I. REVENUE REQUIREMENT

A. Cost of Capital

Capital Structure: What capital structure should be used for determining MGE's rate of return?

***Staff Position*: It is Staff's position that a hypothetical capital structure should be used based upon the average capital structure of the proxy group because recent Southern Union financing activities prove that Southern Union does not manage the financing of the natural gas distribution utility operations separate from that of its other non-natural gas distribution utility operations.**

Return on Common Equity: What return on common equity should be used for determining MGE's rate of return?

***Staff Position*: It is Staff's position that the appropriate return on common equity is 9.25% to 9.75%, midpoint 9.50%, based upon its analysis of a proxy group of seven LDCs using a constant-growth discounted cash flow (DCF) model, checked against a capital asset pricing model analysis of the same proxy group and corroborated by other significant evidence.**

Cost of Debt: What cost of long-term debt and short-term debt should be used for determining MGE's rate of return?

***Staff Position*: It is Staff's position that the cost of long-term debt and short-term debt should be based upon the average costs experienced by the proxy group, insofar as those are known, updated in the same manner as the other components of the capital**

structure. Those values are 5.92% for long-term debt and 1.00% for short-term debt.

B. Risk: Would the Commission's adoption of MGE's proposed rate design that recovers all non-gas costs in a fixed customer charge for Residential and SGS customers reduce MGE's business risks? If the answer is "yes," should that reduced risk be recognized in the determination of either cost of capital or the revenue requirement?

***<u>Staff Position</u>*: Yes continuation of MGE's current rate design does reduce the Company's business risk. The reduction in risk is reflected in Staff's recommendation.**

C. Expense Issues

Environmental Expenses: What amount related to Former Manufactured Gas Plant (FMGP) remediation should be used in determining MGE's cost of service?

***<u>Staff Position</u>*: Staff generally supports inclusion in rates of environmental remediation costs imposed upon utilities by law or regulation, except in cases of negligence or imprudence. Staff recommends that MGE's rate recovery in this case for environmental remediation costs be limited to no more than $941,500. In reaching this recommendation Staff has taken a three-year average (calendar years 2006-2008) of MGE's environmental remediation costs ($2.546 million) netted against a three-year average of environmental insurance recoveries ($663,000), resulting in a normalized net expense amount of $1.883 million. Staff recommends reducing this amount by 50% in an effort to encourage MGE to recover certain environmental remediation expenses under the terms of a**

previously-existing Environmental Liability Agreement (ELA) in place between MGE and Western Resources, Inc. (WRI). This reduction calculation produces Staff's recommendation of $941,500. Staff opposes the use of a tracker mechanism to set rates for MGE's environmental costs.

Infinium Software: What amount related to MGE's Infinium Software amortization should be used in determining MGE's cost of service?

***<u>Staff Position</u>*: A normalized level of infinium software amortization, based on the five-year period which the Commission ordered in Case No. GR-2006-0422, should be used to determine MGE's cost of service.**

SLRP Amortization: What amount related to the Safety Line Replacement Program amortizations should be used in determining MGE's cost of service?

***<u>Staff Position</u>*: A normalized level of SLRP amortization, based on the ten-year period which the Commission ordered in Case No. GR-98-140, should be used to determine MGE's cost of service.**

FAS 106/ OPEBs:

a. Should MGE be required to fund its external OPEB trusts in an amount equal to the FAS 106 allowance included in rates such that MGE is required to deposit a "catch-up" amount into its OPEB trusts in order to make use of FAS 106 in determining MGE's cost of service?

<u>Staff Position:</u>

Yes. Section 386.315 RSMo requires a utility using FAS 106 for rate recovery of OPEBs expense to fully fund an independent external funding mechanism with the rate dollars recovered for the OPEB expense. This

issue is before the Commission as MGE asserts that "Section 386.315 does not require any particular funding level," and "OPEBs are funded to the external trust fund mechanism as these benefits are required to be paid regardless of what level of rate relief might be received." Rebuttal testimony of John A. Davis, page 2, line 22, and page 3, line 10.

Section 386.315.3 states a utility:

may file one set of tariffs modifying its rates to reflect the revenue requirement associated with the utility's expenses for postretirement employee benefits other than pensions, as determined by Financial Accounting Standard 106, including the utility's transition benefit obligation, regardless of whether the deferral or immediate expense recognition method was used, if such utility is funding the full extent of its Financial Accounting Standard 106 obligation at the time such tariffs are filed

(emphasis added). The language used in Section 386.315.2 indicates that after the Company's payment of OPEB benefits, any remaining funds will remain in the external funding mechanism utilized by the Company. As cited in testimony, MGE uses the "pay-as-you-go" method, where the Company only transfers funds into the external funding mechanism shortly before the Company pays the benefits out to the eligible retirees. Staff does not agree this is the method intended by the legislature, instead believing the plain language of the statute supports Staff's position that

MGE must fully fund its external funding mechanism; "…. if such utility is funding the full extent of its Financial Accounting Standard 106 obligation…."

Staff's position is that a utility using FAS 106 for rate recovery of OPEBs expense must fully fund an independent external funding mechanism with the rate dollars recovered for the OPEB expense. Staff supports a "full funding" policy, in line with the language and legislative intent of 386.315, and previous Commission cases.

b. If so, what is the appropriate "catch-up" amount?

***Staff Position*:** **$16,496,369 is the appropriate catch-up amount in order for MGE to make its customers whole for the Company's prior underfunding of FAS 106 expense. Staff determined MGE's underfunding of FAS 106 expense began to occur in mid-2003. Starting with 2003, Staff took the cumulative underfunded amount for each year, and added to it the prior year's year-end amount to derive the cumulative balance at year-end. Staff then divided the cumulative year-end balance by two, to derive an average mid-year balance. Staff computed interest on the mid-year balance at a rate of 7.00% for the potential earnings lost by not investing the full FAS 106 recovery in an external funding mechanism. Staff then added the computed interest to the cumulative year-end balance to determine the "catch-up" amount through April 2009.**

c. What is the appropriate level of OPEB expense to use in determining MGE's cost of service?

Staff Position: **After Staff's review of verifiable data, Staff recommends a total of $2,591,538 as the appropriate level of OPEB expense to include in the case (This amount is stated on a total Company basis, before application of an expense ratio factor). The $2,591,538 total recommended recovery is made up of a transition benefit obligation amortization amount of $2,664,792, and an ongoing FAS 106 expense amount of a negative $73,254. Staff determined the latter number based on the amounts reflected in a February 2009 letter from MGE's actuary to the Company, then adjusted to eliminate the detrimental impact of the Company's underfunding of FAS 106 expense.**

Regulatory Commission Expense: What amount related to regulatory expenses should be used in determining MGE's cost of service?

***Staff Position*:** **A normalized level of other regulatory commission expenses, based on a five-year amortization period for the 2005 depreciation study and the invoices received for the NARUC assessment and other regulatory costs, should be used to determine MGE's cost of service. As for rate case expense, Staff included a normalized rate case expense of $72,382 in its Cost of Service Report, calculated using the actual rate case costs incurred by MGE as of April 30, 2009, with a Staff adjustment based upon a three-year normalization. This amount excludes $20,757 of expenses, which the Company booked in the test year and relate to expenses incurred by the Company in Case No. GR-2006-0422.**

Almost all utilities incur the costs of rate case expenses from time to time. A utility may hire outside consultants and legal counsel to assist in the proceedings before this Commission. As with any expense, the Staff recommends inclusion of reasonably and prudently incurred expenses in the utility's cost of service for the purpose of setting rates. Therefore, the Staff recommends the inclusion of MGE's reasonable and prudent rate case expenses in the cost of service, with true-up to determine the final amount.

Uncollectibles Expense: What amount related to uncollectibles expense should be used in determining MGE's cost of service? Should the emergency cold weather rule amortization have an impact upon this amount?

***Staff's Position*: $9,843,535 is the amount to use for uncollectible expense to determine MGE's cost of service. OPC argues an adjustment be made to this amount by the ECWR bad debt deferral amortization recorded by MGE in the test year. The ECWR Accounting Authority Order at issue amortizes bad debt specifically related to the January 1 to March 31, 2006 timeframe. Neither the Staff nor the Company included this amortization amount in their revenue requirement recommendations, nor is the Staff persuaded any "double-counting" of the ECWR amortization and booked write-offs occurred in the three-year period used by Staff to develop the recommended normalized level above.**

Credit Card Fees: Should the cost to accept a credit card payment be included in MGE's cost of service? If so, what amount should be included?

***Staff Position*: Yes.**

II. KANSAS GAS STORAGE PROPERTY TAX AAO – Should the Commission grant MGE an accounting authority order concerning Kansas property taxes on natural gas in storage in the State of Kansas? If so, under what conditions?

***Staff Position*: Yes. MGE's property tax expense attributable to its Kansas gas in storage holdings should be deferred through an accounting authority order because it is appropriate while such property taxes are subject to legal challenge.**

If so, under what conditions?

***Staff Position*: Any accounting authority order authorized by the Commission for MGE's property taxes should be granted only under the following conditions:**

1) That deferral treatment should only be allowed for property taxes associated with Kansas taxing authorities;

2) That MGE should begin amortizing the deferral to expense over 60 month, beginning the month following a judicial resolution of the legality of the Kansas tax;

3) If MGE files its next general rate case prior to the final resolution of the legality of the Kansas tax, then ratemaking treatment of the deferred costs will be considered in that proceeding; and

4) That the Commission include language in its Order stating that granting this AAO does not in any way control how the Commission will treat this deferral for ratemaking purposes in subsequent rate cases.

III. ENERGY EFFICIENCY

A. Relationship to rate design

Should the continuation (for residential customers) or implementation (for small general service customers) of energy efficiency programs be contingent on the adoption of a rate design that protects MGE from negative financial effects associated with usage reductions by these customers?

***Staff Position*: Staff recommends that the Commission order continuation of MGE's current rate design and continuation of the energy efficiency programs..**

B. Funding

Should funding for energy efficiency programs be included as an ongoing expense in rates, or should the Company provide upfront funding with such expenditures to be deferred (after expenditure of the surplus unspent funds for residential energy efficiency programs (expected to be approximately $1 million) that still remain at the time new rates from this case become effective) and included in rate base (with a 10-year amortization period) in subsequent rate cases?

What should the annual funding level be and how should the funding level be determined?

Should interest be applied to unspent residential energy efficiency funds and, if so, at what rate?

Staff Position: The current level of funding from rates is appropriate.

1) **The funding level authorized in the last rate case in appropriate as the energy efficiency programs are now being implemented and will subsequently be evaluated.**
2) **In the future if the programs are expanded additional funding should come from a regulatory asset account. This can be established outside of a rate case.**

3) **Interest should be paid on a going forward basis on the accumulated balance of unspent funds collected in rates for energy efficiency programs.**

C. Continuation/Form of Collaborative Should the energy efficiency collaborative formed after MGE's most recently concluded rate case as a result of the Commission's approval of the Unanimous Stipulation and Agreement in Case No. GT-2008-0005 be modified to an advisory group rather than a consensus decision making collaborative?

Staff Position: The collaborative group should be an advisory group with no direct control over Company expenditures.

IV. RATE DESIGN/COST OF SERVICE

A. Class Cost of Service

What is the appropriate level of revenue responsibility to be borne by each customer class?

Staff Position: **Staff is recommending all customer classes retain their current level of revenue responsibility. Any increase should be borne in equal percentages by each class.**

What rate design should the Commission adopt for the residential customer class?

Staff Position: **Retention of the SFV Residential Rate Design. The Staff supports continuing the current SFV rate design for the Residential class. The SFV rate design was implemented in MGE's last rate case, GR-2006-0422, and has been in place for nearly three years.**

SFV rate design recovers non-gas costs through a monthly fixed delivery charge and actual gas commodity costs are recovered through the per-unit PGA charge. The cost of providing gas service to residential

customers is decoupled from the volume of gas consumed. Collection of the Residential customer's cost of service in a fixed monthly charge is an equitable and reasonable way to recover costs from customers in this class.

Because of the complexity and number of specific cost factors that would have to be considered individual rate design for residential customers is neither desirable or workable. This is why, In determining rates, various classes of customers are designed to have similar characteristics. The residential class exhibits homogeneity in load and usage characteristics among its customers and sets the class apart from large volume general sales classes.

SFV gives the customer a levelized charge for cost of service throughout the year and only the customer's gas usage varies with the winter heating season and customer usage choices. The average residential customer uses 885 Ccf/year and a majority of customers fall within a small band of usage around that average. Comparing this to the largest volume MGE customer using nearly 17 million Ccf/year, the residential usage variance is miniscule. The difference in demand for most residential customers is only a few hundred Ccfs. The difference in demand for LVS customers varies as much as 50,000 Ccfs.

Each LDC has a significant investment in pipeline systems and other long-term assets, together with many other costs incurred to serve customers, such as costs of employees, office space, vehicles, computers

and billing systems, meters, insurance, and phones. These costs are fixed and do not vary when a customer either leaves the system or installs a more efficient furnace. These fixed costs are collected in the fixed monthly charge portion of the SFV rate design.

Because SFV rate design collects its cost of service in one charge and because the collection of those costs are not dependent on the amount of gas sold by the Company, the SFV rate design aligns the interests of Company shareholders with the interest of customer conservation and efficient use of natural gas. In the past, the traditional rate design tied the Company's earnings directly to the amount of gas it sold to its customers – creating a perverse incentive against the greater public policy interest of promoting reduced gas usage and conservation.

Under the current SFV rate design, the Company promotes energy conservation programs to its residential customers without risking the financial health of the company or its shareholders. Under SFV rate design, the company has begun actively researching and implementing energy efficiency programs as the result of the Commission authorized funding of $750,000 in the last rate case.

The SFV's fixed monthly charge, because it is decoupled from the actual cost of gas sold, sends the appropriate price signal to customers. With true, actual cost information, customers are better able to make informed decisions about their own energy use, alternative energy sources, and possible conservation and efficiency investments.

As for the variability of winter weather, the SFV rate design mitigates the risk of the company not being able to earn its cost of service in a warmer than normal winter when the company sells less gas. Likewise, SFV rate design protects customers from overpaying their cost of service in a colder than normal winter when customers buy more gas, an important benefit for all customers, but especially for low-income customers.

1. What rate design should the Commission adopt for the small general service customer class?

Staff Position: **MGE proposes to change its current SGS classification from customers whose usage does not exceed 10,000 Ccfs in any one month to a new SGS classification of customers whose usage does not exceed 10,000 Ccfs on an annual basis. Staff believes that the parameters proposed for the new SGS class are reasonable and provide for a much more homogenous customer class because the new class exhibits more similar load and usage characteristics. MGE proposes the SFV rate design to recover its non-gas costs from the newly defined SGS class in a flat fixed monthly charge.**

SGS *customers* have more end-use options than do Residential customers. For example, SGS customers may use gas for large fryers, dishwashers, or water heating for restaurants and laundries, but many use gas only for space heating. Even with more gas use options, compared with the LGS class, the new, more homogenous SGS class customer loads

are small and are more similar to the loads and usage of Residential customers.

The reasons supporting the retention of the SFV rate design for the Residential class are the same reasons that support adopting the SFV rate design for the new SGS class.

2. What rate design should the Commission adopt for the large volume service customer class?

Staff Position: **As a result of information gained through pre-filed testimony and discussions among the parties, the Staff now supports maintaining the current seasonal rate differential for the LVS class. Because Staff is not aware of information that identifies specific differences in the cost of serving an LVS customer in the summer versus the cost of serving in winter, the Staff proposes a future rate design docket to examine the cost factors of this class to determine whether the seasonal differential or another mechanism, such as a demand charge, would provide the most equitable method of collecting cost of service.**

3. What rate design should the Commission adopt for the large general service customer class?

Staff Position: **Staff concurs with MGE's proposal that customers in the restructured LGS class pay an increased share of their costs in the form of a fixed charge, with the remainder of LGS customers' cost of service to be collected in a two block volumetric rate.**

What miscellaneous service charges should the Commission approve?

Staff Position: **The Commission should approve changes to service initiation fees, revert-to-owner fees, connection and disconnection charges, and reconnection fees to more closely reflect the Company's actual costs of performing these services.**

V. TARIFF CHANGES

A. Transportation/Threshold for Eligibility: Should the Commission reduce the currently approved volume threshold for transportation service eligibility? If so, to what level and under what conditions?

Staff Position: **If the Commission agrees it is reasonable to reduce the threshold for transportation service eligibility, the Commission should assure MGE's other customers do not bear any stranded costs.**

B. Transportation/Other: Should the Commission approve the changes proposed by MGE to its Large Volume Transportation Service tariff for which MGE alleges an intent to encourage Large Volume Transportation Service Customers to maintain a closer balance between their deliveries to the system and their usage on the system, to-wit:

- i) Deadline for notice of pool changes;
- ii) Proposed elimination of multiple pools per aggregation area;
- iii) Transportation charge component of cash-outs for imbalances amount and symmetry of the charges);
- iv) Index price for cash outs;
- v) Circumstances and conditions for calling OFOs;
- vi) Supplier/agent's ability to move customers from a pool on one pipeline to another pipeline in the event of capacity constraints; and,
- vii) Miscellaneous language changes.

Staff's Position**: Staff generally supports, or does not oppose MGE's proposed changes and supports adoption of tariff provisions which**

support MGE's efforts to ensure the integrity and reliability of its distribution system.

C. Non Transportation: Liability limitation

Staff Position: This matter may be addressed in the complaint case currently filed against MGE.

D. PGA

Uncollectible Gas Cost Recovery in PGA: Should the Commission authorize MGE to recover uncollectible gas costs through the PGA mechanism?

Staff Position: **No. MGE's proposal to collect bad debt through the PGA is unlawful. Only certain types of costs may lawfully be passed through the PGA. While the Commission may treat some expense items differently, these expenses must have certain characteristics. *Hotel Continental et al. v. Burton,* 334 S.W.2d 75 (Mo. banc 1960).**

In considering the PGA, the courts have determined wholesale gas costs may be treated differently from other utility costs because the gas costs which the PGA mechanism allows the companies to pass on are almost entirely the cost of obtaining the gas itself and these costs are a bill the company paid with no input. Bad debt is not such an expense. With bad debt, there is no bill or invoice showing how much a company paid a supplier. In *UCCM*, where the Fuel Adjustment Clause was disapproved, the court found a FAC unlawful because these costs were not based on "just a bill that the company paid with no input" . . . and because the company could economize in other areas of its operations. *Utility*

Consumers Council, Inc. **585 S.W.2d 41, 47 (Mo. banc 1979)(emphasis added.)(UCCM)**

Bad debt is not a wholesale cost or a cost the Company incurs to acquire the gas supplies and transportation services needed to serve its customers. and may, therefore, not lawfully be included in the PGA.

Kansas Storage Gas Property Tax Recovery in PGA: Should the Commission authorize MGE to recover Kansas storage gas property taxes in the PGA mechanism?

Staff's Position: **Yes. An AAO for Kansas Property Tax (for 2009 and subsequent years) may be granted with any ratemaking treatment addressed in next rate case, with the conditions noted below:**

a. The Commission, in its order, shall direct MGE to begin to defer only the amount of property tax expense associated with assessments from Kansas taxing authorities;

b. The Commission shall order MGE to begin to amortize this regulatory asset over a 60-month period beginning the month following a final judicial resolution of the legality of the Kansas tax.

c. If MGE files its next general rate case prior to final judicial resolution of the legality of the Kansas tax, then ratemaking treatment of the deferred costs will be considered in that proceeding.

d. **The Commission shall include language in its Order stating that granting this AAO does not in any way control how the Commission will treat this deferral for ratemaking purposes in subsequent rate cases.**

FERC Regulatory Expense Recovery in PGA: Should the Commission authorize MGE to recover FERC regulatory expenses in the PGA mechanism?

<u>Staff's Position:</u> **No. MGE's proposal to collect FERC regulatory expenses through the PGA is also unlawful. These are not the types of costs the Courts have determined are appropriate for such recovery. While the Commission may treat some expense items differently, these expenses must have certain characteristics. *Hotel Continental et al. v. Burton,* 334 S.W.2d 75 (Mo. banc 1960).**

"[T]he reason why the PSC is not to consider some costs in isolation- because it might cause the PSC to allow the company to raise rates to cover increased costs in one area without realizing that there were counterbalancing savings in another area." *MGUA* at 480. FERC regulatory costs are not lawful as PGA pass through costs because there may be counterbalancing savings in another area. The company may economize in other areas of its operations. *Utility Consumers Council, Inc.* 585 S.W.2d 41, 47 (Mo. banc 1979)(emphasis added.). Costs where there may be offsetting savings or counterbalancing savings may not lawfully be included in the PGA.

VI. CAPACITY RELEASE/OFF-SYSTEM SALES: Should the Commission amend the currently approved sharing grid pursuant to which net revenues derived from MGE's capacity release and off-system sales activities are shared between customers and shareholders? If so, what changes should be made?

Staff Position: Yes

MGE's customers pay for the capacity, salaries and everything else necessary for MGE to make off-system sales and capacity release transactions. As an incentive to maximize the revenue from capacity release and off-system sales, the Commission permitted MGE to implement a sharing grid which allows it to keep a certain percentage of the profit from these transactions. The remaining amount of profit goes to reduce the gas costs of its customers through the PGA process. The percentage MGE is allowed to retain increases as the level of off-system sales & capacity release increase because each additional dollar of off-system sales and capacity release profit requires more expertise and effort on the part of the Company. The current tiers/thresholds within the sharing grid were granted by the Commission 5 years ago when the annual revenue from off-system sales and capacity release was significantly less than it has been recently. Staff's position is the tiers/thresholds should be increased from $300,000 to $2 million increments to give MGE a meaningful incentive to continue to perform these types of transactions.