charitable trust also includes several unregulated entities, such as Proliance Energy, LLC, which may contribute to the regulated endeavors. Given this unique climate, it is important for the charitable trust to maintain communications with the Commission so that the Commission has the information it needs to ensure that there is an appropriate balance between the interests of the trust and those of its beneficiaries and ratepayers.

IT IS THEREFORE ORDERED BY THE INDIANA UTILITY REGULATORY COMMISSION that:

1. Petitioner Westfield Gas shall be and hereby is authorized to adjust and increase its rates and charges for gas utility service, which rates and charges shall be designed to produce total annual operating revenues of $5,878,385 and annual net operating income of $586,924.

2. Petitioner's proposed Energy Efficiency Adjustment Rider shall be and hereby is approved. Petitioner shall implement the Energy Efficiency Adjustment Rider in accordance with Finding No. 8 herein. Petitioner is authorized to integrate its Energy Efficiency Portfolio into the Citizens Gas Energy Efficiency Oversight Board and establish the funding level for the first year of its Energy Efficiency Portfolio in accordance with Finding No. 8 herein. The Energy Efficiency Portfolio shall extend through August 31, 2012.

3. Petitioner shall be and hereby is authorized to recover its unaccounted for gas costs, up to a maximum of 1.26%, and the gas cost component of net write-offs at a fixed ratio of 0.32% of gas costs through its gas cost adjustment charge in accordance with Finding Nos. 9.C and 9.D herein.

4. Petitioner's proposed terms and conditions for gas utility service shall be and hereby are approved and Petitioner is authorized to implement such terms and conditions in accordance with the next paragraph.

5. Petitioner shall file with the Natural Gas Division of this Commission, prior to placing into effect the rates and charges and terms and conditions for gas utility service authorized herein, tariffs incorporating said rates and charges and terms and conditions. Said tariffs shall be effective upon filing and approval by the Natural Gas Division and shall thereafter apply to Petitioner's rendering of gas utility service.

6. Petitioner shall be and hereby is authorized to recover the regulatory asset authorized in Cause No. 43600 in accordance with Finding No. 9.B herein.

7. Petitioner shall be and hereby is authorized to adopt and use the depreciation accrual rates in accordance with Finding No. 9.E herein.

8. The Service Agreement between Petitioner and Citizens Energy Group shall be and hereby is approved.

9. Petitioner is hereby directed to file as a compliance filing in this Cause proposed commercial and industrial transportation rates in accordance with Finding No. 9.G herein.

10. This Order shall be and hereby is effective on and after the date of its approval.

HARDY, ATTERHOLT, LANDIS, MAYS, AND ZIEGNER CONCUR:

APPROVED: MAR 10 2010

I hereby certify that the above is a true and correct copy of the Order as approved.

Brenda A. Howe

Brenda A. Howe
Secretary to the Commission