BEFORE THE PUBLIC SERVICE COMMISSION
STATE OF MISSOURI

In the Matter of Missouri Gas Energy's Tariff Sheets Designed to Increase Rates for Gas Service in the Company's Missouri Service Area	))))	**GR-2004-0209**

INITIAL BRIEF OF MISSOURI GAS ENERGY

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Comes now Missouri Gas Energy ("MGE"), a division of Southern Union Company ("Southern Union), by counsel, and submits this initial brief in support of its pending rate increase request, Case No. GR-2004-0209.[1]

I. Introduction

MGE filed its request to increase rates by approximately $45 million on November 3, 2003, its fourth general rate case filing since 1996. After approximately five and one-half months of time for audit and review, the Staff ("Staff") of the Missouri Public Service Commission ("Commission") and the Office of the Public Counsel ("OPC") filed direct testimony regarding revenue requirement items on April 15, 2004. Various parties filed direct testimony regarding rate design matters on April 22, 2004. A number of activities ensued thereafter, including local public hearings throughout MGE's service territory in late April, a pre-hearing conference in the first week of May, additional rounds of testimony in May and June, with an evidentiary hearing in late June and early July, and culminating with a true-up hearing on July 23, 2004 (collectively, the "Hearings"). Increased rates resulting from this case are scheduled to take effect on October 2, 2004, in accordance with section 393.150 RSMo.

A. Status of Revenue Requirement Recommendations.

In its direct testimony filed on November 4, 2003, MGE recommended a rate increase (also called revenue deficiency or revenue requirement) of approximately $45 million. (Ex. 8, Sch. A) As of July 2, 2004, MGE's revenue requirement recommendation was approximately $38 million, based on the update of the test year to

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[1] Citations herein to the record are in the following form: pre-filed testimony, "Ex. [number] at [page number:line number]"; oral testimony, "Tr. [page number:line number of the hearing transcript -- mini-script version]"; exhibits received into the record, "Hearing Ex. [number]".

December 31, 2003. (Hearing Ex. 857) At the close of the record, MGE's revenue requirement recommendation stands at approximately $40 million based on the true-up through April 30, 2004. (Ex. 49, Sch. A).

The Staff filed direct testimony on revenue requirement issues on April 15, 2004. At that time, the Staff recommended a $330,000 rate increase for MGE. (Ex. 828 at 2:18) As of July 2, 2004, the Staff's revenue requirement recommendation was approximately $8.9 million, based on the update of the test year to December 31, 2003. (Hearing Ex. 857) At the close of the record, the Staff's revenue requirement stands at approximately $12.7 million based on the true-up through April 30, 2004. (Ex. 862, Sch. 1). The OPC's revenue requirement recommendation as of July 2, 2004, was approximately $13.2 million, based on the update of test year to December 31, 2003. (Hearing Ex. 857)

The following chart shows how the Staff and MGE revenue requirement recommendations have changed over time.

Revenue Requirement Recommendations Through Time
(Dollars Expressed in Millions)

	Direct Testimony	7/2/04 End of Hearing	7/19/04 True-Up
MGE	$45 (11/4/03)	$37.8	$40
Staff	$0.3 (4/15/04)	$8.9	$12.7

While MGE's revenue requirement recommendation has remained relatively consistent since MGE filed this rate case last November, the Staff's revenue requirement recommendation has increased significantly in the three-month time period between the filing of its direct testimony and the conclusion of the true-up hearing.

B. In Determining MGE's Revenue Requirement, The Commission Must Ensure That MGE Is Competitive.

During the Hearings, the parties frequently referenced the United States Supreme Court's landmark decisions in ***Bluefield Water Works v. Public Serv. Comm.***, 262 U.S. 679 (1923) and ***Fed. Power Comm. v. Hope Natural Gas Co.***, 320 U.S. 591 (1944), and the guidance provided by those decisions with respect to the determination of a fair and reasonable rate of return for public utilities. Those decisions make it clear that in the context of utility regulation, fairness and reasonableness are synonymous with *competitiveness*. In other words, MGE's revenues must be sufficient to ensure that it can compete with like-risked enterprises in its efforts to, among other things, attract investors and the necessary capital such investors provide:

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

Bluefield, 262 U.S. at 692 (emphasis added). *See also* ***In re Permian Basin Rate Cases***, 390 U.S. 747, 792 (1968) (a regulatory agency's rate of return order should "reasonably be expected to maintain financial integrity, attract necessary capital, and fairly compensate investors for the risks they have assumed . . .").

The Supreme Court's use of the future tense "will permit" recognized that setting rates is by necessity a prospective process. Further, in using the phrase "will permit it to earn a return," the Court also established the importance of the actual earnings levels produced by rates set for a utility in assessing the adequacy of utility rate orders. In addition, by requiring that a utility's rates permit a return "equal to that generally being made . . . on investments in other business undertakings which are attended by

corresponding risks and uncertainties," the Supreme Court unequivocally required that the authorized return level for a utility be competitive with returns of other comparable businesses.

To achieve these results, the Commission must balance its concern for utility ratepayers with the utility's need for rate levels that sustain sound infrastructure and discretionary capital investment. (Ex. 6 at 2:12 to 3:2, 6:9-23, 8:10-22) The setting of appropriate rate levels also requires the Commission to make a reasonable forecast of what the future holds for the utility in question, ratepayers, utility investors and the utility industry as a whole. (Ex. 7 at 6:10 to 8:9) This is particularly so in a jurisdiction, like Missouri, that uses a historical test year to set future rates. (*Id.*) This means that the dataset being used to set rates in this case ended as of April 30, 2004, even though the rates will not take effect until October 2, 2004. As the Commission is well aware, MGE's business continues to operate throughout that interim period and thereafter, adding plant in service, hiring necessary employees, awarding pay raises to employees as a result of either union contract or market requirements, and all of the other factors that make the natural gas distribution business an increasing cost business over time.

C. The Staff's And OPC's Revenue Requirement Recommendations Defy *Bluefield* And *Hope* Guidelines Because They Would Deprive MGE Of A Competitive Position In The Utility Industry.

MGE initiated this proceeding because, over the past eight years, MGE has been unable to earn the rate of return approved by this Commission (Ex. 11, Sch. MRN-5) due to a variety of factors, including (1) actual bad debt expense that has exceeded the rate case allowance for bad debt expense by approximately $1.5 million annually, on average; (2) actual average use per residential customer that has consistently fallen short of the

average use per residential customer assumed in the rate setting process; (3) rate design decisions for MGE that have placed heavy reliance on volumetric revenue recovery resulting in significant variability in revenue streams; and (4) a failure to account for costs that MGE necessarily incurs in its operations. (Ex. 8 at 25:4-8, Sch. G-3; Ex. 23 at 8:3 to 9:16; Ex. 25 at 30:20 to 31:19; Ex. 14 at 14:22 to 15:14) For MGE to have any realistic chance of actually achieving its Commission-authorized earnings level, the ratemaking process must reasonably reflect MGE's operating reality. Instead of working toward this goal, the OPC and the Staff have not only opposed MGE's request for changes in its rate design, they have recommended a significant lowering of MGE's approved rate of return to 7.38 percent or less – an unjustifiable result that would ensure that MGE is non-competitive for the foreseeable future.

Indeed, as MGE has demonstrated, the Staff and OPC have for several years now consistently recommended rates of return for Missouri utilities below that allowed other comparable utilities across the country. (Ex. 3 at 24:7 to 26:7 and Schedule JCD-7) Continuing this dangerous trend, the OPC and Staff make similarly low recommendations here. For example, the OPC and Staff are recommending that the Commission adopt a return on equity for MGE of substantially less than the national average of 11 percent other Commissions are authorizing for natural gas distribution utilities: *i.e.,* from 8.52 percent to 9.52 percent. Of course, in making this unreasonably low recommendation, the Staff and OPC never address the question of how MGE is supposed to attract equity investors if such a built-in competitive disadvantage is approved by the Commission.

MGE's recommended return on equity (12 percent) and rate of return (9.55 to 9.6 percent) are based on the testimony of a 35-year veteran of utility finance, Mr. John Dunn

("Dunn"), and are consistent with accepted utility finance practices. Further, MGE's recommendation is based on a realistic assessment of the present state of the utility industry, reasonable projections of how that industry will perform in the future, and a detailed analysis of the specific risks faced by MGE as compared to other enterprises in the natural gas distribution industry. In contrast, the Staff's and OPC's recommended rates of return are based on misused financial models and unreliable datasets. Further, and most disturbingly, both the Staff and OPC openly ignore the results of their calculations when such results fail to serve their pre-determined conclusion – *i.e.,* that MGE should receive the lowest possible approved rate of return. Not surprisingly, this so-called analysis is supported by witnesses who are less qualified and have less experience and training than Dunn.

During the Hearing, and in their prepared testimony, Staff and OPC witnesses implied that their unreasonably low revenue requirement recommendations were driven by a desire to punish MGE for Southern Union's 2003 acquisition of Panhandle Eastern Pipeline Company ("Panhandle") and the additional leverage that acquisition temporarily required. These positions were not supported by any analysis of Panhandle's or Southern Union's business or any alleged increased risks to Missouri ratepayers. Indeed, Dunn testified to the contrary: the fact that companies are leveraged differently does not mean that management acted improperly. (Tr. 264:4-7) Dunn confirmed that decisions by Southern Union management about what type of capital structure the company has do not affect the customers of MGE. (Tr. 247:15 to 249:12) OPC witness Allen agreed that each company's optimal capital structure is different, and is a management decision. (Tr. 474:4-15) The Staff and OPC positions regarding Panhandle were further contrary to

both principles of utility finance and the conduct of Southern Union, which has worked diligently to reduce the debt it incurred in acquiring Panhandle. In fact, on July 20, 2004, Southern Union announced the issuance of over 11 million new shares of common stock, 4.8 million of which will be used for general corporate purposes, including the paying down of existing debt. (*See* Hearing Ex. 55) Southern Union's continuing actions to address the temporary changes caused by the Panhandle acquisition confirm that the Staff's and OPC's hyperbole about the evils of "Panhandle debt" is not based on the facts and is nothing but unprincipled demagoguery.

As the United States Supreme Court has recognized, utilities like MGE must be competitive. MGE cannot operate in the State of Missouri, and cannot attract the capital necessary for doing so, if investors and analysts view it as an unsatisfactory investment as against other natural gas distributors. (*See* Tr. 469:10-18) As Dr. Roger Morin – one of the pre-eminent experts in utility finance – established in his Hearing testimony, data on utilities' allowed rates of return is closely scrutinized by market analysts and is fundamental to investor valuations and investment considerations. (Tr. 1704:13 to 1706:4; *see also* Ex. 3 at 24:10 to 26:7) Although each utility is unique, the market's focus on performance indicators such as allowed returns on equity means that an aberrationally low authorized return – like that recommended by the Staff or OPC – will necessarily cause a negative effect on investor sentiment toward MGE.

In seeking to remain competitive, and in seeking a fair rate of return that it can reasonably expect to earn through its operations, MGE relies on sound regulatory principles and reliable assessments of the utility industry and markets in general. Indeed, as the Commission is fully aware, MGE has focused on the need for reliability during

these proceedings. MGE submits that when the evidence before this Commission is thoroughly analyzed, the reliable data and the reliable use of financial methodologies supports MGE's tariff request.

II. Issues

A. MGE's Required Rate of Return

An important step in determining how MGE's revenue requirement should be established is the calculation of a required rate of return. Such a calculation is a three-step process. First, a proper capital structure (*i.e.,* MGE's mixture of common equity, preferred stock and long-term debt) must be determined. Second, the required rate of return must be calculated for each component of MGE's capital structure. Third, MGE's overall required rate of return (or the weighted average cost of capital, "WACC") must be calculated using the components of MGE's capital structure and each component's required rate of return. Lastly, as a fourth consideration, MGE is recommending a small upward adjustment in its approved rate of return based on MGE's high level of management efficiency. MGE addresses each of these steps below.

1. Capital Structure

a. MGE's Recommendation

MGE recommends that for the purposes of calculating a required rate of return, the Commission adopt a capital structure for MGE consisting of 41.10 percent common equity, 11.49 percent preferred equity and 47.41 percent long-term debt. (Ex. 49, Sch. F; Ex. 3 at 9:3-21) This capital structure is based on Southern Union's consolidated capital structure as of April 30, 2004, the true-up date, with the debt and equity associated with Southern Union's 2003 acquisition and ownership of Panhandle removed pursuant to

generally accepted accounting principles ("GAAP") (the "Fully Adjusted MGE Capital Structure"). (*Id.*, at 9:22 to 10:7)

Alternatively, MGE recommends that the Commission adopt a capital structure for MGE consisting of 40.30 percent equity, 53.96 percent long-term debt and 5.74 percent preferred equity. This alternative capital structure is based on a hypothetical capital structure calculated by analyzing the capital structures of the proxy group of utility companies utilized by OPC witness Travis Allen ("Allen") in his testimony before the Commission (the "Hypothetical MGE Capital Structure"). (Tr. 482:11 to 485:17; Hearing Ex. 32)

b. OPC's Recommendation

The OPC recommends a capital structure of 28.37 percent common equity, 6.06 percent preferred equity, 59.77 percent long-term debt and 5.80 percent short-term debt. This capital structure is based on Southern Union's consolidated capital structure as of April 30, 2004, but makes absolutely no effort to exclude debt or equity associated with Panhandle. (Ex. 233 at 1:13 to 2:10) This failure to exclude Panhandle debt and equity is inexcusable under basic corporate finance practices: Panhandle is an independent subsidiary that is funded and operated separately from Southern Union's natural gas distribution operations. Further, Panhandle's debt – most of which was issued years ago to finance Panhandle's pipelines – is nonrecourse to Southern Union and thus, MGE. (*See, e.g.*, Ex. 2 at 9:19 to 14:13; Ex. 3 at 3:3 to 4:6)

As an alternative, because the consolidated capital structure of Southern Union is outside the "zone of reasonableness" range for comparable natural gas utilities, the OPC recommends a hypothetical capital structure for MGE of 35.42 percent common equity, 5.71 percent preferred stock, 53.07 percent long-term debt and 5.80 percent short-term

debt as of the true-up through April 30, 2004. (Tr. 448:1-7) The OPC calculated this hypothetical capital structure by creating a "zone of reasonableness" for the capital structures of the fifteen utility companies used by MGE witness Dunn in his testimony, and then arbitrarily assigning MGE to the very bottom of this zone. (Hearing Ex. 235; Ex. 201 at 12:1 to 13:12)

c. Staff's Recommendation

The Staff recommends a capital structure for MGE of 29.99 percent common equity, 6.40 percent preferred equity and 63.61 percent long-term debt. (Ex. 860 at 2:2-8) This capital structure is based on Southern Union's consolidated capital structure as of April 30, 2004, and inexplicably includes no effort to insulate MGE from the impact of debt or equity associated with Panhandle. As with the OPC, this position is unjustifiable under accepted utility finance practices. Moreover, Staff's position on capital structure in this proceeding is at odds with positions it has taken in prior ratemaking proceedings before this Commission. (*See* Ex. 3 at 5:12 to 6:27, 7:9 to 8:3)

The Staff has made no effort to calculate a hypothetical capital structure for MGE, although Staff witness David Murray ("Murray") has recognized that such structures are used in utility finance and ratemaking proceedings. (Tr. 780:14 to 781:9)

d. The Importance of a Proper Capital Structure

Utilities, like most companies, obtain the capital they require from different sources. Utilities borrow some of the capital they need, and raise other capital through the sale of equity securities. Each form of capital has its costs and benefits. For example, debt is typically cheaper than equity, but it adds financial risk to a company and, thus, increases the cost of equity. Indeed, as Dr. Morin testified at the Hearing, the benefits of cheaper debt are reduced by the increased returns required on equity, and at a certain

level of debt, the increased cost of equity outweighs the benefits of more debt. (Tr. 1694:11 to 1699:16, 1719:23 to 1721:12)[2]

In order to assess the true risk associated with an enterprise such as MGE, a proper capital structure must be utilized. Accordingly, because MGE is a division of Southern Union -- a corporation with diverse interests -- MGE's true capital structure must be calculated to ensure that MGE is not judged by the capital structure of other, differing enterprises or ventures. As Dr. Morin has written in his seminal textbook:

> Figure 14-1 [re Corporate-Wide v. Risk-Adjusted Cost of Capital] bears a crucial message: the cost of capital for a division, investment project, or specific asset investment depends on the riskiness of that investment, and not on the identity of the company undertaking that project. *The cost of capital depends on the use of funds and not the source of funds.* This is because the cost of capital is fundamentally the opportunity cost of the investor, that is, the foregone return on comparable risk investments.

R. Morin, REGULATORY FINANCE, 344 (Public Utility Reports 1994) ("REGULATORY FINANCE") (emphasis added).[3]

e. The Fully Adjusted MGE Capital Structure

Southern Union is comprised of two basic businesses, natural gas pipeline operations (*i.e.,* Panhandle) and local natural gas distribution (*i.e.,* MGE and other similar distribution divisions). (Tr. 227:8 to 229:9) Given the distinct differences in these

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[2] For example, assume that Company A has 50 percent common equity, with a required return on equity of 10 percent, and 50 percent long-term debt, with an imbedded cost of 5 percent. Increasing the amount of the cheaper debt will, by necessity, increase the required return on equity: shareholders in Company A will demand more of a return as Company A takes on more debt and financial risk. If the financial benefit derived from increasing long-term debt is greater than the increased return demanded by Company A's shareholders, then increasing the percentage of long-term debt above 50 percent makes sense. However, if the increased return demanded by Company A's shareholders is greater that any cost reduction gained from more debt, changing the capital structure does not make sense.

[3] Dr. Morin's textbook was referenced frequently during the Hearings. (*See, e.g.,* Tr. 164:15 to 165:1, 172:6 to 173:20, 181:22-18, 435:22 to 436:8, 750:13 to 751:23, 1692:20 to 1693:4, 1735:24 to 1737:2)

businesses, MGE witness Dunn – an experienced witness before this Commission and a certified rate of return analyst – has provided this Commission with a capital structure that excludes the capital structure of Southern Union's Panhandle pipeline operations and focuses on the common equity and debt associated with Southern Union's natural gas distribution operations, including MGE. (Ex. 3 at 9:3 to 10:7; Tr. 261:2-19)

In addition, MGE witness John J. Gillen ("Gillen") – a certified public accountant with significant experience in the utility industry – has provided testimony to this Commission confirming that the manner in which Dunn removed the debt and equity associated with Panhandle from Southern Union's consolidated capital structure is consistent with GAAP. (Ex. 4 at 5:3 to 9:11 and Sch. JJG-1 and 2) Specifically, Dunn's Fully Adjusted MGE Capital Structure removes from Southern Union's consolidated capital structure:

(a) the debt of Panhandle (*i.e.,* the debt assumed or issued by Southern Union in its acquisition of Panhandle);

(b) the common equity issued by Southern Union as part of its acquisition of Panhandle ($ 48.9 and 84.5 million); and

(c) the retained earnings of Panhandle up to April 30, 2004 ($ 91 million).

(Ex. 3 at 9:3 to 10:7; Ex. 4 at 5:3 to 9:11 and Sch. JJG-1 and 2)[4]

[4] As Gillen explained in his testimony, the Fully Adjusted MGE Capital Structure *does not* remove from Southern Union's consolidated capital structure the common equity of Panhandle *prior to Panhandle's acquisition.* To do so would be nonsensical: the common equity of Panhandle prior to its acquisition was the equity investment of Panhandle's previous investors. Southern Union bought Panhandle from those investors. Accordingly, that equity investment was paid off and no longer exists. (Ex. 4 at 7:14 to 8:19)

With these adjustments, the Fully Adjusted MGE Capital Structure as of April 30, 2004 is as follows:

	Ratio
Long Term Debt	47.41%
Preferred Equity	11.49
Common Equity	41.10
TOTAL	100.00%

(Ex. 49, Sch. F; Ex. 3 at 8:15 to 9:21)

The Fully Adjusted MGE Capital Structure is a reliable measure of the capital structure supporting the distribution operations of Southern Union, including MGE, and its use – in lieu of Southern Union's consolidated capital structure – is fully consistent with accounting and utility finance principles. As noted, utility finance authorities have repeatedly recognized that accurate calculations of capital structure for diversified or conglomerate corporations require a business unit-by-business unit calculation of capital structure; simply assuming that a business unit or subsidiary has the same capital structure as its parent company is a universally rejected methodology. *See, e.g.*, REGULATORY FINANCE, *supra,* at 472 (demonstrating inequity of using parent company capital structure to calculate subsidiary's cost of capital); L. Gitman, M. Joehnk & G. Pinches, MANAGERIAL FINANCE, 726 (1985) ("Because of the vast differences in business and financial risk among various lines of business, and because of the growth of conglomerates and other diversified firms, many companies have begun to use risk-adjusted divisional costs of capital").

In fact, an influential industry survey regarding the overall approach to calculating capital structure found that *100 percent* of the textbooks reviewed, and *100 percent* of the

companies interviewed, recommended and/or used distinct capital structures for each division in a corporation. *See* R. Bruner, K. Eades, R. Harris & R. Higgins, *Best Practices in Estimating the Cost of Capital: Survey and Synthesis*, 8 Finance Practice & Education Journal, 17 (Spring/Summer 1998) (*cited at* Ex. 2 at 19:10 to 22:12)

The Fully Adjusted MGE Capital Structure is also entirely consistent with the order of this Commission approving the Stipulation and Agreement, filed with the Commission on March 23, 2003, which allowed for Southern Union's acquisition of Panhandle (the "Stipulation"). Under the terms of the Stipulation, Panhandle is isolated from, and operated and financed independently of, MGE:

> Southern Union Panhandle Corporation ("SUPC") and Successor Entities or any direct or indirect subsidiary of Southern Union that acquires or owns any equity interests in Panhandle, will be owned and operated as a separate subsidiary of Southern Union. Southern Union and MGE will not, directly or indirectly, allow any Panhandle debt to be recourse to them; pledge Southern Union or MGE equity as collateral or security for the debt of any Panhandle entity; give, transfer, invest, contribute or loan to any Panhandle entity, any equities or cash without Commission approval. Southern Union will not transfer to SUPC and Successor Entities or any subsidiary thereof, directly or indirectly, assets necessary and useful in providing service to MGE's Missouri customers without Commission approval. Southern Union will not enter, directly or indirectly, into any "make-well" agreements, or guarantee the notes, debentures, debt obligations or other securities of any Panhandle entity without Commission approval. Southern Union will not adopt, indemnify, guarantee or assume responsibility for payment of, either directly or indirectly, any of the current or future liabilities of any Panhandle entity without Commission approval. Southern Union will exercise its best efforts to insulate MGE from any adverse consequences from its other operations or the activities of any of its affiliates.

(Stipulation, at § 2.) Implicit in the Stipulation's provisions is the recognition that Panhandle – a natural gas pipeline – is a business with different business risks, financial risks and capital requirements from that of MGE, a natural gas distribution company. (*See* Ex. 2 at 9:6 to 13:25, 17:26 to 23:8; Tr. 261:2 to 262:5) Accordingly, including

Panhandle's capital structure in a required rate of return calculation for MGE is unsupportable and improper.

f. The Hypothetical MGE Capital Structure

Both MGE and the OPC have proposed, as an alternative for the Commission, calculating a "hypothetical" capital structure for MGE, because the consolidated Southern Union capital structure is so unrepresentative of natural gas utilities like MGE. (*See* Ex. 203 at 6:11-19; Tr. 448:1-17; Tr. 780:14 to 781:9; Ex. 3 at 10:27 to 11:13, 35:14 to 36:12; Tr. 1694:11 to 1709:17) This methodology uses the capital structures of various comparable natural gas distribution companies (also referred to as "proxy companies" or a "proxy group") to determine a percentage of common equity for MGE. (*See, e.g.,* Hearing Ex. 32)

Using OPC witness Allen's own calculations based on his own proxy group of natural gas companies, the hypothetical percentage of common equity attributable to MGE is 40.3 percent.[5] (*Id.*) When this calculated 40.3 percent common equity is applied to an overall "hypothetical" capital structure for MGE, the result is as follows:

	Ratio
Long Term Debt	53.96%
Preferred Equity	5.73%
Common Equity	40.30%
TOTAL	100.00%

(Hearing Ex. 32.)

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[5] For the purposes of this Proceeding, MGE accepts Allen's calculation, although MGE questions the fairness of assigning MGE to the bottom of Allen's calculated capital structure range. (*See infra* p. 19.)

A Commission decision adopting the Hypothetical MGE Capital Structure in this case would be fully consistent with this Commission's prior ruling in ***In the Matter of St. Joseph Light & Power Co.*** *("**St. Joseph**"),* Case No. ER-93-41, 1993 Mo. PSC LEXIS 36, 2 Mo. P.S.C. 3d 248 (1993). In ***St. Joseph,*** the OPC, as represented by OPC witness John Tuck ("Tuck"), recommended that the Commission adopt a hypothetical capital structure in the determination of a reasonable rate of return capital for a utility. The Commission followed the OPC's advice and held:

> By adopting a hypothetical capital structure for SJLPC, the Commission is not indicating a preference for hypothetical capital structures in establishing revenue requirements for a company. The Commission, in other cases, has utilized the actual capital structure whenever the debt equity ratio has not been shown to be outside a zone of reasonableness. *However, when as in this case, the actual capital structure is so entirely out of line with what the Commission considers to be a reasonable range, a hypothetical capital structure must be adopted to balance properly the interests of the shareholders and ratepayers.*
>
> The Commission, therefore, determines that the hypothetical capital structure as proposed by Public Counsel should be adopted in this proceeding.

St. Joseph, 1993 Mo. PSC LEXIS 36 at *11-*12, 2 Mo. P.S.C 3d 248 at 253 (emphasis added).

Here, the Staff's and OPC's proposed capital structures for MGE – *i.e.,* Southern Union's capital structure with approximately 28 to 30 percent common equity – are clearly outside the "zone of reasonableness" with respect to the natural gas distribution industry (averaging more than 45 percent equity). Indeed, OPC witness Tuck agreed with this obvious proposition during his testimony before the Commission:

> Q. Including Panhandle, after there's an insulation and using the consolidated structure, even by your own admission, Southern Union's consolidated capital structure is outside the zone of reasonableness for the comp group; right?

A. That's right.

Q. And under that theory, your own sworn testimony previously [in ***St. Joseph***], doesn't that tell you that now is the time to be using a hypothetical capital structure? Isn't that what you swore to previously?

A. Yeah, yeah, I think it's – a reasonable result can absolutely be achieved through the use of a hypothetical capital structure.

(Tr. 729:10-22) (*See also* Tr. 297:24 to 298:11; Tr 1693:24 to 1697:17)

OPC witness Allen agreed: "[T]he consolidated capital structure of Southern Union was outside the zone of reasonableness range, so that's why I – following the Commission's acceptance of this hypothetical development, I followed the methodology that was developed by Mr. Tuck in [the ***St. Joseph***] case." (Tr. 448:1-14) Allen testified that he agreed with the Commission's decision in ***St. Joseph*** that it is appropriate to use a hypothetical capital structure when the consolidated capital structure is out of line with the rest of the industry:

Q. Okay. So you would agree that if the actual capital structure is so out of line with the industry norms, that there should be a deviation to some – at that point you could deviate to a hypothetical capital structure, correct?

A. I would say that's reasonable.

(Tr. 541:1-25)

Most compellingly, however, the Hypothetical MGE Capital Structure (40.30 percent common equity) closely mirrors the Fully Adjusted MGE Capital Structure (41.13 percent common equity). In short, when a careful analysis of Southern Union's natural gas distribution capital structure is undertaken, it becomes clear that the actual capital structure of Southern Union's natural gas distribution business is within the zone of reasonableness for capital structures in the natural gas distribution industry.

g. The Staff's And OPC's Improper Capital Structures

(1) OPC

Southern Union's Consolidated Capital Structure: The OPC continues to recommend – although only lukewarmly – that the Commission use the consolidated capital structure of Southern Union in determining the revenue requirements of MGE. Indeed, as noted, OPC witnesses Tuck and Allen have also proposed a hypothetical capital structure for MGE. Further, both OPC witnesses have has conceded that Southern Union's consolidated capital structure is outside the "zone of reasonableness" standard established in ***St. Joseph***. (Tr. 448:1-14; Tr. 729:10-22)

The OPC does speculate, at times, that the debt assumed or issued by Southern Union in acquiring Panhandle places Missouri ratepayers at greater "risk," and then implies that attributing Southern Union's consolidated capital structure to MGE is an appropriate response. (Ex. 203 at 16:10 to 18:15; Ex. 202 at 8:13-24) Of course, this position ignores the fact that Panhandle's debt is nonrecourse to Southern Union and MGE. Just how does this nonrecourse debt injure Missouri ratepayers? OPC offers no evidence to suggest it does. In fact, the OPC has conducted no analysis of Southern Union's or Panhandle's business to determine if the acquisition of Panhandle – a viable, promising and independent business operation – poses any risk to Missouri ratepayers, and it certainly has done nothing to try to quantify any such purported risk.

A changing capital structure – particularly a temporary change resulting from an acquisition – is not, in and of itself, a bad thing. If it were, mergers and acquisitions would rarely be approved, and the present move in the utility industry toward consolidation would not be occurring. In the end, it is pure OPC demagoguery to argue

– without evidence or analysis – that Southern Union's participation in this consolidation process is inherently bad for Missouri ratepayers. As Dr. Morin testified at the Hearing:

> Q. [JUDGE WOODRUFF]: We've been talking about the fact in this case that, as you've talked about as well, that Southern Union has a lot of debt and is, therefore, outside the normal range of debt equity ratio. The question is, does it matter why the company has a structure that's out of line with normal?
>
> A. [DR. MORIN]: That's a good question. The answer is no, it really doesn't matter. If you go back to my stand-alone principle and if you review MGE's gas operation on a stand-alone basis and ask yourself what would be a fair and reasonable representative capital structure, it would be probably around the 45, 55 range. So that's a pretty good point that it really doesn't matter from a regulatory prospect.
>
> The high leverage of Southern Union is a happenstance of the fact they made a huge acquisition that was debt financed, and we shouldn't be concerned with that.

(Tr. 1729:3-20)[6]

The OPC's Hypothetical Capital Structure: The OPC's alternative recommendation of a hypothetical capital structure is correct in principle, but arbitrary and capricious in application. (*See* Ex. 3 at 35:14 to 36:12)

OPC witness Allen testified that in calculating his hypothetical capital structure, he used 15 natural gas distribution companies to establish a statistical "zone of reasonableness" for common equity of 37.6 percent to 58.2 percent. (Ex. 201 at 11:34 to 13:25) He then saddles MGE with the very bottom of this "zone" (37.6 percent),

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[6] Further, as noted *infra* pp. 22-23, the OPC's (and Staff's) arguments regarding Southern Union's consolidated capital structure ignore basic principles regarding the calculation of return on equity. It defies fundamentals of utility finance to impose a capital structure with 28 to 30 percent equity on MGE, but then use "comparable" utility companies with 45+ percent equity to determine a reasonable return on equity for MGE. *See, e.g.*, REGULATORY FINANCE, *supra,* at 438. (*See also* Ex. 5 at 36:11 to 38:4.)

although he offers no principled reason for doing so and his decision is suspiciously result-oriented.

The truth is that Allen is quite new to utility finance. Allen had worked in the field of utility finance for only one month prior to submitting direct testimony in this proceeding. (Commission Order, dated July 20, 2004, at 2.) MGE respectfully submits that Allen's lack of expertise should be considered, particularly when, as here, he engages in obvious speculation and uses result-oriented "methodologies" for which he has no supporting authority.

(2) Staff

The Staff stubbornly sticks to its recommendation that the Commission impose Southern Union's consolidated capital structure, including Panhandle, on MGE. (Ex. 860 at 2:2-15) The Staff takes this position even though Staff witness Murray testified that insulating Panhandle from MGE was appropriate for ratemaking purposes:

> Q. If the idea was to insulate MGE rate payers from the Panhandle acquisition and the Panhandle operations, isn't it appropriate to insulate it for rate-making purposes, also?
>
> A. Yes.

(Tr. 828:2-6)

The Staff's rationale for imposing Southern Union's capital structure on MGE lacks any principled basis and is supported only by poorly informed speculation. Staff witness Murray has testified that Southern Union's capital structure should be used *because of a comment he read in a Standard & Poors (S&P) analysis of Southern Union;* Murray contends that this S&P comment suggested that "cash is going to flow freely between Panhandle and Southern Union." (Ex. 3, Sch. JCD-6 [Murray's deposition] at 65:23 to 66:10; *see also Id., at* 62:3 to 64:1; Tr. 799:4 to 800:13) Murray relied on this

single, unsubstantiated and incorrect comment without contacting S&P or making any effort to determine whether (a) the S&P commentator was aware of the requirements imposed by the Stipulation on Southern Union, or (b) the comment was consistent with Southern Union's conduct under the terms of that Stipulation. (Ex. 3, Sch. JCD-6 at 67:12-18) As Murray understood full well, any "free flow" of cash from Southern Union to Panhandle would violate the Stipulation:

> Q. And do you agree that the [S]tipulation and order from the Missouri Commission forbids the flowing of cash freely between the Panhandle and Southern Union entities?
>
> A. I believe there was a condition that referred to restrictions on cash down to Panhandle, not necessarily cash up from Panhandle.

(Ex. 3, Sch. JCD-6 at 68:9-15) Murray also conceded that he had "no evidence" of any Southern Union violation of the Stipulation or intent by Southern Union to violate the Stipulation. (Tr. 800:2-13; 806:14 to 807:7)

Murray also attempts to justify his position by citing to a utility finance authority, D. Parcell, THE COST OF CAPITAL – A PRACTITIONER'S GUIDE ("PRACTITIONER'S GUIDE") (1997). (Ex. 827 at 35:25 to 36:23) However, the considerations set forth in Parcell's book clearly refute Murray's position. Specifically, Parcell states:

> Among the considerations which help determine whether the utility vs. parent capital structure is appropriate [in ratemaking proceedings] are:
>
> 1. Whether subsidiary utility obtains all of its capital from its parent, or issues its own debt.
>
> 2. Whether parent guarantees any of the securities issued by the subsidiary.
>
> 3. Whether subsidiary's capital structure is independent of its parent (*i.e.*, existence of double leverage, absence of proper relationship between risk and leverage of utility and non-utility subsidiaries).

4. Whether parent (or consolidated enterprise) is diversified into non-utility operations.

PRACTITIONER'S GUIDE, at 4-19, 4-20.

Murray argues that Parcell's considerations do not apply here because *MGE* is a division, and not a subsidiary, of Southern Union. (Ex. 827 at 36:24 to 37:4) Of course, this bizarre argument side steps the real issue here – *i.e.,* that *Panhandle,* as a separate pipeline subsidiary, should not be included in Southern Union's capital structure to calculate rates for MGE's distribution operations. Applying Parcell's considerations to Panhandle, Panhandle clearly should be removed from Southern Union's capital structure because Panhandle (1) "issues its own debt", (2) receives from Southern Union no "guarantees . . . of the securities" it issues, (3) has a "capital structure . . . independent" of Southern Union, and (4) is a "non-[natural gas]utility operation" distinct from MGE.

* * *

In sum, the Fully Adjusted MGE or Hypothetical MGE Capital Structure is the only reasonable and principled capital structure recommendations before this Commission. However, should the Commission decide to follow the recommendation of the Staff or OPC – and impose Southern Union's consolidated capital structure on MGE – the Commission's analysis cannot end there. *Imposing a debt-rich capital structure on MGE requires that the Staff's, OPC's and MGE's calculated returns on equity be increased significantly.* (*See, e.g.,* Ex. 5 at 36:11 to 38:4) Equity investors bear both business (operational) and financial (leverage) risk. REGULATORY FINANCE, *supra,* p. 43 ("The overall risk to the common stock investor is a composite of the business and financial risk"). Accordingly, as an enterprise's leverage (debt) increases, equity investors demand a higher return. *Id.,* pp. 42-43.

Thus, it defies basic utility finance principles (and common sense) for the Staff and OPC to recommend saddling MGE with a capital structure containing a riskier 28 to 30 percent common equity, and then utilize a group of "comparable" companies that, on average, have a less risky +45 percent equity to calculate MGE's required return on equity. (*See* Ex. 825, Schedule 22 [Murray's "comparable" natural gas distribution companies]; Hearing Ex. 32 [Allen's group]) As Dr. Morin has recognized, such non-compatibility in capital structure requires a "remedial correction" to the return on equity:

> A measurement problem . . . can arise when using the cost of equity capital of other companies as a check against estimates based on the market data for the utility itself. If the group of comparable companies has been carefully designed using adequate risk filters for both business risk and capital structure differences, this will not be a problem. But if substantial capital structure differences exist between the utility and the reference companies, all else being constant, [a] remedial correction . . . is necessary . . . .

REGULATORY FINANCE, *supra*, p. 438. *Cf. In re Arkansas Louisiana Gas Company, a Division of Arkla, Inc.*, 31 F.E.R.C. ¶ 61,318, at 61,730 (1985) (where parent capital structure was imputed to subsidiary pipeline, "the risk adjustment factors used by the presiding judge to adjust the DCF return of Arkla, Inc., [we]re appropriate, because, these factors [we]re supported by the record, and as noted in Arkla's previous cases, a return on equity calculated for [the parent] Arkla, Inc. cannot be applied to [the subsidiary] Arkla, without an adjustment for the difference in risk between the two").

If Southern Union's capital structure is used in this proceeding, the remedial correction to MGE's return on equity will be significant – *i.e.*, up to 330 basis points with respect to the Staff's calculations alone. (Ex. 5 at 36:11 to 38:4) In fact, as Dr. Morin testified at the Hearing, as between using a corrected capital structure for MGE – or adjusting MGE's required return on equity for an improperly imposed debt-heavy capital

structure – the corrected capital structure is the more principled, and potentially less expensive, approach. (Tr. 1695:11 to 1699:16)

h. Short-Term Debt In The Capital Structure

(1) MGE's Recommendation

In November 2003, MGE recommended that the Commission not include short-term debt in MGE's capital structure, because, among other things, most of this debt is used for seasonal purposes and all of it had been scheduled for permanent refinancing. (Ex. 1 at 6:15-7:2; *see also* Ex. 2 at 26:11 to 27:17) Proof of that earlier position is the fact that, as of April 30, 2004 – the true-up date – Southern Union, including MGE, has no short-term debt. (Ex 3 at 9:18-21) In addition, Southern Union had no short-term debt as of May 31, 2004, and as of June 30, 2004, Southern Union had only a nominal amount. (Tr. 2597:2 to 2599:1)

(2) The Staff's Recommendation

The Staff agrees with MGE's position – *i.e.,* that as of April 30, 2004, Southern Union has no short-term debt and no short-term debt should be included in MGE's capital structure for the purposes of ratemaking in this proceeding. (*See* Ex. 860 at 2:5-8)

(3) OPC's Recommendation

The OPC argues that short-term debt should be included in MGE's capital structure because as of December 31, 2003, "Southern Union's short-term debt, less construction work in progress, represents 7.01% of its capital structure." (Ex. 201 at 10:7-14) OPC Witness Allen further testified that he "believe[s] that short-term debt should be excluded from capital structure only if it represents less than 2% of the capital structure after construction work in progress has been subtracted." (*Id.*) Finally, faced with the reality that Southern Union has no short-term debt as of April 30, 2004, Allen

stated that non-existent short-term debt should still be attributed to MGE, because such short-term debt has existed in the past, such short term debt has exceeded "2 percent" of MGE's capital structure, and MGE supposedly has not demonstrated a "change in its policy" with respect to short-term debt. (Ex. 233 at 2:11-18)

Of course, Allen cites no authority for these arbitrary opinions, and given his limited experience in regulatory finance, such unsubstantiated beliefs should carry little to no weight. Indeed, at the Hearing, Allen testified only that his two percent short-term debt threshold was based on his "education" and the fact that a prior witness had used two percent, and he could not cite a single "specific source" for this otherwise random number. (Tr. 511:25 to 513:2, 513:19 to 514:4) Allen also contends that short-term debt should not be viewed at any particular point in time, but should be averaged over a significant period. (Ex. 201 at 2:21 to 3:14) This position ignores the reason that short-term debt is usually excluded from capital structure – *i.e., it is short term,* serving seasonal and construction needs, and is incurred and paid off in short intervals. (*See, e.g.,* Ex. 2 at 26:11 to 27:17) Averaging such debt – over a 13-month period by Allen's methodology (Ex. 201 at 2:21 to 3:5) – is a deceptive device that glosses over the impermanency of these obligations.[7]

[7] For example, as MGE witness Dunn explained, MGE has utilized short-term debt over the past years to finance "temporary working capital needs such as under-collected gas costs and high levels of customer receivables caused by increasing purchase of gas costs." (Ex. 2 at 26:11 to 27:17) These borrowings are now paid off and are clearly not part of any permanent capital structure. Allen, however, would lump these paid-off borrowings into his 12-month average and thereby include them in MGE's capital structure – something that runs counter to basic principles of finance. (*Id.*)

2. Cost of Long-Term Debt

a. MGE's Recommendation

As of April 30, 2004, MGE's embedded cost of long-term debt was 7.434 percent, and MGE recommends that the Commission use this number in its rate of return calculation. (*See* Ex. 3 at 5:5-6)

b. OPC's Recommendation

The OPC's recommended cost of long-term debt for MGE is 7.397 percent. (Ex. 233 at 3:9-10), a difference of approximately .04 percentage points from MGE.

c. Staff's Recommendation

The Staff's recommended cost of long-term debt is unreasonably low, because the Staff persists in its efforts to saddle MGE with Panhandle's obligations. Despite the Stipulation insulating MGE from the acquisition of Panhandle, and contrary to both MGE's and OPC's recommendations, Staff witness Murray recommends that the Commission include the cost of long-term debt of Panhandle in its calculation of a rate of return for MGE. (Ex. 825 at 23:6-12; Ex. 827 at 50:2-13) Murray does so even after admitting that MGE should be insulated from Panhandle for ratemaking purposes. (Tr. 828:2-6)

Once again, Murray attempts to justify his position with unprincipled speculation about how – despite the requirements of the Stipulation – Southern Union might violate the Stipulation and commingle the finances of Panhandle and MGE. In fact, during the Hearing, Murray went beyond his baseless speculation and falsely accused Southern Union of violating the Stipulation by failing to file quarterly reports demonstrating the separateness of funds between Southern Union and Panhandle. (Tr. 814:4-15) On cross

examination, MGE counsel demonstrated that Murray was flatly wrong; the quarterly reports had been timely filed with both Staff and OPC attorneys. (Tr. 847:14 to 858:10; Hearing Exs. 33-40)

Murray's accusation regarding actual or potential future violations of the Stipulation are serious and demand credible evidence. Murray, however, has no such evidence. MGE respectfully submits that the critical determination of a fair and reasonable rate of return for MGE should not be guided by such unsubstantiated accusations.

3. MGE's Required Return On Equity

One of the more contentious issues in this proceeding has been the required return on equity ("ROE") for MGE. Numerous calculations have been presented by direct, rebuttal and surrebuttal witnesses, and significant amounts of criticism have been heaped on all of these calculations. Nonetheless, in this section, MGE will demonstrate that – after a closer analysis of the testimony and work product before this Commission – there is a consistency in many of the calculations, and ample evidence pointing to a fair and reasonable ROE for MGE.

a. The Importance of a Fair and Reasonable Return on Equity

MGE's allowed return on equity is a critical consideration in this proceeding. Whatever ROE the Commission approves, it will send a message to the investment community and impact the relationship of MGE with that community. Once again, the benchmark is not to reward or punish MGE; the benchmark is to establish and maintain MGE competitiveness. As Dr. Morin has explained:

> The economic logic underlying the [***Bluefield*** and ***Hope***] standards is straightforward. There is an opportunity cost associated with the funds that capital suppliers provide a public utility. That cost is the expected return foregone by not investing in other enterprises of corresponding risks. Thus, the expected rate of return on a public utility's debt and equity capital should equal the expected rate of return on the debt and equity of other firms having comparable risks. Moreover, a utility is entitled to a return that will allow it to maintain its credit so that it continues to have access to the capital markets to raise the funds required for investment. The allowed return should therefore be sufficient to assure confidence in its financial health so it is able to maintain its credit and continues to attract funds on reasonable terms.

REGULATORY FINANCE, *supra,* at 10. Further, as Dr. Morin testified at the Hearing:

> Q. [COMMISSIONER CLAYTON:] So we could – if we were to deviate from suggestions that you are making in terms of these costs or that the company is making, but were to perhaps authorize higher O&M costs, that dollar amount that comes out in revenue requirement may be sufficient to attract capital. Is an investor going to look at what type of rate of return we authorize or is it the overall dollar amount that we approve in increased rates?
>
> A. [DR. MORIN:] The investment community will focus on this particular number [rate of return]. I'm part of a group called the Gurman Group on Wall Street, and I receive phone calls probably weekly from Goldman Sachs, Solomon Brothers and all the big huge brokerage houses, and their question always centers around what kind of allowed rates of returns are going on these days? What do you think this commission's going to do? It's a major, major driver of their evaluation of stocks.
>
> Q. So they do pay attention –
>
> A. Oh, absolutely.

(Tr. 1704:13 to 1705:6) (*See also* Ex. 1at 55:4-25; Ex. 3 at 24:10 to 26:7)

In short, if investors are told that this Commission has approved a return on equity materially below that of other utilities, it is matter of common sense that MGE will (a) have significant problems obtaining capital from those investors, or (b) have to pay investors a lot more for that capital.

b. MGE's Recommendation

MGE recommends that this Commission use an ROE of 12 percent in its calculation of an appropriate rate of return. The 12 percent recommendation is the product of two fundamental considerations by MGE witness Dunn: (a) the required return on equity of natural gas distribution companies similar to MGE, plus (b) necessary adjustments for the riskier nature of MGE's business. (Ex. 1 at 31:7 to 52:7)

Dunn's expertise in the field of utility finance is unquestionable. Among other things, Dunn: (a) has a Bachelor's Degree in Economics with a Minor in Mathematics and a Master of Arts Degree in Economics; (b) has been an economic consultant for over 30 years, specializing in the general area of public utility economics and corporate finance with a special emphasis in the area of cost of capital and rate of return; (c) is a certified rate of return analyst; (d) was previously Chief of Economic Research for the Missouri Public Service Commission; and (e) has published various works and lectured numerous times on utility finance issues. (Ex. 1, Appendix A at 2-5) His testimony and calculations regarding a recommended ROE for MGE are based on a thorough analysis of MGE, the natural gas industry and markets in general. Further – unlike the OPC and Staff witnesses – Dunn does not ignore any of his financial modeling results in an effort to reach a pre-determined ROE calculation.

MGE's calculated ROE for similar companies: Dunn uses a "discounted cash flow" (DCF) analysis to reach the first step in his ROE recommendation. (Tr. 264:8-23) As part of this analysis, Dunn relied on analysts' forecasts of utility growth rates for 15 natural gas companies and applied his own knowledge and expertise to the fundamental issue here: what future returns on equity (dividends and/or earnings growth) do MGE

investors expect in the future? The result of Dunn's calculations is an initial ROE range for MGE of 10.9 percent to 11.9 percent. (*See* Ex. 1 at 50:2-18)

The reliability of this range is proven by the fact that it is within a reasonable range of other confirming evidence before this Commission:

- The average authorized return on equity allowed natural gas utilities like MGE in the first quarter of 2004 is 11.1 percent, and for 2002 and 2003 is 11 percent (Ex. 5 at 9:20 to 11:7; Ex. 3 at 23:20 to 24:6 and Sch. JCD-7);
- The DCF analysis of Staff witness Murray generates an ROE of 10.72 to 11.72 percent when corrected for the several deficiencies identified by Dr. Morin (Ex. 5 at 4:9 to 27:13, 41:2 to 43:12);[8]
- The Capital Asset Pricing Model ("CAPM") of Staff witness Murray generates an ROE of 11.6 percent when corrected for the deficiencies and errors identified by Dr. Morin (*Id.*, at 31:3 to 38:4; 42:11-30);
- The risk premium analysis of Staff witness Murray generates an ROE of 10.92 percent (with Murray's 32 basis point risk adjustment), even before deficiencies are corrected (*Id.,* at 30:21 to 31:1); and
- A CAPM analysis of OPC witness Allen generates an ROE of 10.27 percent, without any adjustments for the obvious deficiencies in that model (*see* Ex. 200, Schedule TA-9).

***Considerations of specific MGE risks*:** Dunn's ultimate recommendation of a 12 percent ROE for MGE – which represents a .1 to 1.1 percent increase above his proxy

[8] Dr. Morin opines that 220 basis points must be added to Murray's 8.52-9.52 range. (Ex. 5 at 42:1-10) Dr. Morin's actual calculation adding these 220 basis points (*id.*, p. 41:20-23) is in error because he inadvertently used an 8.2-9.2 range instead of Murray's 8.52-9.52 percent range.

group's range – results from his consideration of risks peculiar to MGE. (Ex. 1 at 60:14 to 61:5) First, Dunn has conducted a statistical analysis demonstrating that MGE is riskier than the average natural gas distribution company. (*Id.*, at 58:18 to 60:13)[9] Second, Dunn gives necessary consideration to the fact that:

- MGE's operations are riskier because it is smaller than the average company in Dunn's proxy group, and he cites several authorities recognizing the appropriateness of a small company market premium (*Id.*, at 53:19 to 55:20);
- MGE's authorized depreciation rates are "substantially lower" than those authorized for comparable natural gas distribution companies, and thus its risk of not fully recovering its capital investment in an asset prior to the asset's retirement is greater (*Id.*, at 58:11-16); and
- MGE faces greater regulatory risk than comparable natural gas distribution companies as a result of, among other things, the ratemaking process in years past, wherein MGE has "consistently produced actual earnings that fall short of MGE's authorized return" (*Id.*, at 58:6-10; Ex. 8 at 25:11-18, Sch. G-4; Ex. 11, Sch. MRN-5).

These further considerations justify the relatively small upward adjustment in MGE's required ROE (only 60 basis points from the midpoint in his ROE range) that Dunn recommends.

c. OPC's Recommendation

Based primarily on a DCF analysis, the OPC recommends that this Commission authorize a required return on equity of only 9.01 to 9.34 percent for MGE. This

[9] OPC's effort to refute Dunn's statistical analysis actually provides further evidence that Dunn is correct. (*See* Ex. 3 at 36:14 to 37:4)

recommendation is made through the testimony of OPC witness Allen, a newcomer to utility finance. Indeed, in his deposition, Allen admitted that:

- During his education, he never applied the DCF methodology or other financial models to utilities like MGE (Hearing Ex. 216 at 24:14-18);
- He is not a certified rate of return analyst, has published no articles or textbooks and has taught no classes (*Id.,* at 4:23 to 5:20);
- His first job in utility finance was at the OPC (*Id.,* at 10:13 to 12:24);
- He was first employed with the OPC in March 2004 (*Id.,* at 12:21-23), one month before he submitted his direct testimony in this proceeding;
- He was told on his first day of work at the OPC that he would be an "expert" witness in this proceeding (*Id.,* at 33:2-12);
- During this one month of employment, he took no courses, programs, classes or seminars (*Id.,* at 27:10 to 28:3);
- The only "training" he received was one meeting, and "less than ten" telephone conversations with Tuck (*Id.,* at 28:4 to 29:10, 32:14-18); and
- Other than his conversations with Tuck, the only other thing Allen did to prepare himself as an "expert" was to review various textbooks and prior testimonies (*Id.,* at 36:13 to 38:2).

One month of reading – and the occasional conversation with a former OPC employee – does not create much expertise in a field as complex as utility finance. MGE respectfully submits that the limited nature of Allen's experience, and the aberrational numbers he has generated, should be carefully considered in judging the weight and credibility of his testimony.

The OPC's misuse of its CAPM model: The most disingenuous part of Allen's ROE presentation is his selective use of his CAPM model. Allen ran three CAPM models, generating calculated ROE's for MGE of 9.17 percent, 10.05 percent and 10.27 percent. *He then arbitrarily chose the lowest number – 9.17 percent – and self-servedly concluded that this number was a verifying "check" on his DCF analysis.* (Ex. 200 at 18:16-23 and Sch. TA-9) Allen had no legitimate reason for making this convenient choice, as his testimony during the Hearing made quite clear:

Q. And when you ran your CAPM to check [your DCF analysis], did you notice a difference between the 9.34 number and the 10.27 number that you got?

A. Yes. I noticed there was a difference between those two numbers.

Q. And you decided to ignore the 10.05 and the 10.27 numbers that you got, right?

A. That's not correct.

Q. You didn't use them, did you?

A. I did not use them, but I told you beforehand that I determined what I was going to use before I even ran the calculations. So what the numbers turned out to be, that's what they turned out to be. I didn't manipulate the data.

Q. There was no reason to even do that calculation, then, right?

A. There was a reason to do the calculation, as I said, because I knew that there would be controversy regarding my use of the 3-month T bill. So I ran the other models just for completeness.

Q. And then ignored them after you ran them, right? You didn't adjust anything for them?

A. I didn't use them.

Q. You ignored them, right?

A. I didn't use them.

(Tr. 506:5 to 507:4) Although Allen concedes the "controversy" surrounding his inappropriate use of the 90 day "T-bill" in his CAPM model (which generated his lower 9.17 percent ROE),[10] he does nothing to address this controversy and seizes the most convenient result. The issues in this proceeding – including the financial integrity of one of Missouri's public utilities – demand a more principled approach before this Commission.

There are two significant ramifications of Allen's decision "not to use" two of his three CAPM models:

First, Allen ran his three CAPM models as a "check" on his DCF analysis. (Tr. 504:21-23) The two models Allen decided not to "use" strongly suggest that Allen's DCF calculation was fundamentally flawed – *i.e.,* that Allen's calculated DCF return on equity of 9.01 to 9.34 percent was wrong. This conclusion was confirmed by Dr. Morin during his deposition:

> Q. [OPC COUNSEL:] Let me say that you have a DCF analysis and you come up with a DCF range of 9.01 percent to 9.34 percent. Can you make that assumption?
>
> A. [DR. MORIN:] Yes.
>
> Q. Let's say that you do a capital asset pricing method analysis and you come up with a result of 9.17 percent. Can you make that assumption?
>
> A. Yes.
>
> Q. What does that tell you?
>
> A. That tells you that something's wrong, because I can't visualize a rate of return of 9 percent when the long-term treasury bonds are expected to be 6 percent.

[10] As Dr. Morin explained at the Hearings, the most appropriate proxy for a risk-free rate in the CAPM model is the 30 year treasury note (Tr. 1721:17 to 1722:9), not the 90 day treasury bill.

Q. Well, that wasn't my question about whether or not -- my question was, what does that tell you about the reliability of the DCF method and the CAP-M method?

A. It tells you that those two are consistent with one another, but it doesn't tell you that that's the – that that's the cost of equity. It's not implemented properly.

Q. What does it mean if they're consistent with one another from a statistical standpoint?

A. Roughly within the same range, maybe within 50 basis points of one another.

Q. And if you had that example that I just gave you of DCF range of 9.01 to 9.34 percent and a CAP-M result of 9.17 percent, wouldn't that indicate that your CAP-M and your DCF were compatible?

A. It would probably indicate to me that they're both wrong.

(Ex. 3, Schedule JCD-3 [Morin deposition] at 105:5 to 106:7) Clearly, Allen's 10.27 percent CAPM result (compared with a DCF result of 9.01 to 9.34 percent) far exceeds Dr. Morin's 50 basis point threshold for statistical consistency.[11]

Second, the CAPM models that Allen "did not use" show that the fair and reasonable ROE for MGE must – as Dr. Morin recognized above – be higher that the paltry 9.01 to 9.34 percent Allen is recommending to this Commission. All three of Allen's CAPM models are artificially low given, among other things, his failure to use an empirical CAPM model, add an adjustment for flotation costs and consider the specific higher risks associated with MGE. (*See, e.g.,* Ex. 1 at 48:18 to 49:19; Ex. 5 at 34:23 to 35:18) Accordingly, if Allen had properly used the CAPM methodology, his 10.27 percent ROE result would have easily reached the 11 percent ROE industry average.

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[11] In his questioning of Dr. Morin, OPC counsel (like Allen) conveniently used the lower 9.17 percent number generated by Allen's CAPM models; counsel's questioning, and Dr. Morin's answers, would have been vastly different if counsel had used Allen's higher CAPM result of 10.27 percent. (*See also* Tr. 507:16 to 510:24)

At the Hearing, the OPC tried to bolster Allen's recommendations with testimony from Tuck, a former OPC employee. Tuck ran four separate CAPM models during his testimony, all of which were fundamentally flawed by, among other things, a stale and unreliable market risk premium[12] and an incorrect measure of the risk-free rate. Inexplicably, during a hearing held in June of 2004, Tuck used a market risk premium (5.5 percent) from a 2001 source. (Hearing Ex. 219) Moreover, this market risk premium was not a calculated or researched number; it was the result of a "survey." (*Id.*)

Further, Tuck used the 10-year treasury note as the risk-free rate, when the 30-year note is the more accepted measurement. (Tr. 1721:17 to 1722:9) Dr. Morin's testimony during the following exchange elucidates these two errors in Tuck's methodologies:

> CHAIRMAN GAW: Judge, could you hand him that exhibit, Exhibit 219, would you mind?
>
> JUDGE WOODRUFF: I can do that.
>
> BY CHAIRMAN GAW:
>
> Q. Dr. Morin, there was a witness from Public Counsel also that testified and I think put together just one page of his own calculation of what the cost of equity should be. If you would look at that, and I don't know if there's enough information there for you to say anything one way or the other about it.
>
> A. [DR. MORIN:] Yeah. I've seen it, so I can make some comments on it. Obviously the first input, the risk-free rate of 4.7 percent in line with our earlier discussion, you and I, would be probably 5.4 percent if you believe in using spot rates.

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[12] The market risk premium is "the difference between the market return and the risk-free rate." REGULATORY FINANCE, *supra,* at 311. The CAPM model multiplies the market risk premium by the "beta" of a particular company or group of companies, and then adds the product to the risk-free rate to determine investor expected return on equity.

Q. Do you know, can you attribute that 4.7 percent?

A. It's a 10-year Treasury yield that I presume prevailed at the time that this exhibit was prepared.

Q. Okay.

A. I would – since the regulation is prospective as much as possible, I would prefer to use longer-term rates and preferably even forecast rates. The beta, you know, these are fairly reasonable ValueLine beta estimates for gas companies around .7, .75.

The big huge problem here is the market risk premium, which relies on Welch's surveys, and that's about the worst technique you can think of to determine the market risk premium. The preferred technique is to use the historical record, the historical market risk premium over a long, long, long time period.

I refer to the Ibb[o]tson & Associates market risk premium of about 7 percent earlier in my comments, or to do sort of a prospective DCF analysis on the market as a whole, which also indicates about 6 to 7 percent.

The survey technique is particularly in September 2001, we've seen the debacle again of the high tech sector of the economy. I'm sure Mr. Welch would probably have revised upwards his estimate of market risk premium since. But that is not reflective of the consensus in both the academic communities and the empirical research in finance.

The market risk premium, as I said earlier, can vary anywhere between 6 and 8 1/2 percent, according to all the empirical studies that have been done on the subject. So if you substitute a risk-free rate of 5.4 percent and market risk premium somewhere around 6 to 7 percent, you'll get cost of equity estimates that are a little bit closer to 11.

(Tr 1726:21 to 1728:21) (emphasis added)

Errors in the OPC's DCF model: The errors in OPC witness Allen's DCF model are significant, but his most egregious mistake was the use of the "retention growth" or "sustainable growth" methodology to calculate what growth equity investors expect in the future. As Dr. Morin testified in his deposition, the retention growth method of

calculating investor expectations incorporates – in the context of utility finance – an impermissible circularity:

> Q. [OPC COUNSEL:] In arriving at growth estimates, is it reasonable to look at dividend earnings and the level of earnings being retained by a company?
>
> A. [DR. MORIN:] Yes. One of the drivers of growth is the increments to the asset base. In other words, the retention of earnings. What is -- what earnings are not paid out of dividends are plowed back or retained in the asset structure and then that will translate into future growth later on. That's the sustainable growth model approach.
>
> Q. And is that an acceptable approach?
>
> A. It is widely used and should be used except in the utility context. The problem with using it in the utility rate case, it's very, very circular. You have to assume an ROE to get an ROE so you're caught in a hopeless circular logical trap here.
>
> Q. What if you use projected growth?
>
> A. What do you mean by that? You mean –
>
> Q. For your sustainable growth rate.
>
> A. But, again, if you're projecting an expected ROE, the only way that the company can earn it is if the Commission sets rates to produce that ROE. So how can the cost of equity be any different than the ROE? See the circular logic here?

(Ex. 3, Schedule JCD-3 at 82:20 to 83:17.) (*See also* Ex. 2 at 51:6 to 52:8; Tr. 1713:24 to 1714:4.)[13]

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[13] Allen cites to a textbook from 1974, M. Gordon, THE COST OF CAPITAL TO A PUBLIC UTILITY (1974), as authority for his use of this controversial growth methodology. However, a lot can change in thirty years – including the development of empirical literature showing a lack of correlation between sustainable growth calculations and other measures of value. *See, e.g.,* REGULATORY FINANCE, *supra,* at 161-162 (because of the difficulty in calculating the components of the sustainable growth model, its potential circularity and the fact that empirical evidence has shown that it is not "significantly correlated to measures of value, such as stock price and price/earnings ratios," the sustainable growth method is the "least desirable" method for determine investor growth expectations in the utility industry). (*See also* Tr. 171:5-13.)

Allen also fails to include a flotation cost adjustment in his DCF analysis. A flotation cost adjustment recognizes that issuing equity is not costless, and past and future equity issuances involve incurred costs and expenses that should be recognized as a "cost" of equity:

> . . . Flotation costs have a direct and an indirect component. The direct component represents monetary compensation to the security underwriter for marketing/ consulting services, for the risks involved in distributing the issue, and for any operating expenses associated with the issue (printing, legal, prospectus, etc.). The indirect component represents the downward pressure on the stock price as a result of the increased supply of stock from the new issue. The latter component is frequently referred to as "market pressure".
>
> Flotation costs for common stock are analogous to the flotation costs associated with past bond issues which, as a matter of routine regulatory policy, continue to be amortized over the life of the bond, even though no new bond issues are contemplated. In the case of common stock, which has no finite life, flotation costs are not amortized. Therefore, the recovery of flotation costs requires an upward adjustment to the allowed return on equity.

(Ex. 5 at 12:7-20.) (*See also* Ex. 2 at 40:10-15) ("Common stock, when sold to the public, has expenses associated with the sale which are not collected from the customers. It is appropriate and customary that those expenses be included in a calculation of the cost of common equity. Failure to do so means that the company cannot, if common stock is issued, earn the authorized return").

Allen's disagreement with a flotation cost adjustment is apparently based on his assertion that equity issues by Southern Union are solely to benefit Panhandle:

> Q. . . . I want to focus on floatation costs. Okay. It's your belief that the request for flotation costs is inappropriate because it relates to an equity offering, and the equity offering is solely because of the Panhandle related acquisition, right?
>
> A. Yes, I believe that the Panhandle acquisition substantially leveraged their capital structure.

(Tr. 517:14 to 518:17) Once again, Allen conducted no analysis leading to this conclusion. Southern Union has issued significant amounts of equity in the past, and recently it has announced its intention to issue more (Hearing Ex. 55): is it Allen's contention that all of it relates to Panhandle? Of course not, and such a contention would be absurd. MGE agrees that equity "solely" related to Panhandle is not a justification for a flotation cost adjustment to MGE's required ROE, but the vast majority of equity issued by Southern Union is not related solely to Panhandle.

OPC witness Tuck also engages in some ruminations about flotation cost adjustments (Ex. 203 at 43:8 to 46:7), and why they are not necessary, but he cites not a single authority for his assertions, and they run counter to common sense: issuing equity costs money, and any argument to the contrary must be viewed with significant suspicion unless it is supported by empirical evidence. Tuck has no such evidence.

d. Staff's Recommendation

The Staff recommends that this Commission adopt an ROE for MGE of 8.52 to 9.52 percent. This recommendation is based on unreliable datasets and financial models that the Staff either manipulates or ignores. The only apparent purpose for the Staff's approach to calculating an ROE is to ensure the lowest possible ROE for MGE.

Central to the Staff's approach is a non-critical DCF model that incorporates either stale or unreliable data in an inappropriately mechanistic way. Utility finance authorities universally condemn such an approach:

> The DCF method cannot be applied in a robotic, mechanistic manner. Mechanical approaches designed simply to insert numbers into an algebraic equation without regard to the reasonableness of such inputs in a regulatory setting must be avoided. For example, the determination of expected growth is judgmental, since expected growth lies buried in the minds of investors, unobservable. *Any inconsistency between historically-based growth estimates, analysts' forecasts, and sustainable growth*

estimates should be explainable by objective common-sense economic reasoning.

REGULATORY FINANCE, *supra,* at 244. *See also id.* at 237 ("A note of caution is also necessary when dealing with historical growth rates and their use in the DCF model. Historical growth rates can be downward-biased by the impact of diversification and restructuring activities and by the impact of abnormal weather patterns in the case of energy utilities"); J. Bonbright, A. Danielson & D. Kamerschen, PRINCIPLES OF PUBLIC UTILITY RATES ("PUBLIC UTILITY RATES"), 319 (Public Utility Reports 1988) ("It should be obvious that one can get any expected return on equity one wants simply by picking a particular growth rate. This is where most of the controversy arises among cost of capital witnesses. The first point to remember in evaluating the growth rate is that it is not what a witness thinks the growth rate should be that matters. What matters is what investors expect the growth rate to be").[14]

Murray purports to also use CAPM and "risk premium" models to "check" his DCF results. However, he misuses his CAPM models, and ignores the significantly

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[14] Indeed, Staff witness Murray, the proponent of this mechanistic model, has demonstrated his lack of analysis by his fundamental misunderstanding of what data he was really using. For example, Murray testified that he had "reviewed the information I have as far as growth rates and I noticed that the historical and projected were fairly close." (Ex. 3, Sch. JCD-6 at 88:4-18) This cannot possibly be true: if Murray had truly conducted such a "review," he would have observed that certain of his historic data are completely at odds with his projected data. For example, Murray incorporates into his DCF model a 5 year earnings per share (EPS) growth rate of only 1.72 percent. (*See* Ex. 825, Sch. 15-2) *Every projected growth rate he uses was at least twice, and sometimes three times, as much.* (*Id.,* Schedule 16) Murray also testified that he had not used, and did not intend to use, 2003 historic data because "I don't know that the – the growth prospects have fundamentally changed that much." (Ex. 3, Schedule JCD-6 at 88:4-18.) Clearly, Murray did no analysis on this point: if Murray had updated his 5-year EPS growth data to incorporate readily available 2003 data, his aberrational 5 year EPS growth rate of 1.72 percent would now be more than 7.5 percent.

higher ROE he calculates with his risk premium model. In the end, the errors and manipulations in Murray's work product render it incredible.

Staff's flawed DCF model: The errors in Murray's DCF model are addressed in detail in Dr. Morin's rebuttal testimony and include Murray's:

- improper dividend yield calculation which fails properly to (a) adjust for equity flotation costs, and (b) incorporate a dividend growth rate (Ex. 5 at 11:9 to 14:8);
- use of an annual DCF model when a more accurate quarterly model could have easily been utilized (*Id.,* at 14:10 to 15:11);
- failure to use current stock price data in his dividend yield calculation (*Id.,* at 15:13 to 16:20); and
- use of unreliable data in his growth rate calculation, including negative growth rates (*Id.,* at 18:11 to 19:5),[15] two-year old historic growth data (*Id.,* at 19:7 to 22:14), unrepresentative historic data (*Id.,* at 22:16 to 23:18), and historic dividend data (*Id.,* at 23:20 to 26:12).[16]

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[15] *See, e.g.,* REGULATORY FINANCE, *supra,* p. 141 ("negative growth rates" can be one of the "unreasonable results" of using historic data in DCF calculations).

[16] As Dr. Morin has recognized, a blind use of historic growth rates can, as here, result in misleading calculations:

> Past growth rates in earning or dividends may be misleading, since past growth rates may reflect changes in the underlying relevant variables that cannot reasonably be expected to continue in the future, or may fail to capture known future changes.
>
> . . .
>
> The major point of all this is that it is perilous to apply historic growth when a utility [or utilities] is in a transition between growth paths. When payout ratios, equity return, and market-to-book ratios are changing, reliance on historical growth is hazardous. . . .

REGULATORY FINANCE, *supra*, pp. 149, 153.

As just one example of the impact of Murray's DCF errors, Murray inexplicably refused to use 2003 data in his DCF analysis. (Ex. 3, Schedule JCD-6 at 80:14 to 89:18.) However, if he had used 2003 data, the impact would have been striking. Of the eight companies in Murray's proxy group, seven experienced material to significant growth in earnings between 2002 and 2003, as the economy continued to recover from the 2001 recession. The difference is significant and can be readily seen by comparing the five-year earnings per share growth under the old 2002 data used by Murray of 1.72% in comparison to the five-year earnings per share growth of 7.69% shown by the 2003 data that Murray ignored. (Ex. 2 at 33:21) Murray's calculated EPS growth rates – by ending in 2002 (in the midst of the economic recovery) – ignore this growth, even though 2003 performance is the most relevant data to what investors reasonably expect from 2004 and beyond.

Of course, such mistakes are of no consequence to Murray. *Murray's approach to his DCF model was so result-oriented that he testified that even if more recent data would have "drastically changed" his DCF results, he still would not have changed his recommendation to this Commission*:

> Q. If the 2003 information was available and that would drastically change the numbers contained on Schedule 15.2 and forward, would that cause you any pause in changing your recommendation?
>
> A. No.

(Ex. 3, Schedule JCD-6 at 80:14-18.)

Staff's flawed CAPM model: Murray's CAPM analysis is likewise flawed by errors and unreliable data, including Murray's:

- use of a stale "risk free" rate (Ex. 5 at 31:16 to 32:2);

- use of an improperly calculated market risk premium (*Id.,* at 32:4 to 34:21); and
- failure to use an empirical CAPM model (*Id.* at 34:23 to 35:18).

Staff's ignored risk premium model: Lastly, as previously noted, Murray's risk premium analysis generates a calculated required return on equity of 10.96 percent, even without consideration of the errors he made. (Ex. 5 at 30:21 to 31:1.) Those errors include a flawed methodology for calculating a risk premium (*Id.,* at 27:19 to 29:19), and Murray's failure to adjust his expected returns on equity for his proxy group from year-end book equity to average book equity (*Id.,*at. 30:1-20).

* * *

In sum, the more reliable and consistent data before this Commission points to a required return on equity for MGE of 12 percent, or at least at or above the 11 percent national average. The Staff's and OPC's lower recommendations are (a) based on unreliable datasets and flawed methodologies, and (b) a self-serving selection of their own, conflicting calculations.

e. MGE's Required Overall Rate of Return

(1) The Fully Adjusted MGE Capital Structure

The last step in determining a required rate of return for MGE is calculating MGE's overall required rate of return, or WACC, from its capital structure and the required return on its capital components. REGULATORY FINANCE, *supra,* at 24-26. Using the MGE Fully Adjusted Capital Structure, and the required returns on capital (common equity, preferred and long-term debt) calculated by MGE witness Dunn, MGE recommends that this Commission approve an initial MGE rate of return (prior to consideration of the management efficiency adjustment) of

9.35 percent:

	Ratio	Cost	Weighted Cost
Long Term Debt	47.41%	7.434%	3.524%
Preferred Equity	11.49	7.758	.892
Common Equity	41.103	12.00	4.932
TOTAL	100.00%		
COST OF CAPITAL/ RATE OF RETURN			9.35%

(2) The Hypothetical MGE Capital Structure

Alternatively, using the Hypothetical MGE Capital Structure, and the required returns on capital calculated by Dunn, MGE recommends that this Commission approve an initial MGE rate of return of 9.3 percent:

	Ratio	Cost	Weighted Cost
Long Term Debt	53.96%	7.434%	4.01%
Preferred Equity	5.74	7.758	.45
Common Equity	40.30	12.00	4.84
TOTAL	100.00%		
COST OF CAPITAL/ RATE OF RETURN			9.30%

4. Rate of Return Adjustment for Management Efficiency

Lastly, as MGE witness Dunn noted in his testimony, in MGE's first two rate cases (Case Nos. GR-96-285 and GR-98-140), the Commission made specific reference to customer service performance in its return on equity findings, selecting the low end of a range of recommended equity returns for MGE (in Case No. GR-96-285), and refusing to adjust upward the equity return for MGE on account of leverage risk, because of,

among other things, an expressed reservation regarding MGE's service quality. (Ex. 3 at 61:13 to 62:16) In the past, the Commission has also adjusted equity returns upward on the basis of management efficiency and has acknowledged that such an adjustment has been recognized by the Courts and other Commissions as well. *See* ***Empire District Electric***, 26 Mo.P.S.C. (N.S.) 58, 68-71 (1983); and ***Kansas City Power & Light Company***, 26 Mo.P.S.C. (N.S.) 104, 147-150 (1983).

The record evidence demonstrates that MGE is highly efficient in terms of controlling its operating and maintenance ("O&M") expenses. A comparison of MGE's O&M expense per customer to the O&M expense per customer of other large natural gas distribution companies in the state shows that MGE has kept its O&M expense consistently much lower than the other companies:

Annual Operating & Maintenance Expense Per Customer ($)

	MGE	Laclede	AmerenUE	MoPub
1998	116.85	166.35	167.82	185.21
1999	115.37	162.00	167.01	180.30
2000	119.18	164.89	184.86	212.23
2001	141.59	188.43	215.26	224.42
2002	117.35	193.29	274.22	252.15

(Ex. 8 at 24:14-18, Sch. G-1)

Two significant conclusions can be drawn from this information: 1) year after year, MGE's O&M expense per customer is consistently superior to that of the other companies; and 2) in the five-year period from 1998 to 2002, MGE's O&M expense per customer increased by $0.50, while the other companies' O&M expense per customer increased by $26.94 (Laclede), $106.40 (AmerenUE) and $66.94 (MoPub). MGE's management has been able to control O&M expense per customer in a far more effective fashion than the other companies.

The record also shows that MGE has achieved such efficiencies while keeping its focus on service quality. For example, MGE's abandoned call rate ("ACR") and average speed of answer ("ASA") has been as follows:

Abandoned Call Rate and Average Speed of Answer

	ACR (%)	ASA (Seconds)
1998	8.35	62
1999	5.88	64
2000	6.08	64
2001	9.69	125
2002	4.48	58

(Ex. 12 at 2:11-16)

And while MGE acknowledges that external factors—such as gas prices and weather—can have a significant effect on call volumes and resulting ACR and ASA statistics (*Id.*, at 2:18-24), the above statistics show MGE's commitment to customer service. Similarly, the number of estimated meter reads on MGE's system has fallen from 172,217 in fiscal year 1998 to only 556 in fiscal year 2003 (*Id.*, at 3:11-16) and the numbers of complaints/inquiries made by MGE customers to the Commission have also trended favorably (*Id.*, at 3:18-31).

MGE's demonstrated cost-effectiveness and focus on service quality warrant an upward adjustment to MGE's rate of return of 25 basis points. By making such an adjustment the Commission can demonstrate the value it places on management efficiency and encourage MGE and other utilities in the state to be efficient operators.

B. Capacity Release/Off-System Sales Revenues

The ratemaking treatment of MGE's capacity release revenues is an issue because there is *no evidence* that MGE will be able to produce the same level of income from this activity in the future that it has in the past. A new interstate pipeline starting near Cheyenne,

slicing through northeast Colorado and ending in the middle of southern Kansas, will come into service early in 2005 and have an adverse effect on MGE's ability to generate revenues from occasional sales of its temporarily unused interstate pipeline capacity. No one can accurately predict the magnitude of impact at this time. History shows, however, that the new pipeline will increase the amount of capacity available in the relevant market, which in turn will *reduce* the revenue MGE can produce. This is because the people who buy MGE's capacity will have a more attractive and lower-cost alternative in the new pipeline. This significant change in circumstances means it is no longer appropriate for the Commission to assume an arbitrary level of capacity release revenue in base rates premised solely on past experience. To simply average a couple years of previous performance here, which is the essence of the Staff and OPC proposals, is the ratemaking equivalent of driving down the street by only looking in the rear-view mirror, oblivious to the semi parked just ahead.

Given the uncertainty regarding the level of capacity release revenues in the future, now is an appropriate time to change the ratemaking treatment. The Commission should treat these revenues for ratemaking purposes as it does with other gas-related dollars -- on an accurate and audited basis through the Purchased Gas Adjustment (PGA) portion of the tariff. An incentive approach – which was advocated by *all* parties taking a position on this issue -- should continue. That is why MGE has proposed a revenue sharing grid to accompany the PGA treatment.

1. What Are Capacity Release Revenues?

MGE contracts for capacity (essentially space) on four interstate pipelines in order to bring natural gas it has purchased elsewhere to its distribution systems in western

Missouri. MGE has to plan for peak usage levels by its customers and contract to reserve a correspondingly appropriate amount of pipeline space. But during periods such as the summer when customers are not using gas at peak levels, temporarily surplus capacity can be made available to other parties who are willing to pay something for that use. (Ex. 211 at 3:4-7) As correctly noted by OPC's witness Mr. Busch ("Busch"), the Federal Energy Regulatory Commission (FERC) established this procedure as a part of FERC Order 636 to allow the capacity to be used by someone else for varying periods of time and under various conditions. The process is called "capacity release." (Ex. 211 at 3:1-2)

To determine whether any of its reserved capacity can be released, MGE personnel do an analysis each month on how much gas MGE expects its customers to burn compared to its available supply. (Tr. 1472:14 to 1473:16) If it appears there will be any leftover pipeline capacity for that month, MGE determines how much it can release on a monthly basis to someone else, while at the same time holding onto an even smaller amount that it could offer to others on a daily basis if it appears MGE's customers do not need it. (Tr. 1473:4-16)

A capacity release transaction can work essentially like a computer-based auction on eBay with interested parties bidding on the electronically posted offer. (Tr. 1477:23 to 1478:8) It can also happen through two-party contracts. (Ex. 17 at 7:11-12) MGE typically offers to release its temporarily unused capacity on the Pony Express pipeline owned by Kinder Morgan and the Southern Star pipeline (f/k/a Williams). (Tr. 1543:13-17) Capacity releases on the other two pipelines, Panhandle and Enbridge (f/k/a Kansas Pipeline) used by MGE are comparatively non-existent. (Tr. 1543:23) Indeed, until

recently, there had never even been one on Kansas Pipeline due to its non-competitive rate structure. (Tr. 1543:24 to 1545:06) The money MGE obtains from third parties who temporarily take over MGE's capacity is referred to as "capacity release revenues."

These revenues come from willing buyers in an open and free market subject to conditions established by FERC. (Tr.1544:18-20) Because it is an open market, and it is dependent on someone wanting to purchase the capacity from MGE, there is no guarantee that any capacity release will ever be accomplished. (Tr. 1544:14-20) The Staff witness acknowledged that fact. (*Id.*) Accordingly, there is no assurance that any particular level of capacity release revenues will be generated in any given time period.

2. What are Off-System Sales Revenues?

The heading of this issue also mentions off-system sales. Off-system sales are not the same thing as capacity release transactions. For purposes of this discussion, off-system sales are physical sales of natural gas made prior to the entry of the gas into MGE's distribution system. (Ex. 17 at 7:15-17) Typically, MGE has made such sales for system protection purposes only; that is, they are made for operational or reliability considerations, typically due to issues arising on an interstate pipeline. (Ex. 17 at 7:18-20) The particular definition offered by OPC witness Busch that says the sales are bundled with capacity releases is not applicable to MGE. (Tr. 1519:14-16)

There is no evidence in this record that there will be *any* off-system sales made in the future by MGE. Busch noted that "the level of activity in the off-system sales market has declined significantly." (Ex. 211 at 6:19-20) In fact, the evidence in this case showed only two such sales. They occurred almost three years ago in October and December of 2001, and the total amount from both was only $292,656. (Ex. 211 at Sch. JAB-2)

Therefore, for purposes of this case, off-system sales are essentially non-existent and have no bearing on this issue.

3. How Did We Get to This Point?

The money MGE pays to interstate pipelines to reserve the necessary capacity to move natural gas for the benefit of MGE's customers is generally referred to as a "transportation cost." This cost is a component of the PGA rate approved by the Commission because it is a standard cost of MGE doing business. (Tr. 1517:23 to 1518:15) It is also considered a "gas cost" along with the cost of the natural gas itself. (Tr. 1518:11-15) In essence, the ratepayers pay these costs in the PGA/ACA portion of the rate set by the Commission-approved tariff. (Tr. 1549:3-7) These costs have always been treated that way for MGE.

In contrast, capacity release revenues are produced when MGE is successful in finding someone else to temporarily use its reserved pipeline capacity.

Capacity release revenues have been treated for ratemaking purposes in several different ways over time. At the inception of MGE in February 1994, they were treated as a part of the PGA/ACA calculations. (Tr. 1548:8 to 1548:21) They stayed in the PGA until the Commission, in Case No. GO-94-318 (Phase II), adopted an incentive approach to purchased gas for MGE. ***In the matter of the investigation of certain PGA related issues involving Missouri Gas Energy***, 168 PUR4th 61, 4 MoPSC 3d 299 (Jan. 31, 1996). In that order, which dealt with several other matters, including the legality of the PGA clause itself, MGE was ordered to submit tariff sheets to implement an incentive mechanism, effective July 1, 1996. The order notes that "The Commission is of the opinion that MGE's gas cost incentive mechanism should include Staff's

recommendation for the treatment of capacity release revenues." (*Id.*, at 311) That experimental program expired on June 30, 1999, but the capacity release portion continued in existence. (Ex. 211 at 3:22 to 4:4)

As noted in Busch's direct testimony, effective August 31, 2000, the capacity release revenues became part of a fixed rate incentive plan for procuring natural gas, pursuant to a stipulation and agreement approved by the Commission. Its structure included a sharing grid. (Ex. 211 at 4:5-11) According to his testimony, that approach lasted for two years. (Ex. 211 at 4:17-18)

Capacity release revenues then became a fixed component in base (*i.e.,* non-PGA) rates as a result of another stipulation and agreement, this time in an MGE rate case, Case No. GR-2001-292. That stipulation was filed on June 26, 2001 and was approved by the Commission in the "Order Approving Second Revised Stipulation and Agreement," issued on July 5, 2001. In essence, by agreement, capacity release revenues were taken out of the PGA portion of the tariff and put into the non-gas portion (also known as "base rates") at a fixed level of $1,200,000. (Ex. 211 at 6:1-10) In simple terms, this means that in determining the overall level of rates for MGE in that rate case, the Commission necessarily assumed that MGE would generate at least $1,200,000 in capacity release revenues each year thereafter. Obviously, MGE and the other parties all thought MGE would be able to do that since it was a stipulation.

Therefore, structured as it is right now, if the level of capacity release revenues actually produced in a year do not equal at least $1,200,000, MGE's shareholders are ultimately responsible because the assumed level of revenues is not realized. In Busch's words, MGE then "would incur a financial detriment, holding all other factors constant."

(Ex. 211 at 9:8-9) Conversely, if the actual capacity release revenues are greater than $1,200,000 per year, MGE essentially gets to "keep" any dollars after it clears that hurdle. So, again in simple terms, the shareholders assume all the risk, and the ratepayers get all of the benefit, up to the $1.2 million mark. Above that, the shareholders get 100 percent of the benefit. There is no "sharing" of either risks or rewards either above or below that level in the currently-approved approach.

When MGE filed the proposed tariffs that initiated this case, it did not include any assumed level of capacity release revenues in base rates. The Staff and OPC responded with proposals to keep capacity release revenues in base rates but to raise the $1.2 million hurdle. Ms. Allee ("Allee") said Staff's new proposed level is $1,340,400. (Ex. 800 NP at 5:12) Busch said OPC's proposed level is $1,500,000. (Ex. 211HC at 9:14) Both Staff and OPC want to make this particular high hurdle race even tougher in the future.

In contrast, Mr. Noack's ("Noack's") rebuttal testimony (Ex. 10 at 27:1 to 29:13) noted MGE's concerns about the effect of the new Cheyenne Plains interstate pipeline on future capacity release revenues, and instead proposed that any capacity release revenues *actually received* be treated as a part of the PGA, albeit with a sharing grid that maintains the incentive concept which has been applied to these revenues since 1996. Under that sharing grid, both MGE and the ratepayers would share the risks and rewards on a graduated scale. (Ex. 10 at 29:5-13)

4. The Impact of Cheyenne Plains

The main basis for MGE's concerns is that the market for these revenues is going to change significantly in the near future. The evidence in this case is that the Cheyenne Plains Pipeline is a known, future event. (Tr. 1554:15-19) It is a 380-mile long 36-inch

diameter pipeline, capable of carrying 560,000 Dth per day, which makes it about five and a half times bigger than MGE's capacity on the Pony Express pipeline. (Tr. 1558:8-14; 1524:5-15) The Pony Express pipeline is a major source of these capacity release revenues for MGE. (Tr. 1543:10-17) Cheyenne Plains is under construction now and is scheduled to be in operation in January 2005. (Tr. 1462:10-13) The Staff witness believes it will be placed in service. (Tr. 1554:15 to 1555:23) She testified, though, that she does not know how Cheyenne Plains will affect MGE's future capacity release revenues because she doesn't know how it will impact demand for the capacity MGE presently releases. (Tr. 1577:10-12) She based her proposed level of revenues for inclusion in base rates not on the basis of what may reasonably be expected to happen in the future, but solely on MGE's experience for the past three years. (Tr. 1563:2-4)

MGE does not purport to know exactly to what degree Cheyenne Plains will affect that revenue stream, either. Mr. Hayes ("Hayes"), MGE's employee who deals with capacity releases on a daily basis, candidly admitted it would be difficult to do any sort of study or analysis at this time because of the level of uncertainty. (Tr. 1470:21-22) But he testified that the pipeline will be a "significant change in the relevant market" and it will "introduce a greater degree of uncertainty in the level of capacity release revenues MGE will be able to generate in the future." (Ex. 17 at 8:4-6)

Hayes supported his assessment of the impact Cheyenne Plains will make by showing the impact that another pipeline, Kern River, had on the same market area when Kern River increased its capacity in May of 2003. He documented transactions for the 13 months prior to and after that expansion and presented them in his Schedule JH-1 attached to Exhibit 17. The cold hard facts show that that new pipeline competition

dramatically reduced the potential for capacity release revenues. Before the expansion, the average difference in index prices he identified was $1.33 per Dth, which he said is what MGE can attempt to capture in its releases from Pony Express. After the expansion, the average difference dropped to just $0.22 per Dth. (Ex. 17 at 8:9-15) That represents a decline of more than 80 percent.

Hayes testified that it was reasonable to expect that the pricing differential will continue to fall with the addition of Cheyenne Plains in January 2005, because its existence will further increase the ability of pipelines to take Rocky Mountain natural gas to other areas of the country. (Ex. 17 at 9:6-9) Cheyenne Plains will interconnect with the same pipelines that Pony Express does now. To add even more competition, it interconnects with an additional pipeline – ANR. (Ex. 17 at 9:1-2)

On top of all of those factors that will increase capacity, the Cheyenne Plains Pipeline is publicly stating that its fuel cost will be significantly less than what is currently available on Pony Express. (Tr. 1484:2 to 1485:5) Mr. Hayes said that since the people who bid on MGE's capacity will act in their own best economic interest, this means that the people who buy capacity from MGE now will have a lower cost alternative in Cheyenne Plains. (Tr. 1482:20 – 1483:2) This means they will logically seek to obtain released capacity first on Cheyenne Plains, since it has a lower variable cost. (Ex. 17 at 11:5-9) Only when all the available capacity on Cheyenne Plains is sold will buyers look to Pony Express where MGE has capacity. (Ex. 17 at 11:7-9)

All of these unchallenged facts support MGE's position that sometime in January of next year, just three months after the rates set in this case will have taken effect, the changing capacity release market is likely to cause a dramatic drop in the amount of

capacity release revenues MGE will be able to generate. It is the economic equivalent of a semi parked in the highway lane just around the corner. It is the logical and documented reason why MGE is not comfortable with continuing the existing ratemaking treatment that simply assumes some arbitrary level of past revenue is going to continue. Three years ago when the parties looked out into the future and were comfortable with assuming a level of $1.2 million in revenue, things were different. Cheyenne Plains was not on the radar screen. Now, the capacity release revenue world for MGE will change with Cheyenne Plains. No one at this time knows exactly to what extent.

It is highly illogical to assume, as Staff and OPC do, that the increased pipeline capacity coming into existence next year means MGE will be able to generate higher revenues. That violates the elemental price/supply/demand equation from Economics 101. A greater supply of capacity drives the price down. That was clearly demonstrated last year when Kern River expanded. (Ex. 17 at 8:9-15) An entirely new pipeline, with substantially more capacity and with a cheaper variable cost than Pony Express, clearly means those people who have been buying MGE's temporarily excess capacity on Pony Express will suddenly have another, but bigger and cheaper, place to shop. None of these facts indicate increased capacity release revenues for MGE, which is the sole premise of the Staff and OPC positions. They indicate the exact opposite of what the Staff and OPC are assuming.

Significantly, neither Staff nor OPC presented any evidence to counter the facts that indicate MGE's capacity release revenues are going to fall. None of their testimony contains any sort of analysis of the future market conditions or shipper behavior, as was the case that MGE witness Hayes presented. The Staff and OPC witnesses merely added

up past performance, did a rough average, and produced a number. They are focused only in the rear-view mirror. The last three years are not relevant because the market is going to change in the next few months. As a result, past capacity release revenues are not a reasonable or reliable indicator of what MGE may be able to generate in the future.

It is true that there were increases in the latter half of calendar year 2003 in the reported amounts of MGE's capacity release revenues, and Staff and OPC will undoubtedly point to that in support of their arguments. But there are important things to remember in considering any such argument. The first is that those increases come before the existence of Cheyenne Plains, so they do not predict what the market will be like after it is in service. The second is that there was no evidence as to which pipeline was the source of those revenues. The third is that neither Allee nor Busch know *why* those revenues increased. Allee admitted she could not articulate a reason why they are increasing at this time. (Tr. 1583:18-22) Busch also could not explain why they are showing an increase even when he had the opportunity. He admitted he had not even asked. (Tr. 1523:3-12; 1523:19-23)

Busch is also obviously very suspicious about the recent increases he observed. Essentially, he does not think they will continue. He points out that in his analysis, there is a "three year trend of increasing capacity revenues" and that the most recent yearly total is $1,759,929. (Ex. 214HC at 20:18-20) That is about $260,000 *more* than even he is proposing be assumed in base rates. He said "If I was anticipating MGE to be able to continue its current level of capacity release revenues I would have either used the total revenues from year ending 2003 ... or done a trend analysis ... ." (Ex. 214HC at 20:21 to 21:3) So Busch obviously has some reason to be cautious about whether the recent trend

will continue. But, as previously noted, neither the Staff nor OPC can explain the reason for the recent increase. They cannot identify whether it is due to some temporary market condition. Neither of them purport know the effect of Cheyenne Plains. So both of them are essentially relying on what has happened in the past and assuming the future will be roughly the same.

MGE has a very different view, born of its experience in this market. MGE has seen the effect additional capacity can have and its knowledge gained from such experience can be trusted. Think of it this way. If MGE had *any* reasonable indication that its capacity release revenues were going to increase in 2005 and beyond, this would *not* be an issue. You would not be reading a brief on this point. If MGE's view of the future regarding capacity release revenues were the same as Staff and OPC's, MGE would readily agree to an assumed level of revenues in base rates close to what is there now. That is because the way it is presently structured, *any* revenue achieved above the target level *solely benefits MGE.* Busch called it "the ultimate incentive." (Ex. 214 at 21:19) It therefore would be in MGE's best interest to stay with that approach in this situation if the past were truly prologue.

But all the forward-looking indications are that MGE might not even achieve $1.2 million in 2005 because all those people currently buying the Pony Express capacity can be expected to act logically and migrate to Cheyenne Plains for their capacity needs. No buyers of MGE's capacity on Pony Express means no purchases which means no MGE capacity release revenue. It follows, then, that it is illogical and unreasonable to put some historical number that will no longer have relevance into base rates as an "assumed" level of revenue that will be generated. At this point, any number is just a guess.