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MISSOURI PUBLIC SERVICE COMMISSION

MISSOURI GAS ENERGY

CASE NO. GR-2004-0209

SURREBUTTAL TESTIMONY

OF

JOHN M. QUAIN

ON BEHALF OF MISSOURI GAS ENERGY

Jefferson City, Missouri

June 2004

**SURREBUTTAL TESTIMONY OF JOHN M. QUAIN  
ON BEHALF OF  
MISSOURI GAS ENERGY**

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**SURREBUTTAL TESTIMONY OF JOHN M. QUAIN  
ON BEHALF OF  
MISSOURI GAS ENERGY**

1   **Q.   PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

2   A.   My name is John M. Quain, and my business address is Klett Rooney Lieber &  
3       Schorling, P.C., 240 North Third Street, Suite 700, Harrisburg, Pennsylvania,  
4       17101.

5

6   **Q.   HAVE YOU PREVIOUSLY TESTIFIED IN THIS PROCEEDING?**

7   A.   Yes, I offered direct testimony in this proceeding on behalf of Missouri Gas  
8       Energy ("MGE"), a division of Southern Union Company ("Southern Union")  
9       with respect to public policy considerations relevant to the issue of MGE's return  
10      on equity and a fair opportunity to earn that return.

11

12   **Q.   WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?**

13   A.   The purpose of my testimony is to respond to certain comments in the rebuttal  
14      testimony of Staff witnesses Murray and Oligschlaeger. As part of my response, I  
15      will update my direct testimony, and, from my perspective as a former regulator, I  
16      will address the ongoing issue in this proceeding of setting a return on equity  
17      ("ROE") consistent with appropriate public policy and legal standards and  
18      provide my viewpoint on how allowed ROEs in other jurisdictions should be  
19      taken into consideration in making this determination. I will also comment on the  
20      criticality of providing a fair opportunity to earn the established return on equity.

21

1 **I. ESTABLISHING A FAIR RETURN ON EQUITY**

2 **Q. ON PAGE 4 OF YOUR DIRECT TESTIMONY, YOU PROVIDED THE**  
3 **COMMISSION WITH SOME INFORMATION REGARDING ROEs**  
4 **AUTHORIZED BY OTHER UTILITY COMMISSIONS IN 2002 AND THE**  
5 **FIRST HALF OF 2003. AT THIS POINT, DO YOU HAVE UPDATED**  
6 **INFORMATION THAT YOU WISH TO PROVIDE?**

7 **A.** Yes. For calendar year 2003, Regulatory Research Associates, Inc., ("RRA")  
8 reports that the average equity return authorization for natural gas companies was  
9 10.99% (based on 25 major rate cases). For the first quarter of 2004, the average  
10 natural gas company equity return authorization was 11.1% (based on 4 major  
11 rate cases). In this proceeding, the Staff and the Office of the Public Counsel  
12 ("OPC") have recommended a range of ROEs, the midpoints of which are 9.02%  
13 and 9.175%, respectively.<sup>1</sup>

14  
15 **Q. ON PAGE 40 OF HIS REBUTTAL TESTIMONY, STAFF RATE OF**  
16 **RETURN WITNESS MURRAY STATES THAT, "THE STAFF OF THE**  
17 **MISSOURI PUBLIC SERVICE COMMISSION DOES NOT USE**  
18 **ALLOWED ROEs IN OTHER JURISDICTIONS IN ORDER TO**  
19 **RECOMMEND A FAIR AND REASONABLE ROE FOR UTILITY**  
20 **COMPANIES IN MISSOURI." HOW DO YOU RESPOND?**

21 **A.** When I first read this statement by Mr. Murray, I was puzzled why the Staff  
22 would not want this Commission to consider comparative ROE data from other

---

<sup>1</sup> The Staff and OPC recommend ROEs in ranges of 8.52-9.52% and 9.01-9.34%, respectively.

1 jurisdictions. Such data shows how other Commissions have resolved this  
2 difficult issue in natural gas cases in their respective jurisdictions. As I  
3 considered the matter further, and after reviewing MGE witness Dunn's  
4 Surrebuttal Schedule JCD-7, the likely answer became clear. For the last several  
5 years both the Staff and OPC recommendations regarding return on equity have  
6 consistently been far below the RRA average, so obviously the Staff has  
7 concluded there is little relevance in considering comparative data of allowed  
8 returns in other jurisdictions in arriving at an ROE.

9  
10 However, in my view, the allowed return in other jurisdictions is extremely  
11 relevant information and should be taken into consideration by the decision  
12 makers in this proceeding. In this sense, what happens in other jurisdictions is  
13 relevant because it brings into focus the broader context in which the present  
14 recommendations are being made. In this regard, I believe that it is important for  
15 the Commission to keep in mind the fact that investors have choices about where  
16 to place their capital and that the market for such capital is a competitive one.

17  
18 It is also worthwhile to restate that from a public policy perspective, as well as  
19 from the perspective of the Commission's obligation to meet the legal standards  
20 of Hope and Bluefield, the return on equity authorized in other jurisdictions  
21 should be taken into consideration in making the proper determination of ROE in  
22 this case. While no single factor is determinative in establishing the appropriate  
23 return on equity in any case, the large disparity between the ROE recommended

1 in this proceeding by the Staff and OPC, as compared to that authorized in other  
2 jurisdictions, should be a matter of serious concern and inquiry for the  
3 Commission.

4  
5 As the Commission will recall, in my direct testimony, I emphasized the relevant  
6 statement by the United States Supreme Court in Bluefield:

7 A public utility is entitled to such rates as will permit it to earn a return on  
8 the value of the property which it employs for the convenience of the  
9 public equal to that generally being made at the same time and in the same  
10 general part of the country on investments in other business undertakings  
11 which are attended by corresponding risks and uncertainties.

12  
13 Bluefield Waterworks & Improvement Company v. Public Service  
14 Commission of the State of West Virginia et al, 262 U.S. 679 (1923).  
15

16 The Commission needs to be aware that the Staff and OPC recommendations with  
17 regard to ROE in this case continue to depart substantially from returns being  
18 authorized in other jurisdictions. The Commission must consider these facts in  
19 light of its obligation to meet the Hope and Bluefield standard.

20  
21 **Q. ON WHAT OTHER INFORMATION DO YOU BASE YOUR**  
22 **TESTIMONY THAT THE STAFF HAS DISREGARDED ROE**  
23 **DETERMINATIONS MADE BY OTHER UTILITY COMMISSIONS?**

24 **A.** In addition to the statement by Mr. Murray in his rebuttal testimony, a review of  
25 ROE recommendations made by the Staff over a specific period of time reinforces  
26 this conclusion. See, Dunn Surrebuttal Schedule JCD-7. In and around 1998, the

1 Staff ROE recommendations began to diverge significantly from the RRA data.  
2 Again, the likely explanation for this is that the Staff no longer viewed ROE  
3 determinations by other jurisdictions as relevant, and that explanation appears to  
4 have now been corroborated by Mr. Murray's rebuttal testimony.

5  
6 **Q. WHY IS THIS DIVERGENCE OF CONCERN?**

7 A. The RRA data and the Dunn graph depicting the ROE recommendations made by  
8 the Staff in major gas rate cases since 1993 reveals a fact that I find very relevant.  
9 A significant divergence in ROE determinations always commands attention from  
10 the decision makers' point of view. Staff ROE recommendations trended fairly  
11 close to the average ROE being authorized by other regulatory bodies across the  
12 country until about 1998. Since 1998, the Staff ROE recommendations have  
13 trended considerably lower than the average ROE being authorized by other  
14 regulatory bodies. In making its determination in this case, the Commission  
15 should query the Staff as to what the basis for this significant divergence was and  
16 continues to be, because on its face, it appears to be the implementation of the  
17 policy which Mr. Murray has stated in his testimony.

18  
19 **Q. FROM YOUR PERSPECTIVE AS A FORMER REGULATOR, IS**  
20 **ESTABLISHING A RETURN ON EQUITY WELL BELOW AN**  
21 **INDUSTRY AVERAGE GOOD PUBLIC POLICY?**

22 A. No. As I previously testified, while it is tempting to approve low rates, rates must  
23 be set in a realistic fashion. Every utility must have an appropriate return on

1 equity, and the fair chance to realize that return. These are legal requirements as  
2 well as sound public policy. The instant case presents the Commission with an  
3 opportunity to carefully evaluate its legal obligations, its public policy objectives,  
4 and the manner in which the ratemaking process is viewed not only by the utilities  
5 it regulates and their customers, but also the investors who are evaluating whether  
6 to place capital in the state of Missouri.

7  
8 **II. ESTABLISHING A REALISTIC OPPORTUNITY TO EARN A FAIR ROE**

9  
10 **Q. CAN YOU COMMENT ON THE FOLLOWING QUESTION AND**  
11 **ANSWER IN STAFF WITNESS OLIGSCHLAEGER'S TESTIMONY:**

12 Q. Having made these points concerning MGE's earnings analysis, do you  
13 disagree that MGE has had a tendency to under-earn in its short history to date?

14  
15 A. No. Given the fact that MGE has added much plant in service to its rate base  
16 in recent years, and the nature of the ratemaking process in Missouri, that  
17 phenomenon is exactly what would be expected to happen. Oligschlaeger  
18 ~~Sur~~rebuttal, p. 12 ll. 17-21

19  
20 A. Mr. Oligschlaeger goes on to explain his answer in a manner which makes clear  
21 that he is not condemning the regulatory process in Missouri, *per se*, but rather he  
22 is trying to explain that the nature of the Missouri ratemaking process provides  
23 significant challenges to the company and regulators alike in ensuring that under-  
24 earning does not occur. If this is in fact the intent of Mr. Oligschlaeger's  
25 comment, I agree that significant challenges exist; however, these challenges must  
26 be overcome if the rates set by the Commission are to comport with the standards  
27 of Hope and Bluefield as described more fully, below.



1 By its very nature, the ratemaking process is a difficult one on several levels.  
2 Principal amongst the challenges is the requirement to set rates for prospective  
3 application based upon historic information. As a result, a lag occurs between the  
4 items used to calculate rates and the time period in which those rates will be in  
5 effect. This lag is exacerbated in states such as Missouri which employ the  
6 historic test year model. Consequently, unless great care is taken to identify the  
7 proper level for the individual cost of service elements which are used to calculate  
8 prospective rates, a utility will undoubtedly either over- or under-earn. As Mr.  
9 Oligschlaeger points out, in the case of MGE, the problem is one of continuous  
10 *under-earning*. He goes on to suggest that the remedy to this situation is for MGE  
11 to file more frequently for base rate increases.

12  
13 However, as set forth in my direct testimony, MGE witnesses Oglesby and Noack  
14 have testified in the instant proceeding that individual rate elements such as  
15 billing determinants and uncollectible expenses, have not been accurately set  
16 because MGE's actual earnings have fallen well short of authorized levels even in  
17 the years when rate increases were granted. What this demonstrates is that unless  
18 the cost of service elements are properly set, a company such as MGE will likely  
19 never emerge from an under-earning situation regardless of the frequency of its  
20 rate filings.

21  
22 While it is always important to establish individual rate making elements at the  
23 proper level, this legal requirement is of even greater importance when

1 prospective rates are set on an historic test year basis. This is true because it is  
2 already recognized that there is a significant mismatch in time between the data  
3 used to establish rates and the period of time when those rates will be in effect.  
4 Consequently, in order for the Commission to meet its fundamental legal  
5 obligation to set rates which will allow MGE a fair opportunity to earn its return,  
6 extraordinary care must be taken to ensure that the individual elements of the  
7 ratemaking process are just and reasonable to both shareholders and customers  
8 alike. Only in this manner can the Commission ensure that its public policy  
9 objectives and the standards required by law are adequately met.

10  
11 **Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?**

12 **A.** Yes, at this time.

