BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Missouri Gas Energy's Tariffs Increasing Rates for Gas Service Provided to Customers in the Company's Missouri Service Area.	))))	Case No. GR-2006-0422

MISSOURI GAS ENERGY'S PREHEARING BRIEF

I. INTRODUCTION

Missouri Gas Energy ("MGE" or the "Company") is committed to being a low cost provider of quality natural gas service in those areas certificated to it by the Commission. The Company's management endeavors to balance the interest of its employees, customers and shareholders. The record in this case will show that although MGE has been successful in meeting the needs of its customers and employees, MGE has been considerably less successful in meeting the needs of its shareholders. (Hack Direct, pp. 3-4).

Robert Hack, the Company's Chief Operating Officer, describes the steps that MGE has taken to achieve employee satisfaction by creating a constructive working environment coupled with regular meetings and briefings about the Company's objectives and priorities. (Hack Direct, pp. 4-5). Similarly, Mr. Hack describes for the Commission the Company's efforts to achieve customer satisfaction by providing high quality customer service in a cost-effective fashion. MGE has implemented a variety of projects and programs to enhance communication with its customers, social service agencies and faith-based organizations. (Hack Direct, pp. 6-9). MGE also works with state and local policymakers concerning energy policy issues. (Hack Direct, pp. 6-9). These

efforts on the part of MGE have been successful despite chronic, significant earnings shortfalls.

MGE provides the most cost-effective service of any Missouri LDC. Standard performance measures such as average speed of answer and abandoned call rate are quantitative measures of that success. (Hack Direct, pp.9-12). MGE is committed to continue providing high quality service, but the maintenance of these achievements cannot be viewed in a vacuum.

MGE is concerned that it finds itself necessary to make another rate increase request so soon after its most recent rate order which took effect in October of 2004. (Hack Direct, pp. 12-13). Manning its call centers to deal with historically high levels of customer phone calls requires a significant commitment of resources. For example, MGE hired nine (9) new employees for training for its contact center in March of 2006 while at the same time the Company's margin revenues were falling far short of budgeted expectations. (Hack Direct, pp. 11-12). While filing and prosecuting general rate cases is part of doing business as regulated utility in this state, it also is an expensive and time-consuming process that can divert substantial management attention away from the Company's principal mission which is to provide safe and reliable gas service to its customers. Nevertheless, without revenues sufficient to generate a return that is competitive in the marketplace, MGE will not be in a position to provide the quality of service its customers expect and deserve. (Hack Direct, p. 13). Additionally, MGE shareholders are entitled to a reasonable and realistic opportunity to achieve the

return authorized by the Commission and, ultimately, service quality must be balanced by cost and earnings considerations. (Hack Direct, p. 12).

The rates this Commission authorizes should be set so as to provide MGE with a reasonable opportunity to achieve its authorized return. (Hack Direct, pp. 13-14). Although this is the stated purpose of the process followed by the Commission, the fact of the matter is that the results of the process historically have failed to achieve that objective even though MGE manages its operations in an efficient manner.[1] MGE's consistent failure to achieve its authorized return has resulted because its rates have been established on the basis of assumptions that have not reasonably reflected the reality of MGE's operations. In particular, the rate design policies and decisions in past cases have relied on volumetric rate elements for recovery of fixed costs, making the Company's revenues and earnings dependant on cold weather despite the fact that the vast majority of MGE's costs do not vary with changes in volumes or weather. Additionally, actual per customer usage on MGE's system has rarely, if ever, reached the per customer usage assumptions employed in the regulatory process of setting the Company's rates. Finally, actual bad debt expense has exceeded MGE's rate case allowance by approximately $1 million annually, on average over the past ten (10) years. This situation has been exacerbated by extraordinarily high natural gas commodity prices. (Hack Direct, pp. 14-15).

The reason for filing another request for a general rate increase so soon after the decision that implemented new rates in 2004, is that MGE still is not

[1] Staff does not contest the fact that MGE historically has underearned stating that this is "the nature of the ratemaking process." (Oligschlaeger Rebuttal, pp. 12-13).

achieving its authorized rate of return. (Noack Direct, pp. 2-3). In this case, MGE has requested a revenue increase of $37,513,421.00 (Noack Rebuttal, pp.2-3). However, if the Commission adopts the Company's straight fixed-variable rate design proposal, which is endorsed by Staff, the revenue deficiency would be reduced to $36,449,902.00 as a consequence of the Company's lower recommended return on equity. (Noack Surrebuttal, pp. 24-25).

A major issue for the Company in this case is the deficiencies of the traditional rate design approach employed by the Commission of relying on volumetric rate elements for recovery of fixed costs. The Company in this case is proposing a straight fixed-variable rate design or, alternatively, a weather normalization adjustment. The objective in each case is to sever cost recovery and earnings from volumes of throughput. MGE urges the Commission to pay particular attention to this very important aspect of MGE's rate setting proposal.

The Commission should reexamine the way in which it sets rates for MGE. If history has shown anything, it is that simply taking a business-as-usual approach has not worked in affording MGE a reasonable opportunity to achieve its authorized return. If a meaningful solution to the issues identified by MGE is not implemented in this rate case, then the Company's only practical remedy will be to file another general rate proceeding almost on the heels of this case. The Company does not believe that serial rate cases are in the best interest of any of MGE's primary stakeholders. (Hack Direct, pp. 19-20; Surrebuttal, p. 3).

II. COST OF CAPITAL

MGE witnesses Frank J. Hanley and Michael R. Noack provided the Commission with testimony on these issues, as have Staff witness David Murray and Public Counsel witness Russell W. Trippensee.[2] Mr. Hanley[3] provided evidence of a recommended common equity cost rate of 11.75 percent and the use of a hypothetical capital structure. Mr. Hanley's recommended fair rate of return is 8.85 percent applicable to a hypothetical ratemaking capital structure consisting of 54 percent total debt and 46 percent common equity capital. The long-term and short-term debt cost rates utilized relate to the hypothetical debt ratio of 54 percent which is comprised of 44.09 percent long-term debt and 9.91 percent short-term debt with cost rates of 6.57 percent and 5.47 percent. (Hanley Direct, p. 2; Hanley Rebuttal, pp. 26-27)

a. Capital Structure and Costs of Capital other than Common Equity

It is critically important that the risk rate reflected in the cost of capital applied to MGE's gas distribution rate base be reflective of the risk of a local distribution company ("LDC"). MGE is a division of Southern Union Company ("Southern Union") and has no common stock of its own. MGE is but one of

[2] MGE does not believe Mr. Trippensee qualifies under the law as an expert witness for this proceeding. It is also apparent that Mr. Trippensee did not utilize an accepted methodology and did not rely upon data commonly relied upon by experts in this field. Accordingly, a motion to exclude Mr. Trippensee's "expert" opinion testimony will be filed by MGE, but MGE will not address Mr. Trippensee's lack of qualifications in this pre-hearing brief.

[3] Mr. Hanley holds a Bachelor of Science degree, is certified by the Society of Utility and Regulatory Financial Analysts, and has been with AUS Consultants-Utility Services since 1971. As an expert witness on behalf of investor-owned companies, municipalities, and state public utility commissions, Mr. Hanley has offered testimony on the subjects of fair rate of return and utility financial matters in more than 300 cases and dockets before various regulatory agencies and courts. He has authored or co-authorized various articles in his field of study and has appeared as a guest speaker at many venues. (Hanley Direct, App. A, pp. 1-8)

several business units of Southern Union,[4] and, for his cost of capital recommendations, Mr. Hanley does not rely at all upon Southern Union. (Hanley Direct, p. 4) In order to assess the true risk associated with an enterprise such as MGE, a proper capital structure must be utilized. Accordingly, because MGE has no discretely identifiable capital structure of its own and is a division of Southern Union – a corporation with diverse interests – an appropriate capital structure must be calculated in the setting of MGE's rates to ensure that MGE is not judged by the capital structure of other, differing enterprises or ventures that have significantly different risk characteristics.

Due to the unique situation involving MGE (the regulated utility) and Southern Union (the parent company), neither MGE's nor Southern Union's capital structure is suitable for a cost of capital determination in this proceeding. Consequently, Mr. Hanley evaluated the market data of two proxy groups of LDCs and adjusted the common equity cost rate derived therefrom to reflect MGE's greater risks. (Hanley Direct, p. 5) Because Southern Union's market prices are not reflective of the risks associated with a LDC, it cannot be utilized as a proxy for how MGE's rate base should be financed. (Hanley Direct, p. 6)

As this case is presented to the Commission, the parties will likely frequently reference the United States Supreme Court's landmark decisions in *Bluefield Water Works v. Public Service Comm'n.,* 262 U.S. 679 (1923) and *Fed. Power Comm'n. 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

[4] Two LDC divisions have been sold since the filing of MGE's direct testimony. Only two remain, although Southern Union also has two pipeline units and a gathering/processing unit.

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. MGE's revenues must be sufficient to ensure that it can compete with like-risked enterprises in its efforts to attract investors and the necessary capital such investors provide.

To achieve this result, the Commission must balance its concern for utility ratepayers with the utility's needs. The setting of appropriate rate levels also requires the Commission to make a reasonable forecast of what the future holds for the utility, its ratepayers, utility investors, and the utility industry as a whole. The use of comparable risk LDCs as proxies is essential to determining how MGE's rate base should be financed consistent with the principles of fair rate of return established in *Hope* and *Bluefield*. (Hanley Direct, p. 6)

Staff's Recommended Capital Structure. Mr. Hanley's rebuttal and surrebuttal testimony describes the errors in Staff witness Murray's logic in using Southern Union's capital structure as a proxy for MGE's. Mr. Hanley describes Staff's position as "erroneous" and "backward-looking" with regard to capital structure and related ratios. (Hanley Surrebuttal, p. 2)

Even though Mr. Murray acknowledges the need to update to June 30, 2006 and true-up to October 31, 2006, the reliance on Southern Union's capital structure is still incorrect. First, there is a mismatch between the use of the December 31, 2005 Southern Union capital structure and its 36.31 percent common equity ratio and current 2006 market data which reflects investors' very different perspective of Southern Union (not as a gas distribution company), and understatement of

common equity cost rate. Second, the use of a subsequent period such as October 31, 2006 for a true-up will further exacerbate the understatement, because it ignores the risk to which the capital invested in MGE is put. This causes a mismatch between capital structure and common equity cost rate. (Hanley Rebuttal, p. 2)

Southern Union's capital structure for a subsequent period is no longer reflective of the risk of a LDC like MGE. As Mr. Hanley explains:

> (A)pplying a common equity cost rate derived from a proxy group of LDCs, which has a significantly greater average common equity, to Southern Union's common equity ratio, results in a gross mismatch and understatement of the required common equity cost rate as well as the overall fair rate of return related to MGE's rate base.

(Hanley Rebuttal, pp. 2-3) Additionally, Mr. Murray's use of the Southern Union consolidated capital structure -- which includes all of Southern Union's long-term debt capital, including that held by the Panhandle Eastern subsidiaries, but excludes the carrying costs associated with the debt of those subsidiaries -- is simply incorrect. (Hanley Rebuttal, p. 3)

Mr. Hanley disagrees with Staff witness Murray's use of Southern Union's capital structure, despite the fact that this Commission utilized Southern Union's capital structure ratios in MGE's last rate case. Mr. Hanley explains why he takes this position. Ratemaking is prospective – rates set in this proceeding will be in effect over a future period of time. The market prices that Mr. Murray utilizes are fairly recent market prices, which reflect investors' expectations of the future. Because investors no longer look at Southern Union as primarily an LDC, but rather as a "midstream company," there is a substantial mismatch between the

common equity cost rate and the capital structure ratios utilized by Mr. Murray. (Hanley Rebuttal, p. 6)

Next, the Southern Union capital structure ratios are inconsistent with those of both Mr. Hanley's proxy group of eight LDCs and Mr. Murray's group of six LDCs. Mr. Hanley continues by explaining that there "is a further mis-match attributable to Mr. Murray's application of a common equity cost rate derived from proxy LDC companies which have a much higher average common equity ratio to the much lower common equity ratio of Southern Union." (Hanley Rebuttal, pp. 6-7) Mr. Murray utilized market data for his proxy LDCs for the months of May, June, July and August of 2006 in his DCF analyses. Under the Efficient Market Hypothesis ("EMH")[5], current market prices reflect investors' expectations of the future. As indicated in the direct testimony of Mr. Hanley, Southern Union is transforming itself into "a leader in the natural gas transportation and services industry" (i.e., a midstream natural gas company). As such, investors no longer look to Southern Union (and hence Southern Union's capital structure) as a meaningful indicator of how gas distribution assets are, or should be, financed. (Hanley Rebuttal, pp. 7-8)

At odds with Mr. Murray's recommendation is the fact that Mr. Murray acknowledges this transformation by Southern Union: "This acquisition is consistent with Southern Union's recent strategy of transforming itself from primarily a natural gas distribution utility company to a more diversified natural gas service provider, which will be discussed later, involves more business risk than a regulated transmission and distribution company." (Murray Direct, p. 13)

[5] The EMH is fully explained on pages 27 and 28 of Mr. Hanley's direct testimony.

Mr. Murray also acknowledges that, as a result of the announcement of certain transactions, Standard & Poor's placed Southern Union on a Negative CreditWatch. Mr. Murray also acknowledges and discusses his communication with the S&P analyst:

> In fact, S&P analyst Plana Lee informed Staff by email on October 5, 2006, that Southern Union would no longer be assigned a business profile ranking used to compare it to other natural gas distribution and transmission companies. S&P now considers Southern Union as predominately a midstream natural gas company.

(Murray Direct, p. 15) In addition, Mr. Murray acknowledges the impact of Southern Union's transition when he states: "Because Southern Union is transitioning into a diversified natural gas energy company from a natural gas distribution company, any comparison of Southern Union's recent ROEs to those of more traditional natural gas companies is inappropriate." (Murray Direct, p. 16)

Staff witness Murray recognizes that Southern Union is no longer recognized by investors or major rating agencies such as S&P as a natural gas distribution company. Southern Union is now considered a midstream natural gas company. Further, Mr. Murray acknowledges that a comparison of Southern Union to a more traditional natural gas distribution company is inappropriate. If a comparison of Southern Union's ROE is inappropriate, the use of Southern Union's capital structure ratios is also inappropriate. Southern Union simply cannot be viewed as a company typifying gas distribution operations. (Hanley Rebuttal, p. 9)

MGE's Recommended Hypothetical Capital Structure. When an entity which owns an organization is not financed in the same manner in which similar risk organizations are financed, it is appropriate to adopt a hypothetical capital

structure. (Hanley Rebuttal, p. 10) Mr. Hanley notes that Dr. Roger Morin, in discussing a critique of double leverage, confirms that "the returns granted an equity investor must be based on the risks to which the investor's capital is exposed and not on the investor's source of funds."[6] The cost of equity is the risk-adjusted opportunity cost to investors and not the cost of the specific capital sources employed by investors:

> The *Hope* and *Bluefield* doctrines have made clear that the relevant considerations in calculating a company's cost of capital are the alternatives available to investors and the returns and risks associated with those alternatives. The specific source of funding and the cost of those funds to the investor are irrelevant considerations.[7]

The cost of capital is governed by the risk to which the capital is exposed (i.e., where it is put, or how it is used) – not by the cost of those funds or whether they were obtained from bondholders or common shareholders. (Hanley Rebuttal, p. 10)

Another indicator that risk for purposes of this proceeding is where capital is put is contained in Principles of Corporate Finance: "The true cost of capital depends on the use to which the capital is put."[8] Further, Dr. Morin explains with regard to capital structure:

> Regulators frequently assign hypothetical, or deemed, capital structures to utility companies for purposes of revenue requirements computation. This procedure is appropriate only if the cost of equity estimated from current investor expectations is revised to take into account the new capital structure prescribed by the regulator. The cost of equity estimate based on the actual capital structure is no longer consistent with the new capital structure. . . . In other words, the greater the debt ratio, the greater is the

[6] Roger A. Morin, Regulatory Finance – Utilities' Cost of Capital, 1994, Public Utilities Reports, Inc., Arlington, VA, pp. 475-477.
[7] Id.
[8] Third Edition, Richard A. Brealey and Stewart C. Myers, McGraw-Hill Book Company, 1988, p. 173.

> return required by equity investors. . . . In summary, it is logically inconsistent to combine a fictitious capital structure with a return on equity estimate that excludes the effects of the proposed capital structure. By omitting the repercussions on equity costs and debt costs, a serious conceptual error would be committed in determining the cost of equity capital. [9]

Accordingly, because Southern Union's capital structure is no longer representative of how a gas distribution entity is financed, it should not be utilized for the purpose of setting rates in this proceeding. Rather, a hypothetical capital structure should be utilized such as that which Mr. Hanley recommends in his direct testimony. MGE is a division of Southern Union, and, as such, it has no stand-alone capital structure. For the reasons discussed above, Southern Union's capital structure is not meaningful as an indication of the risk of the gas distribution business and how it should be financed. Many events confirm that Southern Union's capital structure is not appropriate as a proxy for how MGE is, or should be, financed. (Hanley Direct, pp. 19-20)

Because there is not a meaningful stand-alone capital structure for MGE, the use of a hypothetical capital structure derived from proxy groups of LDCs must be utilized in this proceeding. Mr. Hanley recommends the use of hypothetical capital structure ratios consisting of 54.0 percent total debt and 46.0 percent common equity capital. Mr. Hanley explains that the use of a hypothetical capital structure as applied herein, by definition, ensures that MGE's ratemaking cost of capital is not increased by Southern Union's CrossCountry Energy acquisition as required by the Non-Unanimous Stipulation and Agreement approved by the

[9] Roger A. Morin, Regulatory Finance – Utilities' Cost of Capital, 1994, Public Utilities Reports, Inc., Arlington, VA, pp. 438-439.

Commission in Case No. GO-2005-0019. (Hanley Direct, p. 21)

As is detailed in Mr. Hanley's direct testimony, the average capital ratios of his selected proxy groups of LDCs are appropriate to use on a hypothetical basis to determine MGE's cost of capital. The average 2005 capital structure of the proxy group of four LDCs consisted of total debt of 55.0 percent and common equity of 45.0 percent, while the five-year average was 54.52 percent total debt and 45.48 percent total equity. (Schedule FJH-6, p. 1) The average 2005 capital structure of the proxy group of eight Value Line LDCs consisted of 52.93 percent total debt and 47.07 percent total equity, while the five-year average consisted of 54.15 percent total debt and 45.85 percent total equity. (Schedule FJH-6, p. 2)

Mr. Hanley explains that, with regard to each proxy group, the average preferred stock ratio is negligible. The average total debt ratio maintained by each proxy group ranged from approximately 53 to 55 percent, putting it within the range required by S&P for an A bond rating and a business profile of 2. (Schedule FJH-2, p. 14) Assuming a hypothetical, comparable, stand-alone bond rating of A and a business profile of 2 for MGE, a capital structure consisting of 54.0 percent total debt and 46.0 percent common equity is reasonable. Mr. Hanley goes on to explain that even if it were assumed that MGE would have a more risky business profile of "3.0", the S&P required ratio of total debt to total capital would be 50 to 55 percent, which would imply the need to maintain total equity of 45 to 50 percent. In either case, "it is clear that the use of a hypothetical capital structure consisting of 54.00 total debt and 46.00% total equity is reasonable." (Hanley Direct, p. 22)

With regard to the relative proportions of long-term and short-term debt, Mr.

Hanley reviewed the capital structure of each company in each of his two proxy groups for the five quarters beginning with the quarter ended December 2004 through the quarter ended December 2005 to determine whether it would be proper to include short-term debt in the capital structure. It was determined that the overall pattern was that short-term debt has been consistently used by every company in each proxy group for almost every quarter. Mr. Hanley thus concluded that it is appropriate to include a proportion of short-term debt in the capital structure. He then relied upon the average of the capital structure ratios for each proxy group for the five quarters ended December 31, 2005, and utilized the average of those ratios as shown in Note 5 to Schedule FJH-1, page 1. (Hanley Direct, pp. 22-23)

With regard to the long-term debt cost rate, the basis for Mr. Hanley's recommendation of 6.57 percent is contained in Schedule FJH-7. The calculations were made based on the information contained in the most recent annual Form 10-K to the SEC for the year 2005. As shown on page 1 of Schedule FJH-7, the composite interest cost rate for the proxy group of four LDCs was 6.68 percent, while it was 6.16 percent for the proxy group of eight LDCs. Because Mr. Hanley relied upon both proxy groups in terms of formulating his recommended hypothetical capital structure and common equity cost rate, he utilized the midpoint of the long-term composite interest cost rates, or 6.42 percent. (Hanley Direct, p. 24)

According to Mr. Hanley, by definition, the composite interest cost rates do not represent the full cost of raising long-term debt capital. There will always be

issuance costs associated with the same. As discussed above, one cannot rely upon Southern Union's data. Accordingly, and because looking at MGE on a stand-alone basis mandates a reasonable allowance for issuance costs, Mr. Hanley made provision for issuance costs of 15 basis points. Based on his experience, this is a typical and reasonable estimate which would, under normal conditions (i.e., no need to adopt a hypothetical long-term debt cost rate), be embedded in yield to maturity calculations. (Hanley Direct, pp. 24-25)

With regard to the short-term debt cost rate of 5.47 percent, which Mr. Hanley uses in his overall cost of capital determination, he explains that the precise basis of the cost of raising short-term debt capital for each of his proxy companies is not available. To the extent possible, Mr. Hanley utilized the three-month estimated LIBOR rate beginning with the first quarter of 2006 and ending with the second quarter of 2007 -- 4.97 percent. Adding an additional 50 basis points, Mr. Hanley arrived at a forward-looking, short-term debt cost rate of 5.47 percent. Again, the use of Southern Union's data is not relevant. (Hanley Direct, p. 25)

The overwhelming weight of the evidence presented in this case demonstrates that, in order for the principles of fair rate of return established in *Hope* and *Bluefield* to be satisfied, a proper capital structure must be utilized, and, in this case, that requires the use of a hypothetical capital structure. The risk rate reflected in the cost of capital applied to MGE's gas distribution rate base must be reflective of the risk of an LDC. There must be a match between risk and return.

b. Return on Equity

As with capital structure, the Commission should adopt the Company's return on equity recommendations in order to fully comply with the principles of fair rate of return established in *Hope* and *Bluefield*. MGE witness Hanley demonstrates that Staff's criticisms of the methodologies employed by Mr. Hanley are misplaced and result in a Staff recommendation which is contrary to regulatory consensus and basic common sense. (Hanley Surrebuttal, p. 2) Return on equity is one of the more contentious issues in this proceeding, and numerous calculations have been presented by direct, rebuttal, and surrebuttal testimony. Nonetheless, as is demonstrated herein and as will be demonstrated at the hearing, after a closer analysis of the testimony and work product, it is clear that the Company's proposed common equity cost rate, as presented by Mr. Hanley, is reasonable, well supported, and the soundest of those offered in this proceeding.

***The Company's Recommendation*.** Mr. Hanley's recommended common equity cost rate of 11.75[10] percent reflects current capital market conditions and results from the application of four established market-based cost of common equity models: the discounted cash flow (DCF) approach, the risk premium model (RPM), the capital asset pricing model (CAPM), and the comparable earnings model (CEM). Each of the models utilized is market-based and predicated upon the EMH. Using two proxy groups and the four common equity models, Mr. Hanley arrived at a common equity cost rate of 11.75 percent. As Mr. Hanley explains,

[10] It should be noted that Mr. Hanley's ROE recommendation falls to 11.5 percent under the straight fixed-variable rate design, which produces a revenue requirement reduction of more than $1,000,000, as compared to the 11.75 percent ROE he recommends under a "traditional" rate design such as that proposed by Public Counsel.

that cost rate needs to be adjusted upward to reflect MGE's greater risk attributable to its smaller size and lack of protection from weather fluctuations as compared to the two proxy groups. (Hanley Direct, p. 7)

Mr. Hanley explains the prudence of relying upon all of the market-based models in arriving at a return on equity recommendation, and this decision is affirmed by the financial literature. Because all of the models are discussed in the financial literature, the EMH requires the assumption that investors rely upon all of these models. (Hanley Direct, p. 31) Consequently, Mr. Hanley relies upon the four most widely-discussed and utilized cost of common equity models as principal tools in reaching his recommended equity cost rate. "No single cost of common equity model is so theoretically superior to the others, or so precise, to justify sole reliance on it in the application of the traditional ratemaking paradigm." (Hanley Direct, p. 7)

Mr. Hanley reviewed the results of the applications of each cost of common equity model in arriving at a common equity cost rate of 11.75 percent which is applicable to his two selected proxy groups.[11] After making an upward adjustment for MGE's additional risk, Mr. Hanley determined that the common equity cost rate applicable to MGE is 11.95 percent. (Hanley Direct, p. 7) Mr. Hanley, however, prepared an update of his common equity cost rate to reflect more current capital market conditions. With this update, Mr. Hanley utilized the same cost of common equity models and applied them in the same manner discussed in his direct

[11] Mr. Hanley explains the selection of his 4-company proxy group on pages 16 and 17 of his direct testimony. The selection of his 8-company proxy group is detailed on page 18 of his direct testimony. When Mr. Hanley updated his common equity cost rate, he excluded Cascade Natural Gas Corp. and Peoples Energy Corp. due to their pending merger/acquisition activity. (Hanley Rebuttal, pp. 26-27)

testimony. Mr. Hanley's updated cost rate of common equity capital is 11.75 percent, with a resulting overall rate of return of 8.85 percent. (Hanley Rebuttal, p. 26)

With both his original recommendation and his updated recommendation, Mr. Hanley tested the reasonableness of his conclusions by calculating an adjusted discounted cash flow ("DCF") cost rate to account for the impact of the added financial risk "attributable to the divergences of the market values and book values of common stocks on DCF cost rate, especially in a volatile stock market." (Hanley Direct, p. 7) According to Mr. Hanley, the DCF model tends to understate the true cost of common equity capital when the market values of utilities' common stocks exceed their book values. As explained by Mr. Hanley, the basis for the adjustments made to account for the greater financial risk of a market-based DCF cost rate, which is applied to a much lower common equity ratio measured at book value (or the common equity financed portion of an original cost rate base), is supported academically in an article by Robert S. Hamada entitled, "Portfolio Analysis, Market Equilibrium and Corporate Finance"[12] and by other regulatory decisions. (Hanley Direct, p. 8)

As illustrated in Mr. Hanley's testimony, and as shown on page two of Schedule FJH-1, a credible unadjusted DCF cost rate ranges from 10.41 percent to 10.43 percent, while the RPM, CAPM and CEM cost rates are in the 10.25 percent to 14.37 percent range. The range of DCF cost rates, adjusted to reflect the added financial risk when applied to the book value of equity, is 11.60 percent

[12] Journal of Finance (Vol. 24, No. 1, March 1969, pp. 13-31).

to 11.69 percent before adjustment to reflect MGE's added risks, and this confirms the reasonableness of Mr. Hanley's original recommendation of an 11.95 percent common equity cost rate. As a further check on the reasonableness of his recommended common equity cost rate, Mr. Hanley reviewed regulatory awards made to LDCs during the period January 1, 2004 through December 31, 2005. He determined that the average awarded ROE in fully litigated cases was 10.66 percent, relative to a 46.91 percent common equity ratio. (Hanley Direct, p. 9) The average award further confirms Mr. Hanley's recommendation as reasonable when recognition is given to the fact that the country is going into a period of rising interest rates – which greatly impacts utilities. It is Mr. Hanley's opinion that, on a prospective basis, the average awarded ROE will rise.

Staff's Unreasonable Recommendation. Staff witness David Murray's recommended range of common equity cost rate of 8.65 percent to 9.25 percent simply does not pass a reality check, especially when MGE's greater risk is taken into account. The problems with Mr. Murray's methodology and ultimate recommendations are detailed in Mr. Hanley's rebuttal and surrebuttal testimony.

Mr. Hanley reviewed recently allowed rates of return on common equity authorized by other regulatory commissions in litigated cases. He found an average of approximately 10.6 percent relative to an average common equity ratio of approximately 48.6 percent. (Hanley Rebuttal, pp. 3, 15) Additionally, Mr. Hanley determined that the average awarded equity risk premium over A rated public utility bonds was 4.71 percent. As explained by Mr. Hanley, with an updated prospective yield of 6.39 percent on A rated public utility bonds (equal to the

average bond rating of his proxy LDC companies), an 11.1 percent common equity cost rate is indicated *before* any necessary adjustments to reflect MGE's unique risks. Mr. Hanley also determined that the average of all litigated awarded ROEs to LDCs during the two-year period ended September 30, 2006 is 10.58 percent. (Hanley Rebuttal, p.3; Schedule FJH-18).

Further confirmation of the inadequacy of Staff's recommended range of common equity cost rate is found in Schedule FJH-19, where Mr. Hanley demonstrates that the average currently authorized rate of return on Mr. Murray's proxy group of six LDCs is 10.66 percent relative to an average authorized common equity ratio of 49.20 percent, and 10.89 percent relative to a common equity ratio of 48.90 percent for the companies with operations in Missouri (excluding MGE). (Hanley Rebuttal, p. 4) It is clear that a recommended common equity cost rate below 10.50 percent fails a common sense reality check.

Contributing to his flawed results, Mr. Murray essentially relies solely upon the DCF model to arrive at his recommended common equity cost rate. He does incorrectly apply the CAPM model,[13] but only as a "check" on his flawed and understated recommendation. (Hanley Rebuttal, p. 5) The EMH, upon which all cost of common equity models are premised, confirms that investors rely upon multiple cost of common equity models in formulating their required rates of return. It is improper to rely solely, or even primarily, upon the results of a DCF model mathematical calculation.

[13] As explained by Mr. Hanley, there are three major problems associated with Mr. Murray's CAPM analyses: 1) his reliance, even in part, on geometric average market risk premiums; 2) his reliance, in part, upon short-term risk premiums; and 3) his failure to utilize the empirical Capital Asset Pricing Model (ECAPM).

Mr. Murray, like Mr. Hanley, was attempting to best emulate investors' actions in formulating his ROE recommendation. It is clear, however, that Mr. Murray fell well short of this target. The DCF model is based upon the EMH, as are all other market-based cost of common equity models. "The generally-accepted, semi-strong version of the EMH states that investors are aware of all publicly-available information and that such information is embedded in the market prices they pay." (Hanley Rebuttal, p. 14) It is clear that the financial literature encourages the use of multiple models. Additionally, many state regulatory commissions consider a number of cost of common equity models and do not rely upon any single model. (Hanley Rebuttal, p. 14) Moreover, there appears to be no empirical evidence which demonstrates that investors rely exclusively upon a single model, such as the DCF, or that proves that the DCF model is a superior predictor of actual earned returns experienced by investors. (Hanley Rebuttal, p. 14)

Considering the foregoing, and because the EMH requires the assumption that investors take into account multiple cost of equity models when considering an investment, sole reliance upon any single model, including the DCF, is simply incorrect.

Mr. Hanley further explains that Mr. Murray's recommended DCF-based common equity cost rate range will mathematically mis-specify investors' required return rate when the market value of common stock differs significantly from its book value. (Hanley Rebuttal, p. 16) Market value and book values are seldom the same, but the market-based DCF model will result in a total annual dollar return on

book common equity equal to the total annual dollar return expected by investors only when market and book values are equal. (Hanley Rebuttal, p. 16) Quoting Dr. Morin, Mr. Hanley notes that another reason for "caution and skepticism is that application of the DCF model produces estimates of common equity cost that are consistent with investors' expected return only when stock price and book value are reasonably similar . . ." Dr. Morin continues:

> As shown below, application of the standard DCF model to utility stocks understates the investor's expected return when the market-to-book ratio of a given stock exceeds unity. . . . The converse is also true, that is, the DCF model overstates that investor's return when the stock's M/B ratio is less than unity. The reason for the distortion is that the DCF market return is applied to a book value rate base by the regulator, that is, a utility's earnings are limited to earnings on a book value rate base.[14]

Utility stocks continue to trade at market-to-book ratios well above unity. As shown on page 11 of Schedule FJH-1, the market-to-book ratios of Mr. Hanley's proxy LDCs are substantially above their book values for his proxy groups as well as for Staff witness Murray's proxy group of six LDCs. (Hanley Rebuttal, p. 17) A market-based DCF cost rate applied to the book value per share will either overstate investors' required common equity cost rate when market value is less than book value or understate investors' required common equity cost rate when market value is above book value. (Hanley Direct, p. 35; Schedule FJH-8) There is no realistic opportunity to earn the market-based rate of return when it is applied to a much lower book value. (Hanley Rebuttal, p. 17)

[14] Morin, *supra,* at p. 236.

To summarize, Staff's recommended range of common equity cost rate of 8.65 to 9.25 percent is not support by the evidence in this proceeding and is "completely unrealistic and outside the regulatory mainstream." (Hanley Rebuttal, p. 15) If this Commission adopts Staff's recommendation, "the financial community would have a very adverse view of Missouri regulation." (Hanley Rebuttal, p. 15) Contrary to the methodology employed by Staff in this proceeding, the recommended cost rate for common equity capital should not simply be the result of a mechanical application of a cost of equity model. (Hanley Surrebuttal, p. 2)

Public Counsel's Unsupported Recommendation. Public Counsel witness Russell Trippensee prepared and filed testimony in this matter to "address the revenue requirement implications of the proposed changes in rate design" and stated that Public Counsel recommends "that the appropriate return on equity be set at an appropriate point between the cost of debt for MGE (7.70%) and the low end of Staff's rate of return recommendation of 8.65%." (Trippensee Rebuttal, pp. 2, 12) At his deposition, Mr. Trippensee confirmed that he is holding himself out as a cost of capital expert witness in this proceeding and is recommending what he believes is the appropriate return on equity for MGE. (Trippensee Deposition, pp. 9, 41-42) Mr. Trippensee also confirmed that it is Public Counsel's position that Staff's rate design proposal is "radical," and he acknowledged that the Company's Straight Fixed-Variable ("SFV") rate design proposal, discussed in section V below, is similar to Staff's rate design proposal. (Trippensee Deposition, pp. 43-44)

Mr. Trippensee argues that if the fixed delivery charge proposed by Staff witness Ross is put into place, MGE will "effectively be guaranteed to earn the

authorized rate of return." (Trippensee Rebuttal, p. 6) If this were true, however, every LDC with some type of similar mechanism would be consistently achieving their authorized rates of return. This, quite obviously, is not the case. (Hanley Surrebuttal, p. 22) MGE witness Noack explains that a fixed residential delivery charge will not eliminate the earnings variability for these customer classes. Mr. Trippensee's statement implies that the residential class volumetric revenue stream represents the only material driver of MGE's earnings variability – which is not the case. (Noack Surrebuttal, pp. 2-4) Mr. Noack points to many variables which contribute significantly to MGE's earnings variability, including: bad debt expense, property tax expense, loss of customers, remediation of former manufactured gas plant sites, and increases in other types of expenses such as wages and insurance premiums. (Noack Surrebuttal, pp. 3-4)

Although the implementation of a SFV rate design will enhance MGE's opportunity to earn a fair rate of return, it does not function as any sort of guarantee as to the Company's ability to achieve its authorized rate of return. In fact, regarding the risk borne by common shareholders, Mr. Trippensee himself admitted that, under Staff's proposed capital structure, "they would be bearing the risk that debt holders have first obligation or first right to the assets of the company before the stockholder, so that is an additional risk that they face." (Trippensee Deposition, p. 27) He also acknowledged that ROE is never guaranteed. (Trippensee Deposition, p. 27)

Mr. Trippensee has not conducted any studies to justify his position regarding risk reduction or the appropriate ROE for MGE. There is simply no

mathematical or analytical support for Public Counsel's ROE recommendation in this case. In fact, Mr. Trippensee admits that he simply applied "basic financial concepts" to the results of Staff witness Murray's ROE calculations. Mr. Trippensee saw no reason to "replicate the Staff's work" or "verify all of their sources." (Trippensee Deposition, pp. 16, 20) It may then come as a shock to Mr. Trippensee that many of the proxy companies utilized by Staff witness Murray and MGE witness Hanley enjoy protections from weather variance and that some also have protections in the form of revenue decoupling mechanisms. (Hanley Surrebuttal, p. 22; Murray Surrebuttal, p. 18)

When all factors are considered and the principles of *Hope* and *Bluefield* are properly applied, it is clear that the Company's proposed common equity cost rate, as presented by MGE witness Frank Hanley, is reasonable. It should be noted, however, that Mr. Hanley believes his recommended common equity cost rate of 11.75 percent should be reduced to 11.6 percent if the Company's proposed WNA is approved or to 11.5 percent if the Company's proposed SFV rate design proposal is approved.[15] (Hanley Surrebuttal, p. 23)

III. INCOME STATEMENT-REVENUES

a. Weather Normalization

MGE's Proposal. MGE proposes to use a 10-year Heating Degree Day ("HDD") average to normalize its annual gas volumes for rate case purposes. Historically, the company has used a 30-year HDD average computed by the

[15] As noted above, Mr. Hanley's ROE recommendation of 11.5 percent under the SFV rate design produces a revenue requirement reduction of more than $1,000,000, as compared to the 11.75 percent ROE he recommends under a "traditional" rate design such as that proposed by Public Counsel.

National Oceanographic and Atmospheric Administration ("NOAA") to normalize its gas volumes for weather. (Feingold Direct Testimony, p. 6)[16] MGE has proposed this change in the calculation of HDD because it believes that the use of a 10-year HDD average will result in improved forecasting for normalizing MGE's gas volumes and that the 10-year average will better reflect the expected normal weather conditions during the period in which its base rates will be in effect. (Feingold Direct, p. 7)

In his testimony, Mr. Feingold examined the Company's annual HDD over the 106-year period from 1900 to 2005 in order to determine the best predictor of future HDD levels for purposes of "normalizing" actual natural gas volumetric consumption during the test year and for the timeframe during which the Company's rates are expected to be in effect. For this analysis, he tested four (4) alternative means for forecasting HDDs: (1) a 30-year average of annual HDD data ending in 2005; (2) a 20-year average of annual HDD data ending in 2005; (3) a 10-year average of annual HDD data ending in 2005; and (4) a 5-year average of annual HDD data ending in 2005. He then conducted a statistical comparison of the predictive capability of these four (4) timeframes to determine which was more accurate. (Feingold Direct, pp. 7-8)

For this analysis, Mr. Feingold adopted the standard NOAA definition of a HDD - the difference between the average daily temperature (based on maximum

[16] Using the ten year average, the Company's measure of normal weather will be 4,967 HDD for its Kansas City and St. Joseph services areas and 4,450 HDD for its Joplin service area. Currently, the measures of normal weather embedded in MGE's distribution rates are 5,249 HDD for the Kansas City and St. Joseph areas and 4,602 HDD for the Joplin area. These values are NOAA's most recent 30-year averages for the years 1971-2000. NOAA only calculates its 30-year average once every ten years. (Feingold Direct, p. 6)

and minimum daily temperatures) and 65 degrees Fahrenheit (or zero if the average temperature is above 65 degrees Fahrenheit). The weather stations used were Kansas City International Airport ("MCI"), Kansas City Downtown Airport ("MKC") and Springfield Regional Airport ("SGF"). First weather averages were calculated for the four (4) alternatives being tested starting in 1901, so it was possible to calculate 30-year, 20-year, 10-year and 5-year averages for the years 1930 through 2005. Mr. Feingold then compared each of the four alternative averages for each year to the actual HDD value observed two (2) years later. The Company attempted to use data ending in the test year, calendar 2005, in order to predict weather approximately two years in the future when its approved rates will be in effect. (Feingold Direct, p. 9)

Mr. Feingold then conducted a statistical analysis to compare the predictive capabilities of the four (4) selected averages using a standard statistic called the "root mean squared error" ("RMSE"). (Feingold Direct, p. 10) The results of this analysis showed that over the 106-year period, the 10-year HDD average outperforms the 30-year average in predicting weather two years into the future. In other words, 10-year averages tend to produce more accurate forecasts of HDD than 30-year averages. Specifically, the forecast errors of 30-year averages are typically higher than those of 10-year averages by approximately 4.6% in Kansas City and by approximately 1.2% in Springfield. Based on the RSME test, the 10-year average represents a better basis for purposes of forecasting HDD during the time when the Company's approved rates in this case will be in effect. The deficiency in the use of the 30-year average in the past has contributed, in

significant part, to the Company's chronic and continuing volumetric revenue shortfalls that have prevented it from earning the return on investment approved by the Commission in prior rate cases. (Feingold Direct, p. 11)

The weather normalization adjustment has the effect of increasing test year volumetric revenues because MGE's gas volumes and the resulting revenues were abnormally low due to temperatures (and HDD) in the test year being warmer than normal. Weather was approximately 3.8% warmer than normal in the Kansas City and St. Joseph areas and approximately 4.0% warmer than normal in the Joplin area during the test year. The weather normalization adjustment is designed to adjust base rates in order to produce the base revenue anticipated under normal temperature conditions which are expected to be in effect after the new rates become effective. (Feingold Direct, p. 14) This weather-related adjustment is based on statistically determined relationships between gas usage (in Ccf) and temperatures (measured by HDD). The adjustment consists of the difference between the volumes statistically explained with normal HDD and volumes experienced with actual HDDs. Pricing the volumetric weather adjustments at the Company's current base rates results in revenue increases of $1,506,308 in residential gas sales, $542,095 in commercial gas sales (or $495,544 in SGS rate class and $46,551 in the LGS rate class), and $112,397 in transportation revenues. Pricing these adjustments at the Company's current base rates results in a $840,063 increase in test year margin. (Feingold Direct, pp. 14-15)

Under the Company's proposal to utilize a 10-year HDD average, the annual normalized use per customer for its residential class is 834 Ccf. Under

Staff's proposal to utilize a 30-year HDD average, the use per customer is 868 Ccf, an increase of over 4 percent. (Feingold Rebuttal, p. 7) Assuming a higher use per customer level in the rate setting process has a negative impact on the Company's ability to generate actual volumetric revenues sufficient to recover its approved cost of service. The Company has experienced significant volumetric revenue shortfalls in its residential service rate class in each of the last seven (7) years due to fluctuations in gas volumes caused primarily by declining use per customer and variations in weather from normal levels. In Mr. Feingold's opinion, the Commission's adoption of a 30-year weather normal for that period contributed to the Company's volumetric revenue shortfall because the "baseline" use per customer used to design rates was too high as is demonstrated by Schedule RAF-7 attached to his Direct Testimony. As a result, the Company was unable to fully recover its approved cost of service simply because it never was able to achieve the assumed higher level of gas sales that the Commission assumed to be "normal." This was true even when the weather was colder than normal such as in 2001. (Feingold Rebuttal, p. 8)

The Staff's Proposal. Staff witness Wells uses the 30-year time period used by NOAA and the World Meteorological Organization ("WMO"). Mr. Wells states in his Direct Testimony that his choice of the 30-year period is based on (1) previous Staff analysis, (2) prior Commission decisions, and (3) the standards for normal weather variables established by NOAA and the WMO. (Wells Rebuttal, pp. 1-6) Mr. Wells's support for a 30-year weather normal can be summarized as follows: (1) 30-year weather normals are standards of NOAA and WMO and are

officially generated numbers; (2) the Commission has utilized 30-year normals as its practice or policy; and (3) the Staff has conducted "analysis" in support of a 30-year normal. (Feingold Rebuttal, p. 9).

Mr. Wells believes that the "test year" concept as practiced in Missouri amounts to a "back cast" of a utility's normal operating conditions to compute its revenue requirement and rates rather than a "forecast" of conditions expected to occur during the time when the new rates are in effect. Thus, he believes that the choice of the weather normal should not be based upon its ability to represent, or predict, future weather. (Wells Rebuttal, pp. 5-6) MGE does not agree with this analysis, however. The 30-year HDD average generated by NOAA is only an historic average and is used as a base against which future climate can be measured. It is clear that the standard for normal weather used by NOAA and WMO has no meaningful significance within the context of a test year used for utility ratemaking purposes. (Feingold Rebuttal, p. 11) Mr. Wells seems to reject the forward-looking nature of establishing a utility's rates and the importance of deriving the utility's revenue requirement and associated rates for its recovery using a test year that is reflective of costs and sales levels that will be experienced in the future. This concept is a fundamental tenet of utility ratemaking and has been acknowledged by other experts in the field. This Commission has taken a similar view of the test year concept by stating that "the purpose of using a test year is to create or construct a reasonably expected level of earnings, expenses and investment during the future period during which the rates to be determined herein will be in effect." *Re Southwestern Bell Telephone Company,* 23 Mo. P.S.C.

(N.S.) 374, 377 (1980). Staff witness Oligschlaeger has offered testimony that validates the Company's contention. He states:

> One of the fundamental principles that has long governed ratemaking in this jurisdiction is the axiom that ratemaking is and should be a forward-looking and prospective process. (Oligschlaeger Rebuttal, p.3)

Additionally, MGE believes that the utility's weather normal should create a situation where the utility will have an equal opportunity to gain or lose from the method. Under the method historically used by the Commission for selecting MGE's weather normal, based on the 30-year HDD average, the situation has been created where MGE has been assured to lose and never to gain. This imbalance is evident upon review of the Company's volumetric revenue shortfalls experienced in its residential class as contained in Schedule RAF-9 attached to Mr. Feingold's Direct Testimony. (Feingold Rebuttal, pp. 14-15) MGE experienced volumetric revenue shortfalls in years 2000 and 2001 despite the very cold Winter of 2000-2001. Other gas utilities in other states use a 10-year average for their weather normalization process, and MGE urges the Commission to re-consider its reliance on the 30-year HDD and allow MGE to use a 10-year HDD weather normal.

Mr. Wells argues that the NOAA 30-year normal is a more stable weather measure than the Company's proposed 10-year normal. His reliance on stability as an important consideration in choosing a utility's weather normal is shortsighted, however, since he has sacrificed the ability of the weather normal to properly reflect the best measure of normal weather during the time the utility's rates are in effect. Mr. Wells is advocating that the Commission blindly adhere to the same

NOAA 30-year average as a weather normal, for as long as ten years after the average has been computed, to achieve the goal of stability rather than have a weather normal that is reflective of more recent trends in weather. (Feingold Surrebuttal, p. 3) The use of a 10-year weather normal will not cause more frequent rate changes than a 30-year average. There is an equal expectation that an adjustment for weather will occur in each rate case whether the normalization process is based on a 30-year average or a 10-year HDD average simply because normal weather seldom, if ever, occurs. (Feingold Surrebuttal, p. 4).

Weather Normalization Summary. It is important to note that there is a relationship between the issues of weather normal and rate design in this case that the Commission should take into consideration. If the Commission approves the SFV rate design proposed by MGE and endorsed in large part by the Staff, the necessity of assuming a level of volumetric revenues that do not actually exist during the test year essentially is no long a consideration, at least for the residential class. If, however, the Commission decides not to adopt the SFV rate design concept proposed by the Company, the choice of weather normal is a much more important consideration to the Company and being afforded a reasonable opportunity to recover its fixed costs of providing gas delivery service to its customers. (Feingold Rebuttal, pp.26-27).

In summary, the Commission should adopt the Company's 10-year HDD average for the following reasons:

1. The Company's 10-year HDD average more accurately reflects the changing trends of the weather which is exactly what is sought when using this

average for ratemaking purposes as a measure of normal weather in the Company's service areas.

2. The 10-year weather normal provides a more balanced opportunity for the Company to gain or lose compared to the asymmetry demonstrated historically under Staff's 30-year weather normal where MGE has consistently lost.

3. The 10-year weather normal more closely tracks the ongoing variation in HDD compared to the 30-year weather normal.

4. The 10-year weather normal is a partial solution to the continuing volumetric revenue shortfalls experienced by the Company caused by warmer than normal weather (as defined under a 30-year weather normal), and the resulting lower use per customer and lower base revenues than those approved by the Commission.

5. The Company's proposed 10-year weather normal uses the most recent weather data available to establish the basis for the Company's normal sales volumes while the Staff's 30-year weather normal relies on weather data that is already five (5) years old, and can be as much as ten (10) years old depending on the timing of a particular utility's rate case filing.

6. The 10-year weather normal recently has been adopted by other state utility commissions and implemented by the gas utilities under their jurisdiction.

7. The odds of returning to colder climatic conditions represented by the current NOAA 30-year average are very low as demonstrated in Mr. Feingold's Direct Testimony.

8. Use of 10 year weather normal is better able to "forecast" conditions expected to occur during the time when the new rates are in effect and thus does a better job of adhering to the Commission's view of the purpose for using a test year as a forward-looking process.

IV. INCOME STATEMENT-EXPENSES

a. Property Tax Refunds

During the test period, MGE received and booked property tax refunds totaling $5,554,068 that related to taxes paid for tax years 2002, 2003, and 2004. Staff proposes that the entire amount of these refunds be set up as a deferred credit and amortized over five years to offset property tax expense during the test period and into the future. (Winter Direct, p. 20)

MGE opposes Staff's proposal for several reasons. First and foremost, Staff's proposed adjustment constitutes retroactive ratemaking, which is unlawful in Missouri.[17] The refunds in question are non-recurring and relate to periods during which rates lawfully prescribed by the Commission were in effect. It would be unlawful for the Commission to reach back to those prior periods to seize the refunds and utilize them for the benefit of future customers through property tax expense that is artificially reduced for ratemaking purposes. As the Missouri Supreme Court stated in *Utilities Consumer Council*:

> The commission has the authority to determine the rate *to be charged*, §393.270. In so determining it may consider past excess

[17] See, e.g., *State ex rel. Util. Consumers Council of Missouri, Inc. v. Pub. Serv. Comm'n*., 585 S.W.2d 41, 58 (Mo. 1979). See also, *Lightfoot v. City of Springfield*, 236 S.W.2d 348 (Mo. 1951) [Federally-mandated refund of impounded funds were property of the utility, not customers, because the money was collected in accordance with Commission-approved rate schedules and utility could not be deprived of the refunds without violating due process clause of the Constitutions of the United States and the State of Missouri]

> recovery insofar as this is relevant to its determination of what rate is necessary to provide a just and reasonable return in the future, and so avoid further excess recovery. [citation omitted] It may not, however, redetermine rates already established without depriving the utility (or the consumer if the rates were originally too low) of his property without due process. (emphasis original)[18]

Paraphrasing the testimony of Staff's witness on this issue, David Winter, the rationale underlying Staff's proposed adjustment is that the tax refunds show that the amount of annual property tax expense that was assumed for ratemaking purposes in MGE's last rate case was not reached for tax years 2002-2004. The so-called "windfall" that the Company realized as a result of these refunds should, therefore, be returned to its customers.[19] Yet what Mr. Winter is suggesting is exactly what the doctrine of retroactive ratemaking prohibits. But even beyond that, the assumptions upon which Staff's adjustment is grounded have no basis in fact. Just because MGE received property tax refunds does not mean its tax payments – on either a gross or net basis – were not at or above the level assumed for ratemaking purposes in previous cases. On their face, the refunds simply reflect the fact that the Company paid more property taxes than it owed – nothing more. Mr. Winter's assertions as to how those payments relate to the level of tax expense that was assumed and included for ratemaking purposes in MGE's past rate cases is pure speculation.

[18] *Id.*

[19] Staff's implications to the contrary notwithstanding, MGE did not realize any windfall as a result of the tax refunds. As shown on page 1 of Schedule G-4, which is appended to the Surrebuttal Testimony of Mr. Noack, during each of the years for which the Company received a property tax refund MGE's earnings were lower than authorized. For the three-year period 2002-2004, MGE's cumulative earnings shortfall exceeded $32 million. (Noack Surrebuttal, p. 9)

Simply stated, it would be unlawful for the Commission to adopt the property tax adjustment that Staff is proposing in this case. Accordingly, the Commission must reject Staff's proposal.[20]

b. Unrecovered Cost of Service Amortization

In MGE's last rate case, Case No. GR-2004-0209, the Company asked the Commission: 1) to authorize a weather normalization clause or a weather mitigation rate design similar to one that had been previously authorized for Laclede Gas Company; 2) to base its weather normalization adjustment on recent weather data that would more accurately predict customer usage; and 3) to approve an attrition adjustment to normalized sales volumes to recognize the fact that MGE has experienced a consistent decline in average, per-customer usage. MGE also proposed to increase the proportion of revenues recovered by way of fixed rate elements – as opposed to volumetric rate elements. The Company made these proposals in an effort to assure that the rate structure adopted by the Commission would give the Company a realistic opportunity to actually recover its allowed cost of service. (Noack Direct, pp. 21-22)

Regrettably, however, none of these proposals was adopted and, as a predictable consequence of extraordinarily warm weather during the first three months of 2006, average per-customer usage for the residential class fell 27.36 percent below the level that was assumed when rates were set in the last case. To recover this shortfall, the Company proposes to amortize over five years the

[20] See discussion, *infra*, in Section III(b). As noted there, the same issues related to the doctrine of retroactive ratemaking apply to the Company's proposed adjustment to amortize its unrecovered cost of service as they did to Staff's proposed property tax adjustment. Accordingly, the Commission should either adopt or reject *both* adjustments. It cannot lawfully, or rationally, adopt one and reject the other.

difference between MGE's actual revenues for the period January 1, 2006, through June 30, 2006, and the level of revenues that was assumed in Case No. GR-2004-0209. The total amount of that shortfall is $15.6 million, and of that total one-fifth, or approximately $3.125 million, would be added to the test period cost of service to be used to set rates in this case. (Noack Surrebuttal, pp. 5-6)

Staff argues that the Company's proposal constitutes unlawful retroactive ratemaking, and opposes the adjustment on that basis. As explained in the testimony of Staff's witness, Mark Oligschlaeger,

> "Retroactive ratemaking" is the setting of rates to allow a utility to recover the specific costs of past events incurred by the utility so as to make utility shareholders "whole" or, conversely, it is the setting of rates to reimburse customers related to past over-earnings of a utility so as to make the customers "whole." Both of these instances contrast with normal ratemaking practices, which are intended to allow a utility to recover a normal ongoing level of costs.

(Oligschlaeger Rebuttal, p. 4) He goes on to state his belief that allowing a utility to recoup past losses, or forcing it to return past gains, through future rates represents a "significant disincentive to utility efficiency," which makes adoption of the Company's proposal bad regulatory policy. *(Id.*, p. 5) Finally, Mr. Oligschlaeger asserts that the Commission should reject MGE's proposed adjustment because "[a] utility assumes the risk that it will not be able to earn its authorized ROE under traditional ratemaking practices . . .." (*Id.*, pp. 5-6)

The Company agrees with Staff's argument that the proposed adjustment for unrecovered cost of service during the first half of 2006 may constitute retroactive ratemaking. But, in so doing, MGE wants to be sure the Commission *recognizes and acknowledges* that Staff's proposed property tax adjustment is

afflicted with the same legal infirmity. As Mr. Oligschlaeger has stated in his pre-filed rebuttal testimony, the doctrine of retroactive ratemaking prohibits recouping both past losses and past gains through future rates. If MGE's unrecovered cost of service adjustment must be rejected as Staff proposes, then so must Staff's property tax adjustment. It would be unlawful, illogical, and fundamentally unfair for the Commission to do otherwise.

c. Rate Case Expense

In MGE's last rate case, the final order allowed rate case expenses totaling $893,823.75 and authorized a three-year amortization of that amount.[21] Rates approved in that case took effect on October 2, 2004,[22] so as of the end of the test period in this case – June 30, 2006 – only approximately 40 percent of the amortization period prescribed by the Commission for recovery of those costs had elapsed and only about $373,000 of the total amount authorized had been collected.

In the current case, Staff recommends a three-year amortization of whatever amount of rate case expense the Commission finds to be reasonable and prudent. But Staff opposes including within that amount the unamortized portion of rate case expense that was approved in MGE's last rate case. As expressed in the direct testimony of Staff's witness on this issue, Paula Mapeka, it is Staff's "policy" to recommend "recovery in rates of normalized rate case expense only on a prospective basis. Staff believes it is inappropriate to allow specific recovery in

[21] *Report and Order*, Case No. GR-2004-0209 (Sept. 21, 2004), p. 91.

[22] *Order Approving Tariff in Compliance with Commission Report and Order*, Case No. GR-2004-0209 (September 30, 2004), p. 4.

rates of amounts related to past rate proceedings." (Mapeka Direct, p. 28)

Staff's policy concerns notwithstanding, the questions of whether to allow recovery of rate case expenses, the appropriate amount of those expenses, and the time period over which they would be recovered are matters for decision by the *Commission* not the Staff. The Commission's decision on those issues is reflected in the Report and Order it issued in MGE's last rate case. Assuming the $893,823.75 in rate case expenses that were authorized in the last case were ratably collected from customers, by the end of 2006 MGE had received only approximately $670,000 of that amount. This leaves a balance of approximately $223,000 – roughly a fourth of the total – remaining uncollected. And, in addition to being contrary to the Commission's order, Staff's refusal to allow the Company to collect this remaining balance because of concerns about "policy" is unconscionable.

The Commission authorized a three-year amortization of rate case expenses from MGE's last rate case and Staff should not be allowed to flout that directive. Whatever level of rate case expense the Commission finds to be reasonable and prudent in the current case must be adjusted to reflect the uncollected balance that remains from the last case at the time rates set in the current case go into effect. This combined amount should then be amortized over an appropriate period – both Staff and MGE have proposed three years – with one-third to be included in the revenue requirement. To do otherwise would deny the Company an expense it was previously authorized to collect, thereby further exacerbating its already substantial earnings shortfall.

d. Depreciation Expense

MGE's Concerns About Staff's Handling of MGE's Level of Depreciation Expense. As it determines what depreciation rates should be prescribed for MGE and what amount of depreciation expense should be recognized for ratemaking purposes, the Commission also should consider several concerns the Company has regarding how Staff, both in the past and in this case, addresses issues of depreciation with respect to MGE. For example, although the Company has dutifully complied with the Commission's rule requiring natural gas distribution utilities to conduct company-specific depreciation studies and to file those studies as part of a general rate increase request,[23] Staff routinely has disregarded those studies in the depreciation recommendations it makes for MGE. And, when MGE has tried to address this situation by seeking Staff's input prior to conducting its depreciation studies and by soliciting Staff's comments when the studies were completed, the Company has received little in the way of a constructive response to its entreaties. (Sullivan Rebuttal, p. 28)

Another example is the inconsistent manner in which Staff has dealt with the issue of depreciation from one MGE rate case to the next. Over the past decade, the Company's depreciation rates have been reviewed by ***four different Staff witnesses*** who have used ***three different methodologies to determine the Average Service Life*** ("ASL") of MGE's plant and ***four different methodologies to determine net salvage***. (*Id.*) Depreciation rates are supposed to be relatively stable, and although MGE's approach to depreciation and the methodologies it has employed to determine ASLs, depreciation rates, and salvage have remained

[23] 4 CSR 240-2.235 (1)(A).

consistent over time, Staff's approach has changed from case to case. (*Id.*, pp. 27-28) Such wide fluctuations in Staff's position on depreciation issues from case to case make it impossible for the Company to know: 1) what Staff's standards and expectations are with respect to depreciation, and 2) what MGE needs to do to comply.

Finally, MGE is concerned about the inconsistent manner in which Staff treats issues related to depreciation from one Missouri gas company to another. For example, in Atmos Energy Corporation's pending general rate case, Case No. GR-2006-0387, Staff has accepted the rates called for by Atmos's company-specific depreciation study, whereas in MGE's current case Staff has rejected MGE's company specific depreciation study, opting, instead, to use an average of the ASLs from three surrogate companies.[24] Staff's rationale for using the surrogate approach for MGE is that there is not a sufficient database of MGE-specific information to allow Staff to perform a company-specific study or to verify the results of the study the Company itself performed. Yet both Atmos and MGE are in similar situations with respect to the condition of their actuarial data. (*Id.*, p. 26) Moreover, the methodology used to perform Atmos's study – a simulation analysis technique – is the same methodology that MGE employed for its study. (*Id.*, p. 27) The main difference between the depreciation studies conducted by the two companies appears to be that Atmos' study resulted in a reduction in its annual depreciation accrual of approximately $591,000 (*Id.*, p. 25), while MGE's study resulted in a recommended increase of $2,645,707. (*Id.*, p. 3) It thus appears

[24] *Compare* Direct Testimony of Gregory E. Macias, Case No. GR-2006-0422, pp. 5-6, *with* Direct Testimony of Guy Gilbert, Case No. GR-2006-0387, p. 8.

Staff's decision to endorse or reject company-specific depreciation studies is based not on the quality of the study, but, instead, on whether the study results in an increase or decrease in a company's current depreciation rates.

MGE's Proposal Concerning Depreciation Rates. As to the depreciation rates and related expense that are at issue in the current case, MGE's recommendations are based on a company-specific depreciation study that was conducted in 2005 by Black & Veatch Corporation. (Sullivan Direct, p. 2) A summary of the accrual rates that resulted from that study, and which the Company is proposing for adoption in this case, are found in Revised Table 4-2 of Schedule TJS-2, which accompanies the surrebuttal testimony of MGE's witness Thomas J. Sullivan. The most significant changes that the Company is recommending are as follows:

- An increase in the depreciation rate for Account 380 (Services) from 2.70 to 3.41 percent and a reduction in the ASL from 37 to 32 years with an annual net salvage value of $800,000. These changes account for approximately $2,017,349 of the total requested increase of $2,645,707; (Id., pp. 3-4)
- An increase in the depreciation rate for Account 376 (Mains) from 2.27 to 2.43 percent by amortizing the reserve deficiency. This increases annual depreciation expense by approximately $47,440; and (*Id.*, p. 4)
- An increase in the depreciation rate for Account 391 (Office Furniture and Equipment) from 8.06 to 9.09 percent and a change in the ASL from 12 to 11 years which increases annual depreciation rates by approximately $61,964. (*Id.*)

The depreciation study performed by Black & Veatch, and the

recommended depreciation rates and ASLs that resulted from that study, are based on a combination of actual MGE experience and data, consideration of similar experience of ten other Midwestern local distribution gas companies, engineering judgment, and consideration of circumstances unique to MGE. (Sullivan Rebuttal, p. 6) The use of company-specific data as a first step in the process was critical because such data, alone, reflect the actual operating characteristics and history of MGE within its service territory. But, because MGE's database of company-specific information is not as large as that of some other gas utilities, the Company's experts believed it was prudent, as a second step, to compare their MGE-specific results with data developed for ten comparable Midwestern gas distribution companies. This comparison provided a check as to the accuracy and reliability of the MGE-specific results. The results from the first two steps were then further analyzed and refined based on engineering experience and expertise derived from conducting numerous depreciation studies for other utilities and previous experience with MGE. A final check was then performed to make sure the results accurately reflected circumstances that are unique to MGE, such as the Company's Safety Line Replacement Program ("SLRP").[25] The results of this process are ASLs and depreciation rates that reasonably and accurately reflect the actual experience of MGE and its customers.

Staff's Recommendation is Arbitrary and Unreliable. Staff's approach,

[25] The SLRP is the Company's effort to respond to the Commission's requirement that MGE replace bare steel, residential gas service lines and other facilities that were installed prior to 1970. Because of their age, these lines are prone to failure and may, therefore, pose a significant threat to MGE's customers and properties nearby. The Company's aggressive replacement program – which has been much more significant that those of other gas distribution companies in Missouri – coupled with the demographic characteristics of the residences whose lines are being replaced, have impacted the ASLs for Account 380 (Services) and, accordingly, the depreciation rates for that account. See Sullivan Rebuttal, pp. 42-45.

as reflected in the testimony of its witness Gregory Macias, however, is significantly different and, for that reason, significantly less reliable. Staff rejects the use of MGE-specific historical data in favor of averages derived from three surrogate companies: Laclede Gas Company and the Missouri gas operations of AmerenUE and Aquila, Inc. (Macias Direct, pp. 5-6) Staff rationalizes this approach by asserting that there are not sufficient historical data available to perform a company-specific study for MGE. But Staff's assertions are wrong. As evidenced by the Black & Veatch depreciation study itself, there are sufficient MGE-specific, historical data available, provided those conducting the study are willing and able to use special tools and employ non-traditional approaches. (Sullivan Rebuttal, pp. 31-32) The fact that Staff may lack experience with such tools and/or is uncomfortable using new approaches does not justify asking the Commission to settle for results that are second-rate.

But even if the Commission were to consider a surrogate methodology as a reasonable substitute for a company-specific study, Staff's application of the surrogate methodology is fundamentally flawed. First and foremost, Staff's three-company universe is too small to produce reliable results. Of the six local gas distribution companies operating in Missouri, Mr. Macias used as surrogates the three largest. He chose not to use data from Atmos, MGE, and Southern Missouri Gas Company, but never explains why he made that choice. (*Id.*, p. 11) From a statistical standpoint, the smaller the sample size the greater the likelihood of distorted results. And three companies is a very small sample. In contrast, the comparable companies group that MGE used to check the results of its company-

specific depreciation study consisted of ten companies – a universe of surrogates more than three times the size of the one used by Staff.

Staff's decision to exclude Atmos from its surrogate group is particularly curious. Both companies' databases of historical actuarial data are limited, so both companies supplemented historical studies with simulations. And both companies also have rate cases pending before the Commission, which means that Staff had available to it a depreciation study for Atmos that is of recent vintage. Atmos' study, in fact, is based on many of the same non-traditional techniques that were used in MGE's study (*Id.*, pp 25-26) but, as noted earlier in this brief, Staff fully accepted the depreciation rates it produced by Atmos's study, in that company's pending rate case – even though that study was based on the remaining life method, which Staff disfavors – while fully rejecting MGE's study in this case. Yet, despite Staff's acceptance of Atmos' depreciation study, Mr. Macias choose not to use Atmos' depreciation rates for purposes of his surrogate analysis, and he did so without explanation.

An illustration of the distorted results that Staff's second-rate depreciation methodology has produced can be seen in Mr. Macias' recommended salvage value for MGE's Mains account. In calculating a net salvage value of five percent for Mains, Mr. Macias fails to correctly account for reimbursements that MGE receives when it is forced to move its facilities in connection with large highway relocation projects. Such relocations, which often are extraordinary events, can grossly inflate the actual value of MGE's plant if the reimbursements that the Company receives for these relocations are not accounted for properly. In his

rebuttal testimony, MGE's witness Sullivan illustrates how, using Mr. Macias' method for calculating salvage values, the net salvage value of a service main that is taken out of service or relocated due to a highway project could appear to be *five times the original cost of the main*. (*Id.*, pp.45-47) The absurdity of such a result is obvious – except, it appears, to Mr. Macias, whose net salvage estimates are based on the principles and formulas that produced the absurd result.

Additional evidence of how unreasonable Staff's proposed net salvage value for Mains actually is can be found by comparing the salvage value Mr. Macias proposes for MGE with the salvage values for one of his surrogate companies, Laclede Gas Company. The net salvage value for Laclede's steel mains is *negative 15 percent*; for cast iron mains it is *negative 165 percent*; and for plastic/copper mains it is *negative 10 percent*. (*Id.*, p. 50) These compare to a recommended salvage value for MGE of *positive 5 percent*.

Even beyond the unreasonableness of the recommended salvage value itself, Mr. Macias' recommendation reflects a change in the way MGE has historically accounted for salvage. Instead of valuing salvage as a percentage of original investment, the Company traditionally has recorded an annual salvage allowance for Mains of $800,000, and this practice was endorsed by Staff in at least one prior MGE rate case. (*Id.*, p. 49) But now Staff proposes to scrap the Company's method in favor of a percentage-of-investment methodology that is inferior to the Company's method and also grossly overstates the actual salvage value of property booked in the Mains accounts. (Id., pp. 49-50)

For all of the reasons stated above, the Commission should disregard all of

Mr. Macias' depreciation recommendations. However, if the Commission believes otherwise, two changes must be made to his recommendations so that the depreciation rates derived from Staff's analysis reach even the threshold of reasonableness. First, the ASL for Services needs to be reduced to 32 years. And second, the net salvage value for Mains should be set at negative 15 percent.

e. Low Income Weatherization/Natural Gas Conservation

1. Natural Gas Conservation

In his rebuttal testimony, MGE's witness David Hendershot describes several gas conservation initiatives that the Company is willing to undertake if the Commission: 1) approves a residential rate design that neutralizes the financial affect on MGE of fluctuating customer usage, and 2) includes the cost of the conservation initiatives in rates to be set in this case. (Hendershot Rebuttal, p. 2)

The Company's proposed initiatives, which are based on data gathered from the National Action Plan for Energy Efficiency, recognize energy efficiency as a high-priority; make a strong and sustainable commitment to implement cost-effective energy efficiency efforts; promote broad communication of the benefits of and opportunities for energy efficiency; and promote timely and stable funding for a program designed to deliver cost-effective energy efficiency. The details of MGE's proposal are set out in Schedule DH-1, which is appended to Mr. Hendershot's testimony. Broadly, the initiatives focus on two main elements. The first is communication and education regarding natural gas conservation and energy efficiency. The second is a water heater rebate program that is designed to encourage customers to install energy efficient water heaters, thereby potentially

reducing a substantial portion of the usage within MGE's residential service class. (*Id.*, p. 4) In developing its program, the Company considered an additional element – a furnace rebate program – but concluded that adding a third element at this time might compromise the success of the first two. A furnace rebate program can be added later after satisfactory progress has been made in the communication/education and water heater rebate elements. (*Id.*, p. 5)[26]

2. Low-Income Weatherization

Staff supports MGE's proposed initiative, and also recommends that the Commission increase the allowed level of expense for the Company's low-income weatherization program from $500,000 to $620,000 annually. (Ross Rebuttal, p. 5; Noack Surrebuttal, pp. 9-10) In addition, Staff recommends that MGE participate in the evaluation of low-income weatherization that is currently being undertaken by Kansas City Power & Light Company ("KCPL") at an annual cost of $20,000. Because many MGE customers also receive electric service from KCPL, a cooperative effort between the two utilities is cost-effective for both the companies and their customers alike. Staff has proposed that this $20,000 be included in the Company's rates to pay for this effort. (*Id.*) MGE concurs with Staff's recommendation and will be pleased to participate in KCPL's weatherization evaluation, provided funds to cover the cost of that program are included in rates set in this case.

[26] To assure implementation of natural gas conservation programs such as these, it is critical that the Commission adopt MGE's proposed rate design, which would recover all of the Company's fixed costs through a fixed monthly charge. Maintaining the current rate structure, which ties recovery of a significant portion of MGE's cost of service to the volume of gas it sells, serves as a disincentive to both maintaining existing conservation programs and expanding those programs in the future.

The City of Kansas City ("City"), through its witness Robert Jackson, has proposed that MGE be ordered to increase its annual contribution to the City's weatherization program from $250,000 to $617,000. (Jackson Rebuttal, p. 4) Although the Company fully supports the City's program and what it has accomplished, MGE believes the program should be expanded more gradually, and related funding increased more modestly, than Mr. Jackson has proposed. (Noack Surrebuttal, pp. 9-10) Should the Commission conclude otherwise, the Company is willing to support the degree of expansion that the City's witness has proposed, provided funding to support that expansion is included in rates.

f. Environmental Response Fund

MGE's Manufactured Gas Plant Site Costs. In early 1994, Southern Union Company ("Southern Union"), MGE's corporate parent, completed its acquisition of the Missouri natural gas operations of Western Resources, Inc. ("WRI") in a transaction that, after thorough review, approved by the Commission in its Report and Order, dated December 29, 2003, in Case No. GM-94-40. Because the property that Southern Union acquired included several Manufactured Gas Plant ("MGP") sites that were subject to environmental investigation and remediation actions that were being conducted by and under the authority of federal and state regulators, Southern Union and WRI, as part of their transaction, entered into an "Environmental Liability Agreement" ("ELA") to "provide a framework for the liability of the parties for Environmental Claims[27] and for the

[27] As defined by the parties, the term "Environmental Claim" means "any and all administrative or judicial actions, suits, demands, demand letters, directives, claims, liens or notices of noncompliance or violation by any Person alleging potential liability to pay removal, response, remediation or cleanup costs, damages or penalties (including, without limitation,

sharing of Environmental Costs[28] . . .." Generally, the purpose of the ELA was to assign responsibility among insurance carriers, other "Potentially Responsible Parties" ("PRP"), ratepayers, Southern Union, and WRI for costs related to the environmental investigation and remediation activities that would be incurred after the closing of the acquisition transaction.

In the current case, MGE seeks authority to establish and fund an "Environmental Response Fund" ("ERF") that would be used to pay the Company's ongoing costs related to the investigation and remediation of the former MGP sites. The terms and conditions governing the proposed ERF are set out on the second page of Schedule H-25, which accompanies the pre-filed direct testimony of MGE's witness Noack. As specified there, costs payable from amounts accrued in the ERF are:

> All the reasonable and prudently incurred costs associated with evaluation, remedial and clean-up obligations of Missouri Gas Energy arising out of utility-related ownership and/or operation of manufactured gas plants and sites associated with the operation and disposal activities from such gas plants. In addition to the actual remedial and clean-up costs, "Environmental Response Costs" also include costs of acquiring property associated with the clean up of such sites as well as litigation costs, claims, judgments, expenditures made in efforts to obtain insurance reimbursements, and settlements – including the costs of obtaining such settlements – associated with such sites.

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potential liability for investigating costs, cleanup costs, governmental or other response costs, property damage or personal injuries) or to undertake compliance actions arising out of (a) the release or threatened release into the environment of any Hazardous Materials; or (b) circumstances forming the basis of an alleged violation of any Environmental Law; or (c) any and all claims by any third Person seeking damages, contribution, indemnification, cost recovery, compensation or injunctive relief arising out of the release or threatened release of any Hazardous Materials."

[28] As defined by the parties, the term "Environmental Costs" means "all out of pocket costs and expenses (including reasonable attorneys' fees and expenses, but excluding consequential damages) actually incurred to respond to and remediate an Environmental Claim."

For each year the ERF remains in effect, MGE will file an annual report with the Commission, with copies provided to other interested parties, that provides a summary and accounting of all expenditures made from the fund. The Commission and each party receiving a copy of the annual report will then have the right to review and challenge any expenditures that are believed to be unjustified, excessive, or otherwise improper.

The types and size of the expenditures that MGE has made and can expect to make in the future are described in the surrebuttal testimony of MGE's witness Thomas Helfrich, who, during his career as an environmental and geotechnical consultant, has worked on more than 230 MGP sites in eighteen states. Mr. Helfrich notes that from February 1994 through June 2006, MGE incurred approximately $9.9 million in costs related to MGP sites in the Kansas City area. These costs included, but were not limited to: records and historical maps research; excavation test trenching; soil borings; installation of groundwater monitoring wells; laboratory analysis of soil and groundwater samples; evaluation of field and laboratory data; excavation and hauling of contaminated soil and debris; report preparation and submission; risk evaluation; and legal costs. (Helfrich Surrebuttal, pp. 2-3) Mr. Helfrich states that still more expenditures will be required, with additional remediation costs likely to fall within a range of $1 million – $10 million. In addition, Southern Union also has MGP sites, for which MGE may be responsible, in Joplin and Independence that also will require expenditures in the future. (*Id.*, pp. 3-4)

Mr. Helfrich also explains why it is impossible to accurately estimate the

future costs of remediation activities at the MGP sites:

[O]nce the investigative and remedial process has been initiated, the timing of any investigative and remedial activity a MGP sites is subject to numerous variables. . . At a minimum, until the site is fully characterized in the in the investigative process the timing and the scope or magnitude of the remedial activities can not be predicted with certainty. Remedial activities are often conducted in a methodical stepwise fashion as well with one phase of the remedial activity determining the scope and magnitude of the subsequent remedial activity. .

. . .

Another factor that greatly influences the timing and magnitude of any investigative and remedial action is the actions of the state and/or federal environmental agencies which exercise jurisdiction over the MGP sites and regulate the investigative and remedial activities. . . Agency responses can sometimes be delayed for years as agencies prioritize allocation of resources to fulfill their responsibilities . . ..

Another factor that influences the timing and magnitude of the investigation and remediation is land ownership and permitting. . . When MGE is not the owner of land on which the investigation or remediation activities are to occur, it is necessary to obtain access from the respective land owner. . . The time frame and cost associated with this process varies greatly depending upon the landowner can range from a few days at no cost to in excess of six months and tens of thousands of dollars. . .

Regarding the magnitude of MGP investigation and remediation, these MGP sites operated up to 125 years ago and have been lying dormant and generally undetected/unnoticed for up to 100 years in some cases. . . No one can ascertain the magnitude of the investigation and remediation activities until the investigation and remediation activities are conducted . . . Therefore, it is not possible to ascertain the magnitude of MGP investigation and remediation that may be required of MGE with any certainty until the investigation is completed. . . .

(*Id.*, pp. 4-8)

MGE's ERF Proposal. Initially, MGE seeks to fund the ERF with an annual target amount of $500,000, to be collected from customers through a discrete rate element included in the basic service charge. Ongoing funding levels, however, will be determined in each subsequent MGE rate case during the life of the ERF. All amounts collected will be retained in an interest-bearing trust account. In addition,

the ERF will receive: 1) a credit of what remains from a $3 million accrued liability that Southern Union established shortly after the closing of its acquisition transaction with WRI, and 2) one-half of any applicable insurance proceeds or contributions that are received in the future from other PRPs, net of costs incurred to obtain those proceeds or contributions.

The purpose of the ERF is twofold. First, it will provide a fund from which the Company can timely recover at least a portion of the substantial costs that will be incurred in the future as a result of the environmental investigation, any remediation liability that is imposed on MGE, and to pursue contributions from insurance carriers and other PRPs. Second, it will avoid the possibility of rate shock that likely will occur in the future if the Company is required to defer and accrue all of the aforementioned costs until such time as all of the activities related to the MGP sites are concluded.

Although MGE's proposed ERF is not a traditional ratemaking mechanism employed in Missouri, several other jurisdictions have seen fit to adopt similar mechanisms that allow the tracking and payment of costs related to MGP remediation sites. As shown on Schedule MRN-1, which accompanies Mr. Noack's surrebuttal testimony, the list of states that have either approved mechanisms similar to the ERF or included remediation costs in rates through a surcharge or other form of recovery includes California, New York, Illinois, Iowa, and Massachusetts. These states, and others, have recognized that for regulators, who are forced to deal with the lengthy and oftentimes costly problems that attend the environmental remediation of former MGP sites, a fund like the ERF offers

significant advantages to both the Company and its customers while disadvantaging neither.

Staff and OPC each oppose the proposed ERF. The following are among the reasons cited by either or both parties for their opposition:

- In the ELA, Southern Union and WRI agreed that the costs of environmental remediation of MGP sites would be borne by themselves, insurance companies, and other PRPs; (Harrison Rebuttal, p. 5; Robertson Rebuttal, p. 12)

- The costs related to remediation are not "known and measurable"; (Harrison Rebuttal, p. 6; Robertson Rebuttal, p. 20)

- Costs the Company will incur to investigate and remediate MGP sites in the future, or to seek contribution from insurance carriers or other PRPs, are not current costs that should be borne by current ratepayers; (*Id.*)

- Guaranteeing MGE full recovery of its costs associated with the remediation of MGP sites through rates will provide a disincentive to pursue recovery of those costs from alternate sources; (Harrison Rebuttal, p. 6; Robertson Rebuttal, p. 21)

- The Company's ERF proposal constitutes single issue ratemaking and retroactive ratemaking; (Harrison Rebuttal, p. 7)

- MGE has already been compensated for the risks associated with the MGP plants through the rates of return or depreciation rates authorized by the Commission; (Harrison Rebuttal, p. 6; Robertson Rebuttal, p. 21) and

- Because the costs relate to MGP plants that are no longer "used and useful," it would be inappropriate to require ratepayers to pay those costs. (Robertson Rebuttal, p. 21)

None of these objections has merit, however, because they all are based on a fundamental misunderstanding or distortion of the terms of the ELA, a misunderstanding or misapplication of certain principles of ratemaking, or both.

A simple reading of the ELA shows that the parties to that agreement established a clear hierarchy of responsibility for the costs and liabilities associated

with environmental remediation of the MGP sites. Insurers, PRPs, and ratepayers were assigned primary liability, followed by an increment of direct liability for Southern Union, and finally joint liability for Southern Union and WRI, provided certain conditions precedent specified in the agreement were satisfied. Staff's and OPC's argument that the ELA imposed liability for remediation cost on the parties to the agreement, insurers, and other PRPs, but not on ratepayers, is therefore completely unfounded. The ELA was reviewed by all parties to Case No. GM-94-40, and none stated any objection to its terms. Likewise, the Commission's order approving Southern Union's acquisition of WRI's Missouri gas properties does not object or take exception to the allocation of liability that is contained in that agreement.

The Costs will be Known and Measurable at the Time Disbursements are Made. The arguments of Staff and OPC that the MGE-related remediation costs are not "current" or "known and measurable" also provide no reasonable basis for rejecting the ERF. The ERF is designed to hold funds in trust that will be used to pay expenses that, although not currently known or measurable, will be both at the time they are paid. As is clearly expressed in MGE's proposal, only costs actually incurred will be drawn from the fund. The withdrawals will not be made until after the costs are incurred – when they are both known and measurable – and they will be fully subject to review and challenge as to their prudence and reasonableness. In addition, the true-up and refund provisions of MGE's proposal assure that any funds that remain in the ERF when all remediation activities have been concluded will be returned to ratepayers. Thus, MGE has built

into the proposed ERF all of the ratepayer protections inherent in the "known and measurable" standard. (Noack Surrebuttal, p. 12)

Staff's and OPC's argument that the ERF provides a disincentive for MGE to seek recovery of its costs from sources other than ratepayers is also invalid because it, too, ignores the fact that all withdrawals from the ERF are subject to review for prudence. If, based on that review, a party believes that the Company failed to aggressively pursue cost contribution from insurers, other PRPs, or WRI, then that issue can be taken to the Commission who has the authority to reduce or negate the withdrawal. (*Id.*, p. 14)

The ERF does not Constitute Single Issue Ratemaking. The argument that approval of the ERF constitutes unlawful single issue ratemaking is also wrong. The Company's proposal to establish and fund an ERF is being presented in the context of a general rate case where the Commission will consider and decide all aspects of MGE's cost of service, including the appropriate rate of return. If approved by the Commission, the funds in the ERF will be held in trust pending conclusion of all MGP-related remediation activities, so even if the ELF is over-funded from time to time that fact will not affect the Company's earnings in any way. Moreover, the Commission has a history of approving cost recovery mechanisms, like the PGA, that are akin to the ELF in that they provide for controlled, carefully scrutinized, and audited recovery of future costs that will be incurred in amounts that are currently unknown. Just as those mechanisms do not constitute single-issue ratemaking, neither does the proposed ELF.

Finally, there is no evidence that MGE's shareholders have already been

compensated for future risks and costs associated with the MGP-related remediation activities. Depreciation rates, which theoretically provide for a return *of* investment made for the public service, do not include costs of potential environmental liabilities in their asset valuations, so plant that is fully depreciated returns only the value of the asset to the shareholder and not the costs of any environmental liability that may be related to that asset. And there is no evidence that this Commission has ever adjusted the rate of return that it has authorized for MGE to compensate the Company and its shareholders for the increased risks associated with MGP-related liability and remediation costs.

MGE's proposal to establish and fund an ERF to pay the ongoing costs associated with environmental remediation of MGP sites in Missouri reasonably and responsibly balances the interests of both the Company and its customers. By providing a pool of funds that the Company can use to help defray future costs related to remediation, the Commission will help safeguard MGE's financial integrity. At the same time, it will avoid future rate shock to customers that will likely result if MGE is forced to accumulate all costs related to its liability for MGP remediation and then pass on those costs to customers at one time.

g. Infinium Software Amortization

In 2005, MGE discontinued use of certain general ledger and related financial reporting capabilities of the Infinium software system, which it had employed for several years. The Company, however, continues to use various of the other capabilities of that system. (Mapeka Rebuttal, pp. 6-7; Noack Surrebuttal, p. 17) Although MGE has fully recovered through rates the original cost of the

Infinium software, $1,225,756 in costs related to updating and maintaining the capabilities of the system that continue to be used remain on the Company's books. In the direct testimony of Mr. Noack, MGE proposed to amortize this balance over three years. (Noack Direct, p. 18) But, in response to the suggestion of Staff's witness Mapeka that the balance be amortized over five years instead of three (Mapeka Rebuttal, p. 7), the Company has elected to change its position to that of the Staff. (Noack Surrebuttal, p. 17) Both MGE and Staff, therefore, now recommend a five-year amortization of the remaining Infinium costs.

The OPC, however, opposes the Commission granting MGE the authority to collect any of the remaining Infinium costs. The OPC's position is that the software is no longer "used and useful." According to OPC witness Robertson, recognized principles of ratemaking and law prohibit MGE from recovering costs associated with the Infinium system. (Robertson Rebuttal, pp. 23-25) But OPC's position is based on errors of both fact and law. As noted earlier, the Company continues to use portions of the Infinium software in its day-to-day activities. Therefore, to the extent that concept of "used and useful" even applies to this issue, the Infinium software is used by the Company and is useful to it in fulfilling is obligation to provide service to its customers. But the regulatory concept of "used and useful" is not applicable to this issue because that concept applies to items of rate base for which a rate of return is being sought. That is not the case here. MGE is not seeking to retain costs associated with the Infinium system as an asset in rate base so that it can earn a return *on* the fair value of that asset. Instead, the Company merely seeks a return *of* the investment it made in the Infinium system,

an investment that relates to functions of the system that continue to provide value to MGE's customers.

As noted in Mr. Noack's surrebuttal testimony, the kind of regulatory treatment that MGE is requesting is something the Commission has endorsed in the past. During the 1980s and 1990s, when telephone switching equipment changed from mechanical to digital, the Commission often faced the situation where the cost of mechanical equipment that was being replaced had not been fully recovered. The only way to rectify that situation was to authorize the telephone company to set up an amortization to recover the balance of its investment. One example of a case where the Commission approved such a recovery was the Report and Order issued in Case No. TR-98-343, Mid Missouri Telephone, where a five-year amortization of the unrecovered switching investment was authorized. (Noack Surrebuttal, pp. 18-19)

Because the OPC's position on this issue is based on errors of both fact and law, that position should be rejected. Instead, the Commission should adopt the recommendation of MGE and Staff that the unrecovered costs associated with the Infinium software system be amortized and recovered over a period of five years.

h. Emergency Cold Weather Rule AAO Recovery Mechanism

By its order dated December 21, 2005, in Case No. GX-2006-0181, the Commission approved an emergency amendment to the Cold Weather Rule, 4 CSR 240-13.055, which contained special provisions applicable only to providers of natural gas service to residential customers. Specifically, the emergency rule provided for additional repayment plans for customers who used natural gas for

home heating but were unable to pay up to eighty percent of their pre-existing bills under the previous rule.

The more liberal payment and reconnection provisions of the emergency rule raised the specter of increased levels of bad debt for Missouri's natural gas utilities. In recognition of this fact, On September 21, 2006, the Commission issued an order granting MGE's request for an Accounting Authority Order ("AAO") that authorized the Company to maintain a regulatory asset on its books for costs related to complying with the emergency cold weather rule. In accordance with that rule, MGE accumulated a balance of $901,331 on its books as of June 30, 2006, which represents the difference between what it would have collected and what it actually collected from 2,976 customers whose service was reconnected under the emergency rule but was later disconnected for non-payment of bills. (Harrison Rebuttal, pp. 16-17)

Staff has audited and verified the amount of the regulatory asset related to the emergency cold weather rule that MGE has recorded on its books, and Staff is proposing that the full amount of that asset be amortized and collected from customers over a period of three-years. (*Id.*, p. 17) Consequently, there is no dispute as to the appropriateness of the Company's proposal.

The OPC did not state a position regarding this issue in any of its pre-filed testimony in this case. If OPC takes a position during the hearings in this case, MGE will respond to that position in the Company's post-hearing brief.

V. RATE DESIGN AND MISCELLANEOUS TARIFF LANGUAGE

a. Rate Design

MGE witnesses Ronald J. Amen[29] and Russell A. Feingold have provided the Commission with testimony on the very important issue of rate design, as have Staff witnesses Tom Solt and Anne Ross and Public Counsel witness Barbara Meisenheimer. The overwhelming weight of the evidence demonstrates that – in order for MGE to be afforded the reasonable opportunity to achieve its authorized return to which it is legally entitled – an innovative rate design proposal recommended by MGE and Staff should be approved by the Commission in this proceeding and Public Counsel's proposal to maintain the traditional rate design must be rejected as a concept that has been proven to fail.

With regard to the allocation of any revenue increase, MGE's witnesses considered various criteria in order to recommend an appropriate apportionment of revenues among the rate classes, thereby deriving a reasonable balance between competing interests. Cost of service, class contribution to present revenue levels, and customer impact considerations were all taken into account, and these criteria were evaluated for each rate class. Ultimately, MGE proposed adjustments to class revenue levels so that the proposed rates would move class revenues closer to the costs of serving those customers. (Feingold Direct, p. 16)

MGE, Staff, MGUA, Central Missouri State University, the University of Missouri, Kansas City and the County of Jackson have agreed and jointly

[29] MGE witness Amen, a Director with Navigant Consulting, Inc., presents to the Commission the results of the retail natural gas cost of service study conducted by Navigant Consulting and will discuss the underlying methodology and basis used in the Company's gas cost of service study. Mr. Feingold relied on the results of Mr. Amen's study in making his rate design proposals to the Commission

recommend that any revenue increase authorized by the Commission should be spread among the rate classes on the basis of an equal percentage of current non-gas revenues. This agreement has been presented to the Commission in the form of a Partial Nonunanimous Stipulation and Agreement filed on December 8, 2006. Although MGE does not accept the cost of service studies presented by Staff or the Public Counsel, MGE agrees, for purposes of settlement, with the equal percentage revenue spread as a fair disposition of this issue for purposes of this case. (Feingold Rebuttal, pp. 5-6)

MGE's SFV Rate Design Proposal. MGE, through its witness, Russell Feingold,[30] has set out two proposals for the Commission's consideration. The Company's primary and preferred rate design proposal establishes a Straight Fixed-Variable ("SFV") rate structure for the residential class and the continuation of the "traditional" rate structures for the SGS, LGS, and LVS rate classes. The alternate proposal consists of a Weather Normalization Adjustment ("WNA") mechanism applicable to the Company's residential, SGS, and LGS rate classes. This alternate proposal is designed to adjust the Company's volumetric rates on a monthly basis to account for changes in weather from the normal levels established in the Company's current rate case and to make more modest changes in the levels of the Company's fixed monthly rate elements for the

[30] MGE witness Feingold is the managing director of Navigant Consulting, Inc., a firm which has been serving the electric and natural gas industries since 1983. Mr. Feingold is the co-leader of the Litigation, Regulatory & Markets Group within the firm's Energy Practice. The firm focuses on large, regulated industry segments and provides consulting services to assist clients in identifying practical solutions to the challenges of uncertainty, risk and distress. (Feingold Direct, p. 1)

residential and SGS rate classes compared to the levels reflected in the Company's primary proposal. (Feingold Direct, p. 5)

Under the SFV rate structure, residential customers will simply pay a flat monthly fee for the delivery services provided by MGE and will continue to pay for the amount of gas commodity used each month on a volumetric basis through the PGA. (Feingold Direct, p. 19) The SFV rate structure is characterized as such because all fixed costs incurred by the utility are recovered from customers through fixed charges, while all variable costs are recovered through variable charges. This pricing concept is new to Missouri LDCs, but it has been used in the interstate gas pipeline industry for many years, and, more recently, it has been adapted for use by gas distribution utilities. (Feingold Direct, p. 20) An SFV rate structure helps to achieve a fundamental objective of ratemaking – the proper alignment of costs with revenues and rates.

The Company is proposing a rate design change at this time because the current "traditional" rate structure in effect for MGE has been proven to be inadequate to address major business challenges gas utilities such as MGE – weather variability, declining use per customer, high and volatile wholesale natural gas prices and resulting increases and volatility in customer bills. (Feingold Direct, p. 5) These factors challenge the ability of customers to manage their energy needs and result in serious challenges to the financial integrity of the Company. (Feingold Direct, p. 5) In order for MGE to have a reasonable opportunity to achieve its Commission-authorized return and compete with some meaningful likelihood of success for the capital it needs to continue operating its distribution

system for the benefit of its customers, MGE must be given a meaningful ability to address these challenges.

As is explained by MGE witness Michael Noack, MGE has experienced chronic and continuing earnings shortfalls. For example, Schedule H-21 demonstrates the volumetric revenue shortfall suffered in January, February, and March of 2006 due to the shortfall in actual average usage per customer when compared to the average usage as determined in the Company's prior rate case. Additionally, Schedule G-4 demonstrates that in each fiscal year from 1996 through 2005, the Company's achieved rate of return was well below the Commission-authorized rate of return. The fixed cost nature of the gas distribution business and a consistent track record of volumetric revenue-driven earnings shortfalls demands a new approach to the ratemaking process so that MGE will have a reasonable opportunity to recover its costs of providing gas delivery service and achieving its Commission-authorized earnings level.

The rate design proposed by MGE in this case is fully cost-based, equitable, and beneficial to the Company and its customers. Under the SFV rate structure, when it is colder than normal, customers do not overpay for the fixed costs, and the Company does not over-recover the approved margin; when it is warmer than normal, customers do not underpay, and the Company does not under-recover the margin. (Feingold Direct, p. 36) Under the SFV rate design for the residential class, the Basic Service Charge will be $27.50/month (based on a number of assumptions, including an overall revenue increase of $41.7 million). The Commodity Charge is eliminated, and the Company's fixed costs of natural gas

delivery service will be recovered from these customers through a single, fixed monthly charge. (Feingold Direct, p. 36)

In addition to affording benefits to MGE, this fixed monthly charge results in numerous benefits for MGE's customers. For example, although the rate design will increase the average customer's bills in the Summer months, the rate design will decrease or moderate the increase in a customer's bills in the winter months – the time period when customers' usage and gas bills are highest and, accordingly, when most difficulties in paying gas bills arise. The practical effect of the SFV rate design is to moderate seasonal variability in the amount of a customer's bill.[31] Accordingly, MGE expects many of its customers will react favorably to this change. The pricing of the Company's gas delivery services using the proposed SFV rate design properly portrays to MGE's customers the fixed nature of the costs, the delivery-only characteristics of the service MGE provides, and the fact that natural gas is the real commodity being purchased. (Feingold Direct, pp. 38-40) Additionally, if the Commission adopts the SFV rate design recommended by MGE and endorsed by the Staff for the residential class, MGE's recommended return on equity would be reduced by 25 basis points, producing a revenue deficiency of $36,449,902 instead of the $37,533,421 which is the case in the absence of any meaningful protections from the weather variations. (Noack Surrebuttal, pp. 24-25)

The Company and the Staff are in conceptual agreement on the rate design that is most appropriate for MGE's residential customers – a SFV type of rate

[31] This nicely compliments MGE's level pay options being promoted by the Company. (Hack Direct, p. 7)

structure. Staff has not, however, applied the principle of recovering fixed costs through a fixed charge for the SGS class. The failure to include the substantial fixed costs attributable to the SGS class is a significant shortcoming in Staff's SFV proposal and, consequently, does not fully address MGE's chronic and continuing volumetric revenue shortfalls. (Feingold Rebuttal, pp. 17-18)

Public Counsel's Status Quo Proposal Represents a Demonstrable Policy Failure. Public Counsel, on the other hand, for its initial position on this issue has proposed that there be no change to the current level of the monthly customer charge for MGE's residential customers, that is, one that would put the Company in the position of trying to recover its fixed costs primarily (and the entirety of whatever revenue increase is authorized in this case) through the volumetric rate component. Public Counsel's recommendation appears to be premised on the assumption that low-income residential customers are low-use customers and, consequently, an increase in the fixed customer charge will disproportionately affect them. (Meisenheimer Rebuttal, pp. 5-6). This assumption is flawed. MGE has sponsored a study showing that usage actually decreases as income rises until the level of annual income reaches the $45,650 to $73,945 level at which time usage begins to increase. (Thompson Rebuttal, p. 9; Schedule PBT-2). This means loading any rate increase on the volumetric rate elements, as proposed by Public Counsel, actually will cause low-income customers to bear a greater increase than middle-income customers. In rebuttal testimony, OPC appears to modify its initial proposal modestly by suggesting that it would find acceptable a residential rate design that maintains the existing proportion of fixed

versus volumetric rate revenue of 55:45, respectively. (Meisenheimer Rebuttal, p. 27) This is *deja vu* all over again. In its last rate case, Case No. GR-2004-0209, MGE sought to change its rate structure to shift some of its revenue from volumetric rate elements to fixed monthly rate elements to address chronic earnings shortfalls caused by decreasing customers usage due to warmer than normal weather. Public Counsel opposed any increase in the customer charge. Ultimately, the Commission decided to maintain the then existing ratio for the residential class of 55% of revenues through fixed monthly rate elements and 45% of revenues through volumetric rate elements. What was the result? Warmer than normal weather caused customer usage levels to drop and MGE fell far short of its authorized earnings level. In the first three moths of 2006 alone average per-customer residential usage fell 27.36% short of assumed usage when MGE's rates were set in 2004, an amount totaling nearly $11,000,000. (Noack Direct, pp.21-22; Schedule H-21). For calendar year 2005, the margin shortfall was over $6,000,000. (Feingold Direct, Schedule RAF-9). With respect to this modest concession on the part of OPC, MGE has "been there, done that" and the results were a demonstrable failure of significant magnitude. There is no reason to believe the same approach in this case will yield a different result.

Either OPC proposal represents nothing more than the *status quo* (or worse) and is seriously deficient and should be rejected by the Commission for a number of important reasons, including that:

- it ignores the significant volumetric revenue-driven earnings shortfalls that MGE has consistently experienced over many years;

- it will not reflect the true costs of serving the Company's residential customers;
- it will perpetuate the intra-class cross subsidies that exist within the residential class;
- it will cause more customers to overpay by a greater amount for gas service during colder than normal periods;
- it ignores the ratemaking initiative embodied in the enactment of Senate Bill 179 and the grant to the Commission of the authority to approve ratemaking mechanisms that address the problem of margin revenue losses; and
- it will not provide an appropriate ratemaking foundation for the Company to offer energy efficiency and conservation programs for the benefit of its customers. (Feingold Rebuttal, pp. 4-5, 19-25) A fundamental presumption of either Public Counsel residential rate design proposal is that a volumetrically weighted rate design provides the most appropriate price signals to customers related to gas consumption, and this simply is not true. (Feingold Rebuttal, pp. 25-26)

In addition to the deficiencies noted above, the bottom line is that Public Counsel's *status quo* proposals represent a demonstrably failed policy. With its rate design recommendations in this case, Public Counsel simply has ignored the serious problems the Company has consistently experienced for more than a decade regarding declining gas use and weather variability and the resulting inability to recover its fixed cost of service previously approved by this

Commission. Additionally, Public Counsel's proposal is heavily biased in favor of the low usage residential customer at the expense of higher than average usage residential customers and the Company's financial health. (Feingold Surrebuttal, p. 8) It also is counterproductive in that it will discourage MGE from promoting natural gas conservation programs because its profitability will remain dependant on greater fuel usage by its customers.[32] This "traditional" rate design advocated by Public Counsel has outlived its usefulness in an era of unprecedented high natural gas prices. It is clear that the Commission should reject Public Counsel's rate design proposal.

MGE's Alternative WNA Rate Design Proposal. In the event the Commission does not adopt a SFV type rate design as proposed by the Company and Staff, MGE has provided the Commission with an alternative. Under the Company's alternate rate design proposal (use of a WNA mechanism), the current rate structure for the residential class was maintained with the proposed Customer Charge set at $15.50/month, and a Delivery Charge designed to recover the balance of the assigned revenue increase for that class. The proposed Customer Charge for the SGS class is set at $20.50/month. For both of these classes, the primary objective is to move the monthly customer charges toward the fixed costs of delivery service – consistent with the results of MGE's cost of service study discussed above. (Feingold Direct, p. 43)

[32] In this case, MGE has proposed specific natural gas conservation initiatives for homeowners subject to two conditions, one of which is that the Commission adopts a residential rate design that "leaves MGE financially indifferent to volumes consumed by residential customers. . ." (Hendershot Direct, p. 2). This illustrates that the disincentive for MGE to promote conservation in such circumstances will be removed.

The proposed WNA mechanism will remedy some of the same problems the Company would like to address with its proposed SFV rate design proposal, although it will not address the problem of declining use per customer caused by factors other than weather. (Feingold Direct, pp. 55-56) Some of the specific reasons behind MGE's selection of the WNA mechanism as an alternate solution are outlined on pages 44 and 45 of Mr. Feingold's direct testimony. The process to be followed each month to calculate the WNA is set forth on pages 49 and 50 of Mr. Feingold's direct testimony, and the appropriate tariff sheets to implement the proposal are presented in Schedule RAF-12.

The Legal Standard that should Guide the Commission. The Commission's power to set rates is anchored in the fact that private property is dedicated to a public use. Otherwise, the Commission has no authority whatsoever. *State ex rel. Danciger Co. v. Public Service Commission*, 205 S.W. 36, 40 (Mo. 1918). That statutory authority, found in the Public Service Commission Act, carries with it the solemn obligation to fix rates that provide for reasonable compensation for service rendered including a fair return on the value of the company's property used in the public service. *State ex rel. Missouri Water Company v. Public Service Commission*, 308 S.W.2d 704 (Mo. 1957). The Commission has long recognized this principle in setting rates for gas utilities. *See*, *Re Missouri Public Service Co*., 17 Mo. P.S.C. (N.S.) 87 (1972); *Re Missouri Power & Light Co*., 1 Mo. P.S.C. (N.S.) 178 (1947). Importantly, it is not the methodology or theory that matters. Rather, it is the actual impact of the rate order that determines whether the rates being established by the process are just,

reasonable and lawful. *State ex rel. Associated Natural Gas Co., v. Public Service Commission*, 706 S.W.2d 870, 879 (Mo.App. 1985) [citing *Hope Natural Gas*, 64 S.Ct. 281, 288 (1944)]. Measured against the foregoing legal standards, MGE's existing rates are clearly insufficient because the impact of those rates is that MGE has **NEVER** achieved its authorized earnings level.

It is time to implement a proposal in the nature of MGE's proposed SFV rate design or alternate WNA rate design. The traditional gas utility ratemaking process – a static process that relies on historically based assumptions of customer gas usage and weather – is simply no longer doing its job. With today's highly uncertain and volatile gas commodity pricing – an environment of which the commissioners are well aware -a historically-based assumptions seldom reflect the actual gas usage levels and weather patterns experienced by a utility in any subsequent twelve-month period. The traditional approach of heavy reliance on volumetric rate elements to recover fixed costs is counterproductive in an environment wherein reduced natural gas use should be a priority to MGE and its customers. A more dynamic process is required in order for MGE to actually recover the Commission-approved cost of service and have a reasonable opportunity to achieve its authorized earnings level. (Feingold Direct, p. 22)

There are two key assumptions inherent in the use of a test year for purposes of establishing a gas utility's base rates: (1) that a test year represents a snap shot in time that reflects a level of plant and expenses which will be representative of the period the new rates will be in effect; and (2) that the utility's costs in a future period can in fact reasonably be represented by its historical costs

or, as in this case, its forecast of future costs. In reality, however, many of a utility's costs are unpredictable, unstable, and uncontrollable. (Feingold Direct, p. 27)

For example, so-called normal temperatures seldom, if ever, occur. Yet, with traditional ratemaking, a utility only has a reasonable opportunity to fully recover its fixed costs of service at established levels if actual temperatures are "normal." (Feingold Direct, p. 24) Additionally, MGE has experienced a substantial decline in gas use per customer. Not unlike other gas customers throughout the United States, customers of MGE have shown a material reduction in their gas consumption. (Feingold Direct, p. 28)

Looking to past rate cases, the Company's baseline use per customer levels have not been representative of the actual use per customer experienced in subsequent years. The baseline use per customer level for MGE's residential class has always been high relative to the actual usage amounts. Accordingly, MGE's collection of margin revenues was low relative to the levels approved by this Commission. (Feingold Direct, p. 29) If this trend continues, base rates will never allow MGE to properly recover the fixed costs incurred to provide its customers with gas delivery service. Total volumetric revenue shortfalls during the last seven years amount to almost $42 million, and this type of under-recovery of fixed costs is not unique to MGE. (Feingold Direct, pp. 31-32) This problem has been solved or mitigated for a growing number of gas utilities, as is discussed below, but this serious problem continues to impact MGE's financial performance and the natural gas bills of its customers.

This revenue shortfall problem has received much attention from state utility regulators over the last five or six years. As outlined in the direct testimony of Mr. Feingold, to mitigate the variability in revenues caused primarily by weather and declining use per customers, the following ratemaking solutions have been implemented: (1) revenue decoupling mechanisms that adjust for changes in usage caused primarily by weather and energy conservation; (2) weather normalization adjustment mechanisms that adjust rates for changes in usage caused by weather; (3) monthly customer charges that more fully reflect the gas utility's fixed costs of providing delivery service (including SFV rate structures); and (4) a measure of "normal weather" that is an accurate predictor of the weather expected in future years and a reasonable basis for deriving a gas utility's normalized sales volume in its rate case. (Feingold Direct, pp. 32-33)[33]

The legal basis for approving the Company's proposal is clear. The Missouri General Assembly has granted the Commission the authority to approve ratemaking mechanisms for gas utilities that address the problem of margin revenue loss. In the opinion of Mr. Feingold, the two ratemaking mechanisms which best meet the apparent intent of Senate Bill 179 and RSMo. §386.266 are WNAs and revenue decoupling mechanisms. (Feingold Direct, p. 33)

Summary. As virtually all of MGE's margin consists of fixed costs, and because the Basic Service Charge under the Company's proposed SFV rate structure for residential customers is designed to recover 100 percent of those fixed costs, the Company's ability to recover its Commission-approved level of

[33] The appropriate measure of weather normal was addressed in more detail in §III.a., *supra*.

margin through base revenues no longer will be subject to the ongoing fluctuations in customer usage caused by weather, energy conservation, and energy efficiency activities. (Feingold Direct, p. 35) MGE's customers will benefit as well by less seasonal variability in their gas bills and, in many instances, by lower yearly gas service costs. Rates should be more stable as well because MGE will not be forced to file for frequent rate increases to address systemic margin losses. Severing revenues from usage also will encourage gas conservation initiatives which will further benefit MGE's customers.

MGE's rate design proposals are no free ride for MGE as Public Counsel suggests. The Company's ability to earn a reasonable rate of return on its investment will, of course, continue to be impacted by how well management can control its costs of providing delivery service. (Noack Surrebuttal, pp.3-4). As was conceded by the Office of the Public Counsel, no matter the rate design, "risk falls back onto management actions" and "ROE is not ever guaranteed." (Trippensee Deposition, p. 27, lines 9-13) Contrary to the opinions expressed in Public Counsel witness Meisenheimer's prepared testimony, MGE's rate design proposals will not "eliminate earnings uncertainty" for the Company. MGE will still need to manage its costs to the levels approved by the Commission, if the Company is to have a reasonable opportunity to achieve its allowed ROE.

In summary, the benefits of implementing a SFV rate design for MGE are many and compelling.

- There will be less seasonal variability in customers' bills. In particular, it will lower Winter bills.

- It removes the disincentive for MGE to actively promote natural gas conservation and the Company's PGA will retain the incentive for customers to conserve on natural gas usage.
- The overall revenue requirement will be over $1M lower with the SFV rate design than in a "traditional" rate design.
- MGE's customers will find their bills easier to understand.
- MGE will be able to file fewer rate cases and thereby lower costs to its customers and free Company management to focus on its principal mission which is to provide safe and reliable gas service to its customers.
- The SFV rate design will send the correct price signals to customers because it is anchored in the actual cost of providing service.

b. The Seasonal Disconnect Tariff Language Proposed by MGE (Sheet No. R-13 should be Approved

MGE has proposed that any customer who voluntarily requests a disconnection of service, and then subsequently requests a reconnection of service at the same address or premise within the next seven (7) months, be charged a reconnection charge equal to the greater of the current $45 reconnection charge or a charge equal to the number of months the service was disconnected, up to seven (7) months, times the basic service charge. (Noack Direct, p. 27; Rebuttal, p. 10)

In response to a suggestion from Staff, MGE has changed its original proposal slightly in order to institute a two-component reconnection charge. First, MGE would charge the traditional reconnection charge plus the monthly Customer charge (in today's environment) or secondly the Delivery Charge (in the proposed

environment) that was foregone during the disconnection period. (Noack Rebuttal, p. 11).

MGE is not advocating an increase in the reconnection charge for customers who have been disconnected involuntarily. MGE does not wish to increase charges for customers who have been disconnected for non-payment or are otherwise having trouble paying their utility bills. For that reason, MGE does not agree with Staff's proposal to apply the disconnection fee with no exceptions. This proposed new charge is to allow MGE to recover its costs associated with voluntary disconnections and to provide a disincentive to customers who disconnect during the non-heating months simply to avoid paying the Basic Service Charge during those months. (Noack Rebuttal, p. 12)

In summary, MGE recommends adoption of the proposed disconnection fee. The resulting tariff language, taking into account MGE's adoption of one change proposed by Staff, would read as follows:

> In the event a customer orders a disconnection and a reconnection at the same premises within a period of seven (7) months, Company will collect, as a reconnection charge, the sum of such minimum bills as would have occurred during the period of disconnection plus the reconnection charge provided for in Section 14 herein.

In his Rebuttal Testimony, Staff witness Ensrud states that, "Staff believes that MGE deserves a chance to demonstrate the effectiveness of its proposal." (Ensrud Rebuttal, p. 2) Thus, this is no longer an active issue as between MGE and Staff.

I. MISCELLANEOUS

a. The Commission should not Order Staff's Proposed PGA Language to be put in MGE's Tariffs

Staff has recommended that language be added to MGE's PGA tariff requiring the Company to provide documentation to Staff which supports its gas procurement activity applicable to each ACA period. The tariff language would require that all documentation concerning the Company's gas purchasing decisions for the ACA period be submitted to Staff. (Allee Direct, p. 5)

MGE does not agree with this proposal. MGE currently provides the workpapers used to prepare the annual ACA filing to the Staff at the time it makes that filing. Other information requested by Staff customarily is supplied in response to data requests on a timely basis. Staff has not alleged that the documentation currently provided by MGE is inadequate, that the annual filings MGE makes to true-up its gas costs and revenues is insufficient or that MGE is not properly planning for its future gas needs. If the Staff believes that MGE should be required to provide additional information with its ACA filing, whether this requirement is to be documented through a tariff sheet or in some other fashion, MGE believes that the Staff should initiate a rulemaking for that purpose which would apply to all of the LDCs in the State of Missouri and not through a proposal that burdens only MGE. This rate case is not the appropriate forum in which to impose this type of requirement. (Noack, Rebuttal, p.5)

In Case No. GR-2004-0209, the Commission addressed a similar request from Staff that MGE undertake additional recordkeeping concerning merger and acquisition activities and found that the rate case was not the proper forum for

resolution of such a request. The Commission found that Staff or any other party could obtain information through the Commission's commonly used discovery methods. (Report and Order, p. 67)

b. The Kansas Property Tax AAO should be Continued Past the Expiration Date Ordered by the Commission in Case No. GU-2005-0095.

Pursuant to the Accounting Authority Order ("AAO") authorized in Case No. GU-2005-0095, MGE has deferred a total of $3,422,206 of Kansas property taxes for the years 2004 and 2005. The issue of whether property taxes should be assessed on stored gas has been appealed and is still pending in the Kansas Supreme Court. The Company does not expect a decision from the Kansas court anytime in the near future. Based upon the prior order of the Commission, MGE will only be allowed to defer property taxes on gas in storage until the end of 2006 before amortization of the balance must begin. MGE does not expect a final court decision to be issued before the end of the current year. MGE is requesting that the Commission continue the deferral until such time as MGE concludes its next general rate proceeding before having to begin amortization. (Noack Direct, p. 20)

Staff has recommended that the Commission grant MGE the authority to continue deferring these costs through the end of an additional year (2007), or until a final decision is issued by the Kansas courts, whichever occurs first and suggests that this authority be included in the Commission's Report and Order issued in this proceeding. (Mapeka Direct, p. 26) Public Counsel, on the other hand, continues to believe that the AAO deferring the taxes should never have been issued and that it should not be continued in this proceeding. (Robertson Direct Testimony, pp. 18-22).

Public Counsel's position on this issue, if adopted by the Commission, would serve as a disincentive for companies to pursue cost saving measures. For example, if MGE had not challenged the State of Kansas' attempt to levy property taxes on gas held on MGE's account in Kansas, there would be no basis to challenge the inclusion of these taxes in customer rates which would be higher as a result. MGE's appeal of this tax will serve to benefit customers if successful. MGE should be allowed to continue the deferral until such time as MGE concludes its next general rate proceeding before having to begin amortization.

c. Policy

The important policy considerations from MGE's perspective are addressed in the Introduction, Section I of this brief. Those considerations are incorporated herein by reference.

VII. CONCLUSION

The success of the Commission's ratemaking policies and practices can be measured by its ultimate result. The record in this case shows beyond question that the ratemaking process for MGE has not worked and cannot reasonably be expected to work if a business-as-usual approach is used. MGE has consistently failed to achieve its authorized return on investment despite the fact it is operated efficiently and safely. Simply put, there is no way MGE can be operated as a successful enterprise if its capital costs are understated, when assumptions as to "normal" weather consistently miss the mark by assuming that temperatures during the time the rates will be in effect will be much cooler than reasonably can be expected (particularly when the recovery of its fixed, unavoidable network costs

are significantly dependent on throughput volumes), when legitimate expenses are understated or disallowed, and if it is compelled to return past gains (while ignoring past losses). The time for change has come.

MGE has shown that its proposals to achieve success for itself and its customers are fact-based, principled and reasonable, both from a policy and practical perspective. The Company urges the Commission to adopt MGE's proposals and adjustment as fully consistent with the regulatory obligations to ensure that the Company is fully and fairly compensated for the property it has dedicated to the public service.

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CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the above and foregoing document was electronically transmitted, sent by U.S. Mail, postage prepaid, or hand-delivered, on this 18th day of December, 2006, to:

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