BEFORE THE
PUBLIC UTILITIES COMMISSION OF OHIO

In the Matter of the Application of Northeast Ohio Natural Gas Corp. for an Increase in Gas Distribution Rates	))))	Case No. 18-1720-GA-AIR
In the Matter of the Application of Northeast Ohio Natural Gas Corp. for Tariff Approval	))))	Case No. 18-1721-GA-ATA
In the Matter of the Application of Northeast Ohio Natural Gas Corp. for Approval of Alternative Regulation	)))	Case No. 18-1722-GA-ALT

SUPPLEMENTAL TESTIMONY OF

GREGORY E. SCHEIG, CPA/ABV/CFF/CGMA, CFA, CEIV

ON BEHALF OF
NORTHEAST OHIO NATURAL GAS CORP.

JULY 25, 2019

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I. PURPOSE OF TESTIMONY

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Gregory E. Scheig. I am a Principal of ValueScope, Inc., 950 E. State Highway 114, Suite 120, Southlake, TX 76092.

Q. ARE YOU THE SAME GREGORY E. SCHEIG WHO FILED PREPARED DIRECT TESTIMONY IN THIS CASE?

A. Yes.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. The purpose of my testimony is to support NEO's objections to the recommendations made by the Staff of the Public Utilities Commission of Ohio ("Staff") in its Report of Investigation ("Staff Report") filed in this proceeding on June 25, 2019.

II. SUMMARY OF STAFF TESTIMONY

Q. HAVE YOU REVIEWED STAFF'S TESTIMONY?

A. Yes, Staff's testimony was submitted on behalf of the Public Utilities Commission of Ohio ("Ohio PUC").

Q. WHAT ARE STAFF'S RECOMMENDATIONS?

A. Staff recommends:

- a capital structure consisting of 64.47% equity and 35.53% debt,
- a cost of debt of 4.72%,
- a return on equity ("ROE") range of 9.50% - 10.50%, and
- a rate of return ("ROR") range of 7.80% - 8.45%.

Q. AFTER REVIEWING STAFF'S TESTIMONY, WHAT DO YOU CONCLUDE?

A. Staff's capital structure and cost of debt agree with NEO. However, Staff's ROE recommendation is not reasonable, nor does it adequately reflect the risk of an investment in NEO stock.

III. REBUTTAL TO STAFF TESTIMONY

Q. DO YOU AGREE WITH STAFF'S ROE RANGE OF 9.5% - 10.5% FOR NEO?

A. No. Staff's ROE recommendation is based on an improper, historical accounting-based methodology. First, Staff based its ROE recommendation on historical ROEs earned by a group of public utilities. ROEs for rate making purposes should be based on the future expectations of a market investor, not calculated historical returns. Staff calculated an arbitrary three-year average of historical ROEs for their comparable group. A calculated return from three years ago is not an indicator of a current, forward-looking return requirement for NEO.

Second, Staff's selection of public comparable utilities is problematic. Although many of Staff's guideline companies were consistent with those used in my analyses from Value Line, several companies were different. The most notable was Staff's selection of Adams Energy & Resources, Inc. (AE) as a "comparable utility."

According to AE's 2018 10-K:

> *"We, through our subsidiaries, are primarily engaged in the business of crude oil marketing, transportation and storage in various crude oil and natural gas basins in the lower 48 states of the United States ("U.S."). We also conduct tank truck transportation of liquid chemicals and dry bulk…"*[1]

AE is an unregulated midstream oil and gas company. Additionally, AE had the lowest average ROE of Staff's comparable companies and in 2017, its upstream subsidiary declared bankruptcy. Therefore, the inclusion of AE in determining an appropriate ROE for NEO is inappropriate and biases Staff's indicated ROEs downward.

Additionally, Staff did not include ONE Gas, Inc. (OGS) in its list of comparable companies. OGS is listed and covered as a gas utility by Value Line and is a "100-percent regulated natural gas distribution utility,"[2] so it is unclear why Staff would not include this company in its analysis.

Third, Staff applied no analysis to its ROE indications, over and above their simple accounting calculation. While using historical data for purposes of determining a future rate is problematic on its own, Staff could have performed an analysis on why some of the average ROEs of its comparable companies were so low. Had Staff analyzed the companies' historical results, they would have seen that several companies had financial reporting impairments (not reflected in regulatory accounting) and other non-recurring events that biased their ROEs downward. For example:

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[1] Adams Energy & Resources, Inc. 2018 10-K, page 4.

[2] ONE Gas, Inc. 2018 10-K, page 5.

- AE's upstream oil subsidiary declared bankruptcy and was sold,
- Northwest Natural Gas Company (NWN) had a $192 million impairment related to its Gill Ranch Facility in 2017 (impairments are a non-cash income statement item),
- NiSource, Inc. (NI) had losses of more than $150 million from early extinguishments of debt from 2016 to 2017 as well as a "material adverse impact" on its financial results from a September 13, 2018 gas explosion involving one of its subsidiaries, and
- South Jersey Industries, Inc. (SJI) had impairments of $196 million from 2017 to 2018 related to its solar investments.

All of the companies above had average indicated ROEs less than NEO's cost of debt. Therefore, these indications are not and cannot be relevant for comparison purposes.

Fourth, Staff rejects academic and utility commission-accepted methods for determining the cost of equity for a regulated utility, in favor of an historical accounting ratio. Staff states that because NEO's stock is not traded and therefore could not have a "beta" coefficient, then the Capital Asset Pricing Model (CAPM) cannot be used. This is incorrect, market participants and investment professionals routinely use betas from comparable public companies as inputs for the CAPM to derive a cost of equity for private companies. Staff also rejected developing a discounted cash flow (DCF) model citing the lack of "an adequate group of comparable companies."[3] This is inconsistent with Staff's

[3] *See* Staff Report, p. 16.

ROE recommendation based on their "comparable group" of public utilities from Value Line.

Q. DID STAFF INCLUDE AN ADJUSTMENT FOR NEO'S SMALL SIZE?

A. In its discussion against creating a DCF analysis, Staff noted that there were no public utilities that were "comparable in size" to NEO.[4] This is exactly why a small stock adjustment is required for a small utility like NEO. NEO lacks the lack of geographic and customer diversification enjoyed by the public comparable companies in the peer group. Recently, for a comparable size utility, Suburban Natural Gas Company, Staff limited the peer group to companies under $100 million.[5]

Q. DO YOU HAVE ANY CORRECTIONS TO STAFF'S ANALYSIS?

A. Yes. Although the methodology used by Staff in their calculations is not appropriate, it could be refined to better determine an indicated return on equity. I have prepared and attached Exhibit GESR-1 for this purpose. In the first section of this exhibit, I present the summary staff numbers and replicate their calculations of the 10% average return on equity from their selected second and third quartiles. The calculation of an average for a sample can be influenced by outliers, so the median is also considered as a relevant metric. Using Staff's numbers, selecting the median as opposed to an average would increase the concluded ROE by 20 basis points to 10.20%.

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4 *Id.*

5 *See* Case No. 18-1205-GA-AIR, Staff Report (Feb. 6, 2019), p. 16.

Q. WHAT OTHER ADJUSTMENTS WOULD YOU HAVE MADE TO STAFF'S ANALYSIS?

A. In addition to performing calculations, it is important to overlay experienced judgment when considering statistical samples and comparable indications. For instance, Staff's calculated returns for their first quartile are all less than NEO's cost of debt. In the bottom section of Exhibit GESR-1, I excluded these companies. On the high end of the range, UGI's 15.55% indicated return is not in line with other indicators, and I eliminated it also. This left eight companies, with four of them comprising the second and third quartiles. For this group of companies, the average rate of return is 10.85% and the median rate of return is 10.87%. Applying Staff's 50 basis point reduction adjustment to the average and median rates of return results in a 10.35% to 10.37% ROE range <u>as the lowest reasonable ROE for the sample</u>. Coincidentally, this is in line with the 10.33% that I calculated in my direct testimony, for a "Large Company ROE," before including a size premium.

Although I disagree with the methodology Staff used, if Staff had refined its analysis to eliminate outliers, Staff's concluded ROE for NEO would have been approximately 10.35% to 11.35%, in line with the calculations that I performed in my direct testimony.

Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?

A. Yes, it does.

Staff Schedule - As Filed

Quartile	Ticker	3-Year Average Earned ROE	
#1	AE	1.10%	
	NWN	3.11%	
	NI	3.54%	
	SJI	3.67%	
#2	CNIG	7.67%	
	SR	8.97%	
	SWX	9.99%	
#3	RGCO	10.39%	
	ATO	11.35%	
	CPK	11.65%	
#4	NJR	12.89%	
	SGU	12.98%	
	UGI	15.55%	
Average of 2nd & 3rd Quartiles		10.00%	
Suggested Range	9.50%	10.50%	
Median of 2nd & 3rd Quartiles		10.20%	*less affected by outliers*
Suggested Range	9.70%	10.70%	

Staff Schedule - Adjusted for Outliers

Quartile	Ticker	3-Year Average Earned ROE	Notes
Excluded	AE	NA	*less than NEO debt*
Excluded	NWN	NA	*less than NEO debt*
Excluded	NI	NA	*less than NEO debt*
Excluded	SJI	NA	*less than NEO debt*
Revised Quartile #1	CNIG	7.67%	
	SR	8.97%	
Revised Quartile #2	SWX	9.99%	
	RGCO	10.39%	
Revised Quartile #3	ATO	11.35%	
	CPK	11.65%	
Revised Quartile #4	NJR	12.89%	
	SGU	12.98%	
Excluded	UGI	NA	*greater than 15%*
Average of 2nd & 3rd Quartiles		10.85%	
Staff Range of Reasonableness	10.35%	11.35%	
Median of 2nd & 3rd Quartiles		10.87%	
Staff Range of Reasonableness	10.37%	11.37%	
Scheig Large Company ROE	**10.33**		