BEFORE THE PUBLIC SERVICE COMMISSION OF THE STATE OF MISSOURI

In the Matter of Missouri Gas Energy and its Tariff Filing to Implement a General Rate Increase for Natural Gas Service	)))	**File No. GR-2009-0355**

REPORT AND ORDER

Issue Date: February 10, 2010

Effective Date: February 20, 2010

Staff Exhibit No 271
Date 12-12-17 Reporter SP
File No GR-2017-0215
GR-2017-0216

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APPEARANCES

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SENIOR REGULATORY LAW JUDGE: **Ronald D. Pridgin**

Procedural History

On April 2, 2009, Missouri Gas Energy (hereafter "MGE"), a division of Southern Union Company (hereafter "SUG") submitted to the Commission proposed tariff sheets, effective for service on and after May 2, 2009, that are intended to implement a general rate increase for natural gas service provided in its Missouri service area.[1] MGE's proposed tariffs would increase its Missouri jurisdictional revenues by approximately $32.4 million, or by 4.7%. The Commission suspended the tariffs until February 28, 2010. Furthermore, the Commission gave interested parties until April 27 to request intervention.

The Commission received timely intervention requests from: ONEOK Energy Marketing Company (hereafter "ONEOK"); the Missouri Department of Natural Resources (hereafter "DNR"); Constellation NewEnergy–Gas Division, LLC (hereafter "Constellation"); Midwest Gas Users Association (hereafter "MGUA"), the University of Missouri-Kansas City (hereafter "UMKC"), Central Missouri State University (hereafter "CMSU"), and Superior Bowen Asphalt Company (hereafter "Superior Bowen"). In addition, the Commission received an untimely intervention request from the City of Kansas City, Missouri (hereafter "Kansas City"). The Commission granted these requests.

At the request of the Office of The Public Counsel (hereafter "OPC") and the Staff of the Commission (hereafter "Staff"), and with the consent of MGE, the Commission changed the end of the update period from June 30 to April 30. No parties objected to the remainder of the true-up dates, and the Commission adopted them. The Commission held local public hearings in Joplin, Warrensburg, St. Joseph, Kansas City and Lee's Summit. Further, the

[1] Unless otherwise stated, all dates are in 2009.

Commission held an evidentiary hearing on October 26 through October 30, November 2, December 23, and a true-up hearing on December 8-9.

Partial Stipulation and Agreement

On November 5, MGE, Staff, OPC, MGUA, UMKC, UCM, Superior Bowen, Constellation and ONEOK filed a Partial Stipulation and Agreement (hereafter "Stipulation"). The Stipulation purported to resolve all of the disputed issues among the parties except for issues relating to cost of capital, rate design, and energy efficiency.

Neither DNR nor Kansas City signed the Stipulation. However, both DNR and Kansas City stated that neither supported nor opposed the Stipulation, and that neither DNR nor Kansas City requested a hearing on any issue covered by the Stipulation.

Because no party objects to the Stipulation, Commission Rule 4 CSR 240-2.115 allows the Commission to treat it as if it were unanimous. The Commission will do so. The Stipulation, affixed to this Report and Order as Attachment A, is reasonable, and the Commission approves it.

Conclusions of Law

The Missouri Public Service Commission, having considered all of the competent and substantial evidence upon the whole record, makes the following findings of fact and conclusions of law. The positions and arguments of all of the parties have been considered by the Commission in making this decision.

Failure to specifically address a piece of evidence, position or argument of any party does not indicate the Commission has failed to consider relevant evidence, but indicates

rather that the omitted material was not dispositive of this decision. When making findings of fact based upon witness testimony, the Commission assigned the appropriate weight to the testimony of each witness based upon their qualifications, expertise and credibility with regard to the attested to subject matter.[2]

Conclusions of Law Regarding Jurisdiction

MGE is a gas utility and a public utility subject to Commission jurisdiction.[3] The Commission has authority to regulate the rates MGE may charge for gas.[4]

The Staff of the Commission is represented by the Commission's Staff Counsel, an employee of the Commission who has been delegated the authority to "represent and appear for the commission in all actions and proceedings involving this or any other law [involving the commission.]" by the General Counsel, who is authorized by statute to perform such duties.[5] The Public Counsel is appointed by the Director of the Missouri Department of Economic Development and is authorized to "represent and protect the interests of the public in any proceeding before or appeal from the public service commission[.]"[6] The remaining parties include governmental entities and industrial and commercial consumers.

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[2] Witness credibility is solely within the discretion of the Commission, who is free to believe all, some, or none of a witness' testimony. *State ex. rel. Missouri Gas Energy v. Public Service Comm'n*, 186 S.W.3d 376, 389 (Mo.App. 2005).

[3] Section 386.020(18), (43) RSMo (Supp. 2009) (all statutory cites to RSMo 2000 unless otherwise indicated).

[4] Section 393.140(11).

[5] Section 386.071.

[6] Sections 386.700 and 386.710.

Burden of Proof

"At any hearing involving a rate sought to be increased, the burden of proof to show that the increased rate or proposed increased rate is just and reasonable shall be upon the . . . gas corporation . . . and the commission shall give to the hearing and decision of such questions preference over all other questions pending before it and decide the same as speedily as possible . . ."[7]

Ratemaking Standards and Practices

The Commission is vested with the state's police power to set "just and reasonable" rates for public utility services,[8] subject to judicial review of the question of reasonableness.[9] A "just and reasonable" rate is one that is fair to both the utility and its customers;[10] it is no more than is sufficient to "keep public utility plants in proper repair for effective public service, [and] . . . to insure to the investors a reasonable return upon funds invested."[11] In 1925, the Missouri Supreme Court stated:[12]

> The enactment of the Public Service Act marked a new era in the history of public utilities. Its purpose is to require the general public not only to pay rates which will keep public utility plants in proper repair for effective public service, but further to insure to the investors a reasonable return upon funds

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[7] Section 393.150.2.

[8] Section 393.130 RSMo (Supp. 2009) requires a utility's charges to be "just and reasonable" and not in excess of charges allowed by law or by order of the commission. Section 393.140 authorizes the Commission to determine "just and reasonable" rates.

[9] *St. ex rel. City of Harrisonville v. Pub. Serv. Comm'n of Missouri*, 291 Mo. 432, 236 S.W. 852 (Mo. banc. 1922); *City of Fulton v. Pub. Serv. Comm'n*, 275 Mo. 67, 204 S.W. 386 (Mo. banc. 1918), *error dis'd*, 251 U.S. 546, 40 S.Ct. 342, 64 L.Ed. 408; *City of St. Louis v. Pub. Serv. Comm'n of Missouri*, 276 Mo. 509, 207 S.W. 799 (1919); *Kansas City v. Pub. Serv. Comm'n of Missouri*, 276 Mo. 539, 210 S.W. 381 (1919), *error dis'd*, 250 U.S. 652, 40 S.Ct. 54, 63 L.Ed. 1190; *Lightfoot v. City of Springfield*, 361 Mo. 659, 236 S.W.2d 348 (1951).

[10] *St. ex rel. Valley Sewage Co. v. Pub. Serv. Comm'n*, 515 S.W.2d 845 (Mo. App. 1974).

[11] *St. ex rel. Washington University et al. v. Pub. Serv. Comm'n*, 308 Mo. 328, 344-45, 272 S.W. 971, 973 (Mo. banc 1925).

[12] *Id.*

> invested. The police power of the state demands as much. We can never have efficient service, unless there is a reasonable guaranty of fair returns for capital invested. * * * These instrumentalities are a part of the very life blood of the state, and of its people, and a fair administration of the act is mandatory. When we say "fair," we mean fair to the public, and fair to the investors.

The Commission's guiding purpose in setting rates is to protect the consumer against the natural monopoly of the public utility, generally the sole provider of a public necessity.[13] "[T]he dominant thought and purpose of the policy is the protection of the public . . . [and] the protection given the utility is merely incidental."[14] However, the Commission must also afford the utility an opportunity to recover a reasonable return on the assets it has devoted to the public service.[15] "There can be no argument but that the Company and its stockholders have a constitutional right to a fair and reasonable return upon their investment."[16]

The Commission has exclusive jurisdiction to establish public utility rates,[17] and the rates it sets have the force and effect of law.[18] A public utility has no right to fix its own rates and cannot charge or collect rates that have not been approved by the Commission;[19] neither can a public utility change its rates without first seeking authority from the Commission.[20] A public utility may submit rate schedules or "tariffs," and thereby suggest to the

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[13] *May Dep't Stores Co. v. Union Elec. Light & Power Co.*, 341 Mo. 299, 107 S.W.2d 41, 48 (Mo. App. 1937).

[14] *St. ex rel. Crown Coach Co. v. Pub. Serv. Comm'n*, 179 S.W.2d 123, 126 (1944).

[15] *St. ex rel. Utility Consumers Council, Inc. v. Pub. Serv. Comm'n*, 585 S.W.2d 41, 49 (Mo. banc 1979).

[16] *St. ex rel. Missouri Public Service Co. v. Fraas*, 627 S.W.2d 882, 886 (Mo. App. 1981).

[17] *May Dep't Stores*, 107 S.W.2d at 57.

[18] *Utility Consumers Council*, 585 S.W.2d at 49.

[19] *Id.*

[20] *Deaconess Manor Ass'n v. Pub. Serv. Comm'n*, 994 S.W.2d 602, 610 (Mo. App. 1999).

Commission rates and classifications which it believes are just and reasonable, but the final decision is the Commission's.[21] Thus, "[r]atemaking is a balancing process."[22]

Ratemaking involves two successive processes: first, the determination of the "revenue requirement," that is, the amount of revenue the utility must receive to pay the costs of producing the utility service while yielding a reasonable rate of return to the investors.[23] The second process is rate design, that is, the construction of tariffs that will collect the necessary revenue requirement from the ratepayers. Revenue requirement is usually established based upon a historical test year that focuses on four factors:[24] (1) the rate of return the utility has an opportunity to earn; (2) the rate base upon which a return may be earned; (3) the depreciation costs of plant and equipment; and (4) allowable operating expenses. The calculation of revenue requirement from these four factors is expressed in the following formula:

$$RR = C + (V - D) R$$

where:
- RR = Revenue Requirement;
- C = Prudent Operating Costs, including Depreciation Expense and Taxes;
- V = Gross Value of Utility Plant in Service;
- D = Accumulated Depreciation; and
- R = Overall Rate of Return or Weighted Cost of Capital.

The return on the rate base is calculated by applying a rate of return, that is, the weighted cost of capital, to the original cost of the assets dedicated to public service less

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[21] *May Dep't Stores*, 107 S.W.2d at 50.

[22] *St. ex rel. Union Elec. Co. v. Pub. Serv. Comm'n*, 765 S.W.2d 618, 622 (Mo. App. 1988).

[23] *St. ex rel. Capital City Water Co. v. Missouri Pub. Serv. Comm'n*, 850 S.W.2d 903, 916 n. 1 (Mo. App. 1993).

[24] In the present case, the test year was established as the twelve months ending December 31, 2008, updated for known and measurable changes through September 30, 2009.

accumulated depreciation.[25] The Public Service Commission Act vests the Commission with the necessary authority to perform these functions. The Commission can prescribe uniform methods of accounting for utilities, and can examine a utility's books and records and, after hearing, can determine the accounting treatment of any particular transaction.[26] In this way, the Commission can determine the utility's prudent operating costs. Finally, the Commission can set depreciation rates and adjust a utility's depreciation reserve from time to time as may be necessary.[27]

The Revenue Requirement is the sum of two components: first, the utility's prudent operating expenses, and second, an amount calculated by multiplying the value of the utility's depreciated assets by a rate of return. For any utility, its fair rate of return is simply its composite cost of capital. The composite cost of capital is the sum of the weighted cost of each component of the utility's capital structure. The weighted cost of each capital component is calculated by multiplying its cost by a percentage expressing its proportion in the capital structure. Where possible, the cost used is the "embedded" or historical cost; however, in the case of Common Equity, the cost used is its estimated cost.

The Issues

On October 21, a list of issues was filed. Commission Rule 4 CSR 240-2.080(15) allows parties ten days to respond to pleadings. No party objected to the list. Therefore,

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[25] *See State ex rel. Union Elec. Co.*, 765 S.W.2d at 622.

[26] Section 393.140.

[27] Section 393.240.

the only issues to be determined are the issues from the October 21 list not resolved by stipulation. The Commission will address the unresolved issues below.

In summary, before the Commission are many rate of return issues; that is, what revenue should be built into rates to cover the cost of paying bondholders and shareholders? Those issues include what capital structure should be imputed to MGE (as MGE does not issue its own stock), what MGE's cost of long-term and short-term debt is, and what return on equity should shareholders have the opportunity to earn.

OPC contests the Straight Fixed Variable rate design supported by MGE and Staff; no other party opposes Straight Fixed Variable. OPC prefers a volumetric rate design. Intertwined with this rate design issue is energy efficiency, including what sort of programs should MGE implement, and how much should MGE spend on those programs.

Finally, Staff contests two "true-up" issues; that is, issues updated for known and measurable changes that have occurred during the pendency of the case. Staff contests Prepaid Pension Assets and Land Rights Depreciation. In addition, OPC contests rate case expense.

Rate of Return

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

Discussion

A company funds its assets generally in one of two ways; namely, it must borrow the money (debt), or it must receive an investment from its owners (equity). The percentage of

money that company receives from lenders and from shareholders can be expressed as a "capital structure". For example, if a company has $1000 cash, and obtained that $1000 by borrowing $600 and receiving $400 in investments, its capital structure would consist of 60% debt and 40% equity.

The actual capital structure, recommended by OPC, contains less equity than does the structures recommended by MGE and Staff. It costs a company more to issue equity than it does to incur debt. Therefore, a capital structure that uses a lot of debt with relatively low levels of equity is less expensive for the company. That means that, all else being equal, a capital structure that includes a low percentage of equity and a large percentage of debt will be less costly, resulting in a lower rate of return, and consequently a lower revenue requirement and lower rates to customers.

However, all else is not equal. Including a high percentage of debt in a capital structure has an effect on the cost of equity. The shareholders in a company – the holders of equity – are subordinate to bondholders. Generally, the company must pay the interest on debt, such as bonds issued by the company, before it can pay dividends to its shareholders, or before it can invest profits in other ways that benefit shareholders. If a company's income goes down, the risk is borne by the shareholders. The holders of debt get paid first in the unlikely event the company is liquidated. The shareholders get only what, if anything, is left over. Therefore, a company with a capital structure that includes a high percentage of debt is more risky for shareholders. The shareholders will consequently demand a higher rate of return to compensate them for the increased risk caused by the high level of debt.

MGE requests a hypothetical capital structure of 52% debt and 48% equity.[28] MGE does so based on the theory that MGE is riskier than the average LDC because it's so small.[29] SUG isn't representative of an LDC, so SUG's capital structure isn't appropriate.[30] MGE looked at market evidence of common equity cost of a proxy group of nine to determine its proposed hypothetical capital structure.[31]

Staff proposes a hypothetical capital structure of 51.06% equity, 40.47% long-term debt and 8.47% short-term debt.[32] Staff based this structure on proxy group's average structure for the most recently reported fiscal quarter, except for short-term debt.[33] Staff averaged the last 4 quarters of short-term debt and the deducted CWIP (Construction Work in Progress) balance.[34]

OPC argues that SUG's actual capital structure should be used.[35] OPC reminds the Commission that in the last two MGE rate cases, the Commission ordered actual, and not hypothetical, capital structure.[36]

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[28] Hanley Direct, Ex. 13, p. 2.

[29] *Id.* at. 4.

[30] *Id.* Because MGE is a division of Southern Union that supplies natural gas to Missouri customers, and MGE has no separate existence from Southern Union, the Commission reminds the reader that any use of MGE or SUG refers to the same entity.

[31] *Id.*

[32] Staff Cost of Service Report, Ex. 39, pp. 7, and 24.

[33] *Id.* at 7.

[34] *Id.*

[35] Lawton Direct, Ex. 69, p. 5.

[36] *Id.* at 50.

Findings of Fact

1. The Commission finds the testimony of OPC witness Lawton to be the most credible for this issue.

2. The overall cost of capital is the sum of the weighted average cost rates of various sources of capital.[37]

3. The most significant relationship in any capital structure is the debt to equity ratio.[38]

4. The advantage of debt in the capital structure is that debt costs less than equity.[39]

5. Thus, the more debt in the capital structure the lower the cost of capital will be.[40]

6 MGE is an operating division of SUG and has no separate existence from SUG.[41]

7. SUG's management decisions determined SUG's capital structure.[42]

8. MGE and Staff are asking the Commission to base rates on a hypothetical capital structure that has more equity and less debt than SUG's actual capital structure.[43]

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[37] Lawton Direct, Ex. 69, p. 47.

[38] *Id.*

[39] *Id.*

[40] *Id.*

[41] *Id.* at 19; Staff Cost of Service Report, Ex. 39, p. 63; Tr. Vol. 9, p. 319.

[42] Lawton Direct, Ex. 69, p. 50.

[43] Hanley Direct, Ex. 13, p. 2; Staff Cost of Service Report, Ex. 39, pp. 7, 24; Lawton Direct, Ex. 69, p. 5.

9. Potential investors in MGE must invest in SUG, since SUG funds all of MGE's activities.[44]

10. Actual capital structure is appropriate as long as the utility is still investment grade, which SUG is.[45]

11. Using a hypothetical capital structure would allow MGE to recover revenues in excess of costs.[46]

12. SUG's capital structure is the result of management decisions, including using a higher percentage of lower cost debt.[47]

13. Using rate base of $609 million, MGE would have a return requirement of $71.4 million under a hypothetical capital structure and $66.6 under actual capital structure.[48]

14. Employing MGE's proposed hypothetical capital structure would allow MGE to earn an equity return on some capital that was financed by debt.[49]

15. The difference between the $71.4 million revenue requirement under a hypothetical capital structure and a $66.6 million under an actual capital structure would be added earnings.[50]

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[44] Hanley, Tr. Vol. 9, p. 127; Lawton, Tr. Vol. 9, p. 358.

[45] Murray, Tr. Vol. 9, p. 253.

[46] Lawton Direct, Ex. 69, p. 50.

[47] *Id.*

[48] *Id.* at 51.

[49] *Id.*

[50] *Id.*

Conclusions of Law

As pointed out by the Court of Appeals, "(p)erhaps the ultimate authority for imputing debt and equity financing . . . is the Supreme Court's statement in *Hope Natural Gas:* "The rate-making process under the Act, *i.e.,* the fixing of 'just and reasonable' rates, involves a balancing of the investor and the consumer interests."[51]

The Commission has repeatedly determined that SUG's management decisions necessitate the use of a capital structure that properly recognizes those decisions. In MGE's 2004 rate case, the Commission rejected MGE's attempt to utilize a hypothetical capital structure and concluded:

> Although Southern Union describes its proposed capital structure as an adjusted actual consolidated capital structure, what it is proposing may more accurately be described as a hypothetical capital structure in that its proposed capital structure clearly does not exist in the real world.
>
> Furthermore, Southern Union's unadjusted consolidated capital structure, with its heavy reliance on debt, results directly from Southern Union's management decision to become highly leveraged to finance the purchase of Panhandle Eastern, as well as earlier acquisitions. Southern Union decided to take on that additional debt because it saw an opportunity to earn greater returns to the benefit of its shareholders. That decision is clearly within Southern Union's management prerogative and the Commission does not wish to criticize or punish Southern Union for that decision. However, Southern Union must operate with the results of its investment decisions and one result of those investment decisions is a capital structure that includes a large amount of debt and relatively low amounts of equity.[52]

In MGE's next rate case, the Commission again rejected MGE's attempt to utilize a hypothetical capital structure. The Commission concluded:

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[51] *State ex. rel. Associated Natural Gas Co. v. Public Service Comm'n of Missouri*, 706 S.W.2d 870, 879 (Mo. App. 1985)(*citing Hope Natural Gas*, 320 U.S. at 603, 64 S.Ct. at 288).

[52] *In re MGE*, Commission File No. GR-2004-0209, Report and Order, pp. 12-13 (September 21, 2004); *aff'd, State ex. rel. Missouri Gas Energy v. Public Service Commission,* 186 S.W.3d 386 (Mo.App. W.D. 2005).

> This issue was discussed by the Commission in MGE's last rate case. As discussed in that case, the capital structure of Southern Union is the result of its management decisions. Hence, Southern Union, and ultimately MGE, must operate with the result of its decisions. MGE stresses that the make-up of Southern Union has changed so dramatically, that use of a hypothetical capital structure is warranted. This premise, however, does not change the Commission's reasoning in MGE's last rate case. Therefore, the capital structure, as proposed by Staff, shall be used.[53]

Indeed, there are at least two instances in which the Commission has the *discretion* to impose a hypothetical capital structure: when the actual debt-equity ratio is inefficient and unreasonable because it has too much equity and not enough debt, thereby giving the utility an inflated rate of return, or when the utility is part of a holding company system.[54]

Decision

The Commission finds that it should use Southern Union Gas Company's actual capital structure.

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

MGE witness Hanley proposes a long-term cost of debt of 6.08%.[55] He arrived at that by looking at Securities and Exchange Commission filings of the proxy group

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[53] *In re MGE*, Commission File No. GR-2006-0422, Report and Order, p. 9 (March 22, 2007), *aff'd*, *State ex. rel. Office of the Public Counsel v. Public Service Commission*, 293 S.W. 3d 63 (Mo.App. S.D. 2009).

[54] *See OPC v. PSC*, 293 S.W. 3d at 84.

[55] Hanley Direct, Ex. 13, p. 23.

companies, and calculating a composite interest rate of 5.93%.[56] He then added 15 basis points for cost of issuance.[57]

Hanley estimated a short-term debt cost of 4.92% for the proxy group.[58] He did so by using an average for the forecast rates for the three-month LIBOR (London Inter-Bank Offer Rate) from Blue Chip Financial Forecasts for the six quarters ending with the second quarter of 2010. That rate is 1.42%. Then, he added 250 basis points plus an up front fee of 100 basis points to arrive at 4.92%.[59] To estimate MGE's cost of short-term debt, Hanley added yet another 100 basis points, due to MGE being at the bottom of investment grade.[60] According to Standard and Poor's, MGE's BBB minus credit rating is one notch lower than the average credit rating of Hanley's proxy group, as well as that of the other two rate of return analysts in this case.[61] Hanley later updated his projection of MGE's short-term interest rate to be 5.492%.[62]

Staff used the average long-term debt cost of its proxy group in calculating the hypothetical cost of long-term debt and included a 10% gross-up to reflect issuance costs.[63] Staff's trued-up figure is 5.89%, which is not very far removed from MGE's figure

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[56] *Id.*

[57] *Id.*

[58] *Id.* at 24.

[59] *Id.*

[60] *Id.*

[61] Hanley Rebuttal, Ex. 14, Sch. FJH-21, pp. 16, 35; Staff Cost of Service Report, Ex. 39, p. 31; Murray Rebuttal, Ex. 57, p. 13; Lawton Surrebuttal, Ex. 71, p. 7 (stating that removing the three companies in Lawton's proxy group that are not in Hanley's proxy group would not change Lawton's analysis).

[62] Hanley Surrebuttal, Ex. 15, p. 12.

[63] Staff Cost of Service Report, Ex. 39, pp. 29-30.

of 6.00% and OPC's figure of 6.25%.[64] For short-term debt, information from all of the proxies was not readily available. Consequently, Staff used figures for two of the comparable companies which had credit ratings equal to the average credit ratings of the proxy group as a whole.[65] Staff's trued-up result, 0.94%, is significantly different from the figures endorsed by MGE and OPC, which are 5.42% and 4.367%, respectively.

OPC witness Lawton proposes using actual costs of debt, which are 6.258% for long-term, and 5.920 for short-term.[66]

Findings of Fact

16. The Commission has already determined that MGE's actual capital structure should be used to set rates based upon the persuasive testimony of OPC witness Lawton.

17. Likewise, the Commission also finds Lawton's testimony of basing MGE's cost of debt upon actual capital structure to be the most persuasive.

18. The long-term cost of debt is 6.258%, and the short-term cost of debt is 5.92%.[67]

19. MGE's actual long-term debt of 6.258% is similar to the 6.08% recommended by MGE,[68] and the approximately 6% cost Staff said actual long-term debt cost should be.[69]

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[64] Murray True-Up Direct, Ex. 111, pp. 3-4.

[65] Staff Cost of Service Report, Ex. 39, pp. 30-31.

[66] Lawton Direct, Ex. 69, p. 47ff.

[67] Lawton Direct, Ex. 69, pp. 47, 51.

[68] Hanley Direct, Ex. 13, p. 23.

[69] Murray, Tr. Vol. 9, pp. 220-221.

20. The actual short-term cost of debt is 5.92%, which is similar to the 5.492% figure sponsored by MGE.[70]

21. Staff's recommendation of short-term debt of approximately 1% is based upon the premise that MGE would continue to be able to issue commercial paper.[71]

22. This is not true, as MGE's credit facilities are about to expire, and Hanley's testimony that MGE will be unable to continue to issue commercial paper due to being at the bottom of the investment grade category is persuasive.[72]

Conclusions of Law

There are no additional conclusions of law for this issue.

Decision

The long-term cost of debt is 6.258%, and the short-term cost of debt is 5.92%, based on actual costs.

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

Discussion

Determining an appropriate return on equity is without a doubt the most difficult part of determining a rate of return. The cost of long-term debt and the cost of preferred stock

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[70] Hanley Surrebuttal, Ex. 15, p. 12.

[71] Murray True-Up Direct, Ex. 111, p. 4.

[72] Hanley, Vol. 9, p. 192; see also Hanley Surrebuttal, Ex. 15, p. 11.

are relatively easy to determine because their rate of return is specified within the instruments that create them. In contrast, determining a return on equity requires speculation about the desires and requirements of investors when they choose to invest their money in MGE rather than elsewhere.

For additional guidance on exactly where the Commission should set MGE's return on equity, the Commission must turn to the expert advice offered by financial analysts. This "is an area of ratemaking in which agencies welcome expert testimony and yet must often make difficult choices between conflicting testimony."[73]

MGE, Staff, and OPC sponsored financial analysts who recommended a return on equity in this case. Their recommended ROEs are: MGE – 10.5%, OPC – 9.50-10.50%, with a midpoint of 10%; Staff – 9.25-9.75%, with a midpoint of 9.50%.

Below is a summary of the testimony of the Return on Equity witnesses.

MGE

Mr. Hanley began estimating an ROE for MGE by constructing a proxy group of similar companies. His criteria for inclusion in the proxy group was Local Distribution Companies that: 1) are in the ValueLine Natural Gas Utility Group (Standard Edition); 2) have Value Line five-year projections of growth rate in EPS; 3) have a Value Line beta; 4) have not cut or omitted their cash common stock dividends during the five calendar years ending in 2008; 5) derived 60% or more of both net operating income and assets

[73] L.S. Goodman, 1 The Process of Ratemaking, 606 (1998).

from regulated gas operations and 6) no public announcement of any merger or acquisition. Nine met the criteria.[74]

Before testifying about different models that can be applied to the proxy group to estimate the proper ROE for MGE, Mr. Hanley stated that all those models are based upon the Efficient Market Hypothesis (hereafter "EMH"). The components of the EMH are: 1) investors are rational and will invest in assets that give the highest expected return for a certain level of risk; 2) current market prices reflect all publicly available information; 3) today's market returns are unrelated to yesterdays', as that information has already been processed; 4) markets follow a random walk, that is, the probability distribution of expected returns approximates a bell curve.[75] Mr. Hanley then posited that no one method gives the necessary level of precision needed, but that each method gives useful evidence to facilitate the exercise of an informed judgment.[76]

One method Mr. Hanley used is the Discounted Cash Flow (hereafter "DCF") method. It is based upon finding the present value of an expected future stream of net cash flows during the holding period discounted at the cost of capital. An investor buys stock for an expected total return rate to come from cash flows in the form of dividends plus appreciation in market price.[77] His analysis using DCF was a range of 7.93 to 11.62%.[78]

Mr. Hanley further used a Risk Premium Model (hereafter "RPM"). The RPM is based upon the theory that the cost of common equity is equal to the expected cost rate for

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[74] Hanley Direct, Ex. 13, p. 17.

[75] *Id.* at 25.

[76] *Id.* at 30.

[77] *Id.* at 32.

[78] *Id.* at 40.

long-term debt plus a premium to compensate shareholders for the added risk of being unsecured creditors and last in line to claim the corporation's assets and earnings.[79]

Mr. Hanley concluded that the proxy group could expect bond yields of 6.89%, and that Southern Union Gas could expect bond yields of 7.09%.[80] The average risk premiums, based on two different historical equity risk premium studies, would be 5.47% applicable to the proxy group and 7.41% applicable to Southern Union Gas.[81] Adding the two together, Mr. Hanley's RPM analysis is that the ROE should be 12.36% for the proxy group and 14.50% for Southern Union Gas.[82]

Mr. Hanley then uses a Capital Asset Pricing Model (hereafter "CAPM"). Briefly, that model applies a risk-free rate of return to a market risk premium.[83]

He selects a risk-free rate of return of 3.38%. His risk-free rate of return is based upon average consensus forecast of reporting economists in the February 1, 2009 issue of Blue Chip Financial Forecasts for the yields on 30-year U.S. Treasury notes for the six quarters ending with the second calendar quarter 2010.[84]

Mr. Hanley arrived at a 10.77% market equity risk premium, working with long-term historical return rates from Morningstar, Inc, and using projected market returns from Value

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[79] *Id.* at 44.

[80] *Id.* at 46.

[81] *Id.* at 47.

[82] *Id.* at 59.

[83] *Id.* at 60.

[84] *Id.* at 63.

Line.[85] His average median CAPM and ECAPM[86] ROE rates applicable to the proxy group are 11.33%, and for Southern Union Gas, is 15.10%.

Mr. Hanley used a Comparable Earnings Method (hereafter "CEM") as well.[87] However, since his results showed an ROE of 22%, he excluded those results as being unreasonably high.[88]

In conclusion, Mr. Hanley arrived at an 11.25% ROE, based upon the midpoint of the lowest ROE of 9.82% and the highest ROE of 12.36% from the above-described studies, plus a 15 basis point adder in recognition of MGE's smaller size, and thus, higher risk, in relation to the proxy group.[89] He later amended his recommended ROE down to 10.5% to reflect recent changes in capital markets.[90]

Staff

Mr. Murray used seven companies in his proxy group.[91] His criteria: 1) Edward Jones classification as a natural gas distribution company; 2) stock publicly traded; 3) information printed in Value Line; 4) ten-year of Value Line historical data available; 5) no reduced dividend since 2006 (eliminated one company); 6) projected

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[85] *Id.* at 65.

[86] Empirical Capital Asset Pricing Model, which is a formal recognition that the observed risk/return tradeoff is flatter than predicted by the CAPM.

[87] *Id.* at 67.

[88] *Id.* at 73.

[89] *Id.* at 75.

[90] Hanley Rebuttal, Ex. 14, at 3.

[91] Staff Cost of Service Report, Ex. 39, p. 29.

growth available from Value Line and IBES (eliminated three companies); 7) at least investment grade.[92]

Mr. Murray calculated a DCF and a CAPM cost of common equity for each of the comparable companies.[93] First, he estimated a growth rate.[94] Then, he calculated an expected yield for each company in the proxy group.[95] Staff concluded that the proxy group's cost of common equity would be 9.25% to 10.25%.[96] But MGE's proxy group companies all have some non-regulated operations affecting their risk profiles, and MGE's Straight Fixed Variable rate design provides MGE with more stable cash flows. Thus, Mr. Murray believes the lower half of Staff's estimated ROE range, 9.25% to 9.75%, is more appropriate. He verified the reasonableness of that result by using the CAPM (Capital Asset Pricing Model).[97]

OPC

As a precursor, Mr. Lawton notes that OPC opposes MGE's SFV rate design. But his testimony states what MGE's revenue requirement should be, assuming the Commission continues with the SFV. Mr. Lawton states that the SFV is a risk reduction to MGE, because it removes the weather-sensitive sales risk away from MGE, and shifts it to its

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[92] *Id.*

[93] *Id.* at 31.

[94] *Id.* at 34.

[95] *Id.* at 36.

[96] *Id.* at 36.

[97] *Id.* at 37.

ratepayers. As such, the Commission should reduce ROE by 50 basis points to account for that lessened risk.[98]

Before Mr. Lawton applied his DCF analysis to determine his recommended ROE, he, like Messrs. Hanley and Murphy, had to construct a proxy group. For his group, consisting of 12 companies, Mr. Lawton used the same group Mr. Hanley did, plus an additional three companies.[99]

Mr. Lawton arrived at a dividend yield of 4.66%, and median growth rates for MGE and the proxy group of 4.3% to 6.3%.[100] But relying on a combination of forecasted Earnings Per Share (hereafter "EPS") estimates and internal growth estimates, Mr. Lawton narrowed the estimated growth rate to 4.9% to 5.4%.[101] Using two different methods of DCF, Mr. Lawton arrived at an ROE range of 9.51%-10.04%, with 9.8% being the midpoint.[102]

Mr. Lawton also used two risk premium analyses. He discarded one analysis that found an estimated 12.3% ROE as too high, instead using a 3.7% risk premium and a BBB bond rate estimate of 6.8% to arrive at an ROE of 10.5%.[103] His CAPM analysis was also discarded, as it arrived at ROEs that were too low.[104] In summary, his range of ROEs is from 9.5% to 10.5%, the midpoint of which is 10%.

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[98] Lawton Direct, Ex. 98, p. 11.

[99] *Id.* at 27.

[100] *Id.* at 31, 33.

[101] *Id.* at 34.

[102] *Id.* at 36.

[103] *Id.* at 38.

[104] *Id.* at 43.

Findings of Fact

Witness qualifications

23. MGE's main witness on this issue was Frank Hanley. Mr. Hanley has a Bachelor of Science degree from the College of Business Administration at Drexel University. He is currently director of AUS Consultants, and has appeared as a rate-of-return witness in over 300 proceedings.[105]

24. Staff witness David Murray earned a Bachelor of Science Degree in Business Administration from The University of Missouri - Columbia in May, 1995, and an MBA from Lincoln University in December 2003. He is the Acting Utility Regulatory Manager for the Staff of the Commission, having been employed with the Commission since 2000.[106]

25. OPC's cost of capital witness, Daniel Lawton, received a Bachelor of Arts Degree in Economics from Merrimack College, and a Masters of Arts Degree in Economics from Tufts University.[107]

OPC witness Lawton

26. The Commission finds OPC witness Lawton's testimony the most persuasive on this issue.

27. Mr. Lawton explains in detail in his testimony how he employed a twelve company comparable group as a proxy.[108]

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[105] Hanley Direct, Ex. 13, App. A, pp. 1-3.

[106] Staff Cost of Service Report, Ex. 41, App. 1, p. 10.

[107] Lawton Direct, Ex. 69, Sch. DJL-1.

[108] Lawton Direct, Ex. 69, p. 26.

28. Mr. Lawton's proxy group of twelve is larger than Mr. Murray's proxy group of seven and Mr. Hanley's proxy group of nine.[109] Lawton's proxy group is 70% larger than Murray's proxy group, and 33% larger than Hanley's proxy group. Lawton's use of the largest proxy group in this case means that his proxy group is less vulnerable to selection bias and the averages derived from his group should more closely approximate the average of the group.[110]

29. Mr. Lawton performed four separate analyses using a Constant Growth Discounted Cash Flow (DCF) model, a Two-Stage DCF model, a Risk Premium model, and a Capital Asset Pricing Model (CAPM).[111]

30. The result of Mr. Lawton's analysis is a range of ROE for the comparable group of 9.5% to 10.5% with 10.0% as a midpoint and a reasonable estimate of MGE's equity costs.[112]

31. Mr. Lawton proposed a 50 basis point reduction in his ROE recommendation if the Commission authorizes a straight fixed variable (SFV) rate design for MGE. However, a majority of the companies in Mr. Lawton's proxy group have significant portions of their revenues either wholly or partially decoupled.[113] The Commission finds the decreased risk associated with having a SFV rate design is already accounted for in Mr. Lawton's return on equity calculation, and no additional adjustment is necessary.[114]

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[109] Hanley Direct, Ex. 13, p. 17; Staff Cost of Service Report, Ex. 39, p. 29; Lawton Direct, Ex. 69, p. 27.

[110] Lawton, Tr. Vol. 9, p. 340.

[111] Lawton Direct, Ex. 69, at 26-45.

[112] Lawton Direct, Ex. 69, p. 6.

[113] Hanley Rebuttal, Ex. 14, p. 10; Hanley Surrebuttal, Ex. 15, p. 4.

[114] *Id.*

32. Even if a 50 basis point reduction were made to Mr. Lawton's recommended ROE range of 9.5 to 10.5%, an ROE of 10.0% would still be within the range he recommended as reasonable and appropriate for MGE in this case.[115]

MGE witness Hanley

33. Mr. Hanley used three equity return models, and then eliminated one result and estimated a midpoint between the remaining results.[116]

34. Mr. Hanley's DCF analysis is consistent with Mr. Lawton's 10.0% recommendation.[117] However, Mr. Hanley applied an arbitrary adjustment to his Risk Premium Analysis. First, Mr. Hanley concluded that stockholders can expect to earn in each of the next three to five years an incredible 28.85%.[118] He then subtracts an estimate for corporate bond yields to conclude that the premium an equity investor demands to purchase equity rather than debt is an astounding 23.77%.[119] Rather than eliminate this obvious unreliable result, Mr. Hanley simply assigns an arbitrary weighting of 20% and includes 20% of the outlier in his analysis.[120]

35. Mr. Lawton testified in response to Mr. Hanley's Direct Testimony analysis that he is not aware of any regulatory authority in the United States that has relied on an equity risk premium at the levels proposed by Mr. Hanley.[121] Furthermore, Mr. Lawton is not aware of any investor services, analyst estimates, or any credible forecasting entity that

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[115] Lawton, Tr. Vol. 9, p. 320.

[116] Lawton Rebuttal, Ex. 70, p. 8.

[117] *Id.*

[118] Hanley Direct, Ex. 13, Sch. FJH-15, p. 6.

[119] *Id.*

[120] *Id.*

[121] Lawton Rebuttal, Ex. 70, p. 10.

is suggesting that investors will earn equity returns of 28.85% over the next three to five years.[122]

36. Mr. Hanley relies on his 28.85% estimate despite concluding in his CEM analysis that a 22.0% ROE result is beyond reasonable and must be excluded.[123] The result is that Mr. Hanley's risk premium analysis is substantially overstated and cannot be relied upon for establishing ROE for MGE.[124]

37. MGE's analysis cannot be supported as a sound basis for setting just and reasonable rates.[125]

38. Mr. Lawton corrected Mr. Hanley's analysis by removing the forecasted returns and the results explain why Mr. Hanley felt the need to apply arbitrary adjustments. Without the inflated forecasted returns, Mr. Hanley's DCF analysis yields a 9.20% ROE, his Risk Premium analysis yields a 10.18% ROE, and his CAPM analysis yields a 9.0%-9.5% ROE.[126]

39. The average of these three models is 9.5%, which is consistent with Mr. Lawton's analysis and the analysis performed by Staff witness Mr. David Murray.[127]

Staff witness Murray

40. Mr. Murray recommends an ROE of 9.5%.[128]

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[122] *Id.*

[123] *Id.* at 10-11.

[124] *Id.*

[125] *Id.*

[126] *Id.* at 6.

[127] *Id.* at 7.

[128] Staff Cost of Service Report, Ex. 39, p. 36.

41. Staff's study, based on a seven company proxy group, supports a common equity range of 9.25 to 10.25,[129] with a true midpoint of 9.75 percent.

42. While admitting that his comparable companies have decoupled rate designs, Mr. Murray nonetheless adopts the lower half of his ROE range for the stated reason that his proxy companies "all have at least some degree of non-regulated operations."[130]

43. Bond ratings are an excellent way to estimate equity risk between companies, because they are the result of a comprehensive analysis of all diversifiable investment risks.[131]

44. SUG's bond rating is Moody's Baa3, which is the bottom of investment grade.[132]

45. The proxy group bond rating is Baa1.[133]

46. The Commission finds that investing in SUG is thus riskier than investing in the proxy group, and investors in SUG would require a higher rate of return to compensate them for that increased risk. Ignoring the upper half of Staff's ROE range, as Staff proposed, runs counter to that increased risk.

47. Further, MGE also engages in unrelated operations, with significant earnings in 2007 and 2008 coming from capacity release and off-system sales transactions. The average of Staff's seven proxy companies had 73.45% of net operating income in 2008 derived from gas distribution operations, with an average of 82.87% of total assets being

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[129] *Id.* at 29, 31, 36.

[130] Hanley Rebuttal, Ex. 14, p. 39; Staff Report, Ex. 40, p. 36.

[131] Hanley Direct, Ex. 13, p. 15.

[132] *Id.* at 25, 46.

[133] *Id.* at 28, 45.

devoted to gas distribution operations. It is clear that investors consider these companies to be gas distribution utilities and that the use of the lower half of Mr. Murray's recommended ROE range is without justification.[134]

Discounted Cash Flow

48. Both MGE witness Hanley and OPC witness Lawton used semi-annual DCF calculations.[135]

49. Murray used annual DCF calculations.[136]

50. Utilities pay dividends quarterly, and MGE is no exception.[137]

51. The Commission finds that the semi-annual DCF model recommended by Hanley and Lawton more closely approximates the returns actually expected by utility investors than the annual DCF calculation of Murray.

Concentration of Return on Equity evidence near 10.0%

52. Hanley's DCF rates have a median of 9.82%, which Staff conceded is a reasonable ROE estimate.[138] His total market equity risk premium was 9.71%.[139] His median CAPM result is 10.44%.[140]

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[134] Hanley Rebuttal, Ex. 14, pp. 39-40.

[135] Hanley Direct, Ex. 13, p. 41; Hanley, Tr. Vol. 9, p. 179; Lawton Direct, Ex. 69, p. 33; Sch. DJL-7.

[136] Staff Cost of Service Report, Ex. 39, p. 35; Murray, Tr. Vol. 9, pp. 297-98.

[137] Hanley, Tr. Vol. 9, p. 179; Murray, Tr. Vol. 9, pp. 296-98.

[138] Hanley Direct, Ex. 13, p. 40; Murray Rebuttal, Ex. 57, p. 2, 19.

[139] Hanley Direct, Ex. 13, p. 49.

[140] Hanley Rebuttal, Ex. 14, p. 44.

53. Correcting Murray's growth rates by using the range of growth rates indicated in Staff's schedules, Murray's DCF would be 10.07%.[141]

54. If Staff's theory of the proxy group's ROE needing reduction due to the group's non-regulated operations is ignored, and the upper half of Staff's ROE range is included, then Staff's recommended ROE range is 9.25-10.25%, with a midpoint of 9.75%.[142]

55. Lawton's constant growth DCF has a range of 9.82-10.04%, his non-constant growth has a range of 9.51-9.53%, and the total range of 9.51-10.04% has a midpoint of 9.8%.[143]

56. Using a risk premium of 3.89% based on historical risk premium calculations, instead of Hanley's 4.66% based on a less reliable estimated risk premium calculations, Lawton arrived at an ROE of 10.17%.[144]

57. A Goldman Sachs report, which Staff said the Commission could rely upon, estimated an ROE of 10-10.5%.[145]

58. Without the inflated forecasted returns, Mr. Hanley's Risk Premium analysis yields a 10.18% ROE.[146]

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[141] *Id.*; Ex. 41, Staff Cost of Service Report Appendices, Sch. 11-1, 11-2, 11-3, 12 and 13 of App. 2.

[142] Staff Cost of Service Report, Ex. 39, p. 36.

[143] Lawton Direct, Ex. 69, p. 36.

[144] Lawton Surrebuttal, Ex. 71, p. 6.

[145] Murray, Tr. Vol. 9, pp. 226-28.

[146] Lawton Surrebuttal, Ex. 71, p. 6; Sch. DJL-2SR.

59. If the Commission were to average Mr. Murray's 9.5% recommendation, Lawton's 10.0% recommendation, and Hanley's revised 10.5% recommendation, the average of these recommendations would be 10.0%.

60. The average ROE for natural gas companies for the most recent three-month period for which data was available was 10.11%.[147]

61. The Commission finds the zone of reasonableness is from 9.11 to 11.11%, with 10.11% being the midpoint.

Conclusions of Law

The Commission must estimate the cost of common equity capital. This is a difficult task, as academic commentators have recognized.[148] The United States Supreme Court, in two frequently cited decisions, has established the constitutional parameters that must guide the Commission in its task.[149] In the earlier of these cases, *Bluefield Water Works,* the Court stated that:

> Rates which are not sufficient to yield a reasonable return on the value of the property used at the time it is being used to render the services are unjust, unreasonable and confiscatory, and their enforcement deprives the public utility company of its property in violation of the Fourteenth Amendment.[150]

In the same case, the Court provided the following guidance as to the return due to equity owners:

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[147] Regulatory Research Associates Regulatory Focus, Ex. 96, p. 2.

[148] C.F. Phillips, Jr., The Regulation of Public Utilities, 390 (1993); Goodman, 1 The Process of Ratemaking, supra, at 606.

[149] *Fed. Power Comm'n v. Hope Nat. Gas Co.*, 320 U.S. 591, 64 S.Ct. 281, 88 L.Ed. 333 (1943); *Bluefield Water Works & Improv. Co. v. Pub. Serv. Comm'n of West Virginia*, 262 U.S. 679, 43 S.Ct. 675, 67 L.Ed. 1176 (1923).

[150] *Bluefield, supra,* 262 U.S. at 690, 43 S.Ct. at 678, 67 L.Ed. at 1181.

> A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties.[151]

The Court restated these principles in *Hope Natural Gas Company*, the later of the two cases:

> '[R]egulation does not insure that the business shall produce net revenues.' But such considerations aside, the investor interest has a legitimate concern with the financial integrity of the company whose rates are being regulated. From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.[152]

The Commission must draw primary guidance in the evaluation of the expert testimony from the Supreme Court's *Hope* and *Bluefield* decisions. Pursuant to those decisions, returns for MGE's shareholders must be commensurate with returns in other enterprises with corresponding risks. Just and reasonable rates must include revenue sufficient to cover operating expenses, service debt and pay a dividend commensurate with the risk involved. The language of *Hope* and *Bluefield* unmistakably requires a *comparative method*, based on a quantification of risk.

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[151] *Id.*, 262 U.S. at 692-93, 43 S.Ct. at 679, 67 L.Ed. at 1182-1183.

[152] *Hope Nat. Gas Co., supra,* 320 U.S. at 603, 64 S.Ct. 288, 88 L.Ed. 345 (citations omitted).

Investor expectations of MGE are not the sole determiners of ROE under *Hope* and *Bluefield*; we must also look to the performance of other companies that are similar to MGE in terms of risk. *Hope* and *Bluefield* also expressly refer to objective measures. The allowed return must be sufficient to ensure confidence in the financial integrity of the company in order to maintain its credit and attract necessary capital. By referring to confidence, the Court again emphasized risk.

The Commission cannot simply find a rate of return on equity that is "correct"; a "correct" rate does not exist. However, there are some numbers that the Commission can use as guideposts in establishing an appropriate return on equity. In a recent Report and Order concerning MGE itself, the Commission stated that it does not believe that its return on equity finding should "unthinkingly mirror the national average."[153] Nevertheless, the national average is an indicator of the capital market in which MGE will have to compete for necessary capital.

That "zone of reasonableness" extends from 100 basis points above to 100 basis points below the recent national average of awarded ROEs. Because the evidence shows the recent national average ROE for gas utilities is 10.11%, that "zone of reasonableness" for this case is 9.11% to 11.11%. The Commission has wide latitude in setting an ROE within the zone of reasonableness.[154] The zone of reasonableness is simply a tool to help the Commission to evaluate the recommendations offered by various rate of return experts.

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[153] *In re Missouri Gas Energy*, 12 Mo.P.S.C.3d 581, 593 (Report and Order issued September 21, 2004).

[154] *State ex. rel. Public Counsel*, 274 S.W.3d at 574 (*citing In re Permian Basin Area Rate Cases*, 390 U.S. 747, 767, 88 S.Ct. 1344, 20 L.Ed.2d 312 (1968))("**courts are without authority** to set aside **any** rate selected by the Commission [that] is within a 'zone of reasonableness')(emphasis supplied).

It should not be taken as an absolute rule that would preclude consideration of recommendations that fall outside that zone.

Decision

The Commission finds that the appropriate return on common equity is 10.0%.

Rate Design

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

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

The rates that MGE will be allowed to charge its customers are based on a determination of the company's revenue requirement. The Commission has resolved issues regarding revenue requirement. Now, what remains is what class of customers must pay what share of that revenue requirement.

This is a zero-sum game. If the Commission wants to remove a dollar's worth of revenue requirement responsibility from one customer class, it must assign that dollar to another customer class to keep revenue requirement the same.

Straight Fixed Variable

Under a traditional ratemaking scheme, a customer's bill would have two main components: a "fixed" charge, which a customer must pay even if he or she uses none of the utility's commodity; and a "volumetric" charge, which varies with the use of the commodity.

MGE and Staff wish to continue the SFV for the residential class, expand the Small General Service (SGS) class to include more customers, and also have a SFV for the SGS class. OPC opposes SFV, wanting the Commission to return to a more traditional, volumetric rate design. In particular, OPC proposed for MGE to collect 55% of residential revenue through a monthly customer charge, and for MGE to collect 45% of residential revenue through a uniform volumetric rate.[155]

Findings of Fact

Witness qualifications

62. Dr. Thompson holds a Ph.D. in economics from The University of Arizona.[156] He was a public utility economist with The Office of Public Counsel. Dr. Thompson has been a professor of economics at The University of Missouri-Rolla, Central Michigan University, and, currently, is an Assistant Professor of Economics at Western Washington University.[157]

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[155] Meisenheimer Rebuttal, Ex. 73, p. 7.

[156] Thompson Rebuttal, Ex. 36, p. 1.

[157] *Id.*

63. Mr. Feingold holds a baccalaureate degree in electrical engineering from Washington University in St. Louis, and a Master of Science degree in financial management from Polytechnic University of New York.[158] Mr. Feingold has over 33 years' experience in the utility industry, and is currently a Vice President at Black & Veatch, an engineering firm.[159]

64. Ms. Meisenheimer holds a Bachelor of Science degree in mathematics from The University of Missouri-Columbia, and has completed the comprehensive exams for a Ph.D. in economics, also at The University of Missouri-Columbia.[160] In addition to being employed as an economist for The Office of The Public Counsel, she also has taught at The University of Missouri-Columbia, William Woods University, and Lincoln University[161].

65. Ms. Ross holds both a Bachelor of Science and Master of Science degree in business administration from The University of Missouri-Columbia. She has been a regulatory economist for the Commission's Staff for 20 years.[162]

66. Mr. Kind holds both bachelor and master's degrees in economics from The University of Missouri-Columbia.[163]

67. Mr. Buchanan holds a baccalaureate degree in political science from Columbia College, and a master of science in public administration from The University of

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[158] Feingold Direct, Ex. 7, Sch. RAF-1.

[159] *Id.* at 1.

[160] Meisenheimer Direct, Ex. 72, p. 2.

[161] *Id.*

[162] Staff's Cost of Service Report, Ex. 41, App. 1, p. 19.

[163] Kind Direct, Ex. 75, p. 1.

Missouri.[164] He has worked for DNR for almost 30 years, and is currently a Senior Planner in DNR's Energy Policy and Planning Program.[165]

68. Dr. Warren has a bachelor of arts and a master of arts in economics from The University of Missouri-Columbia. He also holds a Ph.D. in economics from Texas A&M University.[166] Dr. Warren has been an economist for the Commission's Staff since 1992.[167]

Straight Fixed Variable Rate Design

69. The Commission finds that it should adopt the Straight Fixed Variable rate design for both the Residential and the Small General Service (SGS) customer classes. This finding is based upon the Commission's determination regarding Energy Efficiency issues addressed *infra*.

70. The term Straight Fixed Variable (or SFV) rate design applies to the customer's total bill. The fixed component of SFV is the non-gas, or margin costs. They are collected in a flat delivery charge, and customers pay for each unit of gas they use through the PGA (Purchased Gas Adjustment) charge. The variable component of SFV is the charge for the gas itself.[168]

71. There is only one level of service for residential customers – access to the natural gas distribution system. This service allows a residential customer to consume the amount of natural gas they wish and to consume it whenever they wish. With access to the system comes the billing and customer service for the commodity. The factor that differs

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[164] Buchanan Direct , Ex. 87, p. 3.

[165] *Id.* at 2.

[166] Staff's Cost of Service Report, Ex. 41, App. 1, p. 25.

[167] *Id.*

[168] Ross Rebuttal, Ex. 63, p. 3.

among Residential customers is the actual amount of gas used, and the charge for that is collected in the variable portion (V) of SFV, which is the amount of gas the customer consumes.[169]

Straight Fixed Variable rate design best reflects the actual costs customers impose upon MGE's system.

72. The cost to provide distribution service to customers within these homogeneous customer classes does not vary based on the size of the customer's load.[170]

73. To the contrary, the minimum installed size of distribution main will serve over 99 percent of the Company's residential customers taking into account the average density of the Company's gas distribution system, its standard operating pressures, and the design day load characteristics of the customers served under the RS rate class.[171]

74. MGE's costs to serve any two Residential customers are driven by factors other than customer size, such as distance from the transmission pipeline, customer density in the area, terrain in the customers' geographical area, or the exact age and depreciated cost of the equipment serving the customer.[172]

75. A major goal in establishing reasonably homogenous classes is to limit both inter and intra-class subsidies.[173]

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169 *Id.*

170 Staff Class Cost of Service Report, Ex. 43, p. 10.

171 Feingold Rebuttal, Ex. 8, p. 5.

172 Staff Class Cost of Service Report, Ex. 43, p. 10.

173 Ross Surrebuttal, Ex. 64, p. 2

76. Similarly, the Company's cost of gas delivery service is the same for customers in the SGS class.[174]

77. A two-inch main, the smallest size of main used by MGE, will serve 99 percent of the customers served under its new SGS rate class.[175]

78. SFV rates are intended to recover fixed costs through fixed charges and variable costs (i.e., the cost of the gas commodity) through variable charges. Accordingly, SFV rates properly reflect the nature of the costs incurred by MGE to serve its RS and SGS customers. Very simply, if a customer uses one cubic foot of gas or 13.2 Mcf per day (the design day capacity per customer for a two inch main on the Company's gas system), there is no difference in the cost of delivery service, on average, within the Residential or SGS rate classes.[176]

SFV Rate Design Reduces Spikes in Winter Bills and Moderates Bill Fluctuations Throughout the Year.

79. Under the traditional rate design advocated by OPC, when the weather is colder, two components of a customer's bill – the margin piece and the cost of the gas itself – will combine to sharply increase a residential customer's bill. Conversely when it is warmer than expected, a customer can expect a lower bill.[177]

80. In support of how SFV rate design stabilizes both customers' bills and Residential class revenue, Staff witness Ross persuasively cites the example of calendar year 2008. Because the weather was colder than normal in calendar year 2008, the

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[174] Staff Class Cost of Service Report, Ex. 43, p. 14.

[175] Feingold Direct, Ex. 7, p. 21.

[176] Feingold Surreubuttal, Ex. 9, pp. 5-6; Meisenheimer, Tr. Vol. 9, pp. 441-445.

[177] Ross Rebuttal, Ex. 63, p. 8.

aggregate group of MGE residential customers paid nearly $2,205,000 less with SFV than they would have paid under traditional rate design.[178]

81. While OPC used the table to support a claim that customers paid $18,000,000 more under the SFV rate design, that number was calculated by including 14 non-winter months and only 7 winter months in OPC's analysis.[179] Thus, the analysis was skewed to include two heating seasons by covering 21 months.[180]

82. The $2.2 million savings referenced in Ross' rebuttal testimony reflects the 12-month test year.[181]

83. During colder than normal weather, the customers would have overpaid the utility's cost of service under OPC's traditional rate design because they would have paid an additional charge for each unit of gas.[182]

84. The other component of the customer's bill – the charge for actual gas used – was the same for Residential customers under the SFV rate design as it would have been under the traditional rate design.[183]

85. To demonstrate the benefits of its levelized fixed-delivery charge, MGE conducted a study of revenues over the past nine (9) winter months (November 2007 through March 2008 and November 2008 through February 2009).[184]

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[178] Ross Rebuttal, Ex. 63, p. 9.

[179] *Id.*

[180] *Id.*

[181] *Id.*

[182] *Id.*

[183] *Id.*

[184] Feingold Direct, Ex. 7, pp. 16-17; Sch. RAF-6.

86. That study compares the monthly gas bills of residential customers under the SFV rate design to bills that would have been collected under the previous volumetric rate design recomputed at MGE's revenue level approved in its last rate case.[185]

87. Over the last nine (9) month winter periods, each residential customer saved on average about $81.00 under the SFV rate design compared to the amount they would have been billed under a volumetric rate design proposed by Public Counsel.[186]

88. In short, the SFV rate design provides revenue stability for both customers and the company.[187]

89. What is more, with SFV, roughly 57% of MGE's residential ratepayers should have bills that are as low, or even lower, than they would have been under a traditional rate design.[188] In other words, the majority of MGE's residential ratepayers will be either no worse off or better off under SFV.

SFV Rates Represent Economically Efficient Pricing.

90. When customers lower gas usage, they directly lower the largest portion of their gas bill because 70 to 75% of the customer's bill is for the amount of gas used.[189]

91. With an SFV rate design, the fixed cost component of the rate structure does not change with use.[190]

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[185] *Id.*

[186] *Id.*

[187] *Id.*

[188] Noack, Tr. Vol. 15, pp. 1162-1167.

[189] Ross Rebuttal, Ex. 63, p. 4.; Noack, Tr. Vol. 12, p. 729.

[190] Feingold Surrebuttal, Ex. 9, p. 4.

92. The variable cost component of the rate structure consists of MGE's commodity charge that comprises over 70% of the typical residential bill.[191]

93. This component of the SFV rate design causes bills to increase as use increases.[192]

94. Therefore, it is simply incorrect to conclude that more gas use does not collect more revenue from a customer under an SFV rate design. Customers' bills increase with use based on the variable cost component, which is the cost of gas. Straight Fixed Variable has exactly the efficiency properties required by economic theory since fixed costs have no impact on marginal costs.[193]

SFV Rate Design Simplifies Customers' Bills.

95. The gas bill contains only two parts: (1) the fixed monthly delivery charge and (2) the amount charged for the cost of gas used.[194]

96. The fixed monthly delivery charge component informs the customer of the fixed costs associated with connecting them to the distribution network to receive natural gas service.[195]

97. The PGA (Purchased Gas Adjustment), on the other hand, which represents the great majority of a typical residential customer's annual gas bill, is a direct dollar-for-dollar pass-through of the cost of the gas consumed by the customer.[196]

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[191] *Id.*

[192] *Id.*

[193] *Id* at 4-5.

[194] Staff Class Cost of Service and Rate Design Report, Ex. 43, p. 10.

[195] *Id.* at 11-13.

[196] *Id.* at 4.

98. A pricing structure of this nature is simple, direct and easy for the Company and the Commission's Customer Service Department to explain.[197]

SFV Rate Design Stabilizes MGE's Revenues.

99. SFV rates provide the Company with a more predictable and reliable revenue stream. Fixed distribution costs are recovered evenly throughout the year and recovery of those costs are not subject to the vagaries of weather.[198]

100. This allows the Company to better position itself to cover its costs of operation and to earn its authorized rate of return.[199]

101. But even with SFV rates, there is no certainty of revenue for the utility. For example, there is no guarantee under SFV that MGE's customer numbers will not decline, or that bad debts will not increase during a time of economic hardship. Moreover, MGE will continue to face pressure on earnings in the form of cost increases, infrastructure investments and an aging workforce.[200]

102. Public Counsel's position of wanting a more traditional rate design is grounded on the assumption that higher income households are, on average, higher users of natural gas.[201]

103. But the income-consumption relationship for MGE's customers is "U"-shaped; that is, usage may be high at low income levels and fall as income increases, but then reaches a minimum and begins to climb again after a certain income level. Imagining a

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[197] Ross, Tr. Vol. 13, p. 900.

[198] Ross Rebuttal, Ex. 63, pp. 8-9.

[199] Hack Rebuttal, Ex. 11, p. 2.

[200] Feingold Rebuttal Ex. 8, p. 11.

[201] Meisenheimer, Tr. Vol. 10, pp. 464-65.

graph with income on the horizontal axis and monthly usage per customer on the vertical, the relationship described would have a "U"-shape.[202]

104. The income-consumption relationship becomes positively correlated at higher income levels, but usage at the lowest income levels is greater than the overall average usage.[203]

105. Nothing indicates that low-income customers as a group use a lower than average quantity of natural gas.[204]

106. A volumetric charge would likely have a regressive impact on low income customers because low income customers in MGE's service territory consume higher than average volumes.[205]

107. Such a volumetric charge would not reflect the true costs of serving that class, and would also recreate intra-class subsidies that existed within the residential class.[206]

108. This conclusion is supported by an analysis of those MGE customers who receive low income energy assistance. Approximately 82 percent of the MGE customers who received energy assistance would experience higher winter bills under Public Counsel's volumetric-based rate design proposal than they would under the current SFV charges.[207]

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[202] Thompson Rebuttal, Ex. 36, p. 5, 13.

[203] *Id.*

[204] Thompson Rebuttal, Ex. 36, Sch. PBT-3, p. 8.

[205] *Id.* at 16.

[206] Feingold Rebuttal, Ex. 8, p. 3, 24; Staff Report - Class Cost of Service and Rate Design, Ex. 43, p. 13.

[207] Thompson Rebuttal, Ex. 36, pp. 16-17.

109. This is in line with the theory that traditional rate design harms those unable, as opposed to unwilling, to make their residences more energy efficient, such as the elderly, disabled, and those unable to afford their own homes.[208]

110. Public Counsel's reliance on nationally and regionally aggregated data is less persuasive than MGE's reliance on a study of its own service territory.

111. The U.S. Department of Energy Residential Energy Consumption Surveys are compilations of nationwide household usage data.[209] So, too, is the LIHEAP Home Energy Notebook.[210]

112. Even the regionally aggregated data has Missouri lumped together with much more northern states, including North Dakota.[211]

State Energy Policy Strongly Favors Revenue Decoupling Rate Designs.

113. In 2001, the Commission established a Natural Gas Commodity Price Task Force to investigate the process for recovery of natural gas commodity cost increases by LDCs.[212]

114. The members of the 2001 Task Force, *which included Public Counsel*, issued a Final Report in August of 2001 including a recommendation that there be a "redesign of

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[208] Ross Rebuttal, Ex. 63, p. 12.

[209] Meisenheimer, Tr. Vol. 9, p. 471.

[210] *Id.* at 472.

[211] *Id.* at 473.

[212] Commission File No. GW-2001-398.

base rates for fixed (non-commodity related) distribution charges placing more or all costs in a monthly service charge and less or none in the commodity charge."[213]

115. The Final Report also observed that an LDC "may have little incentive to facilitate programs designed to reduce energy use because in doing so the LDC may be reducing its revenue base."[214]

116. Thus, the Task Force recognized that a revenue decoupling rate design is an essential component of meaningful natural gas conservation policy.[215]

117. Again, in 2004, the Commission established a Cold Weather Rule and Long-Term Energy Affordability Task Force to examine "possible programs to improve long-term energy affordability for persons who need help with their utility bills."[216]

118. Members of the Task Force, *which included Public Counsel*, issued a Final Report that included the recommendation that the Commission consider implementing "rate designs that remove disincentives for utilities to pursue programs aimed at reducing usage" as part of the objective to improve long-term energy affordability.[217]

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[213] Hack Rebuttal, Ex. 11, p. 4.

[214] *Id.* at 4-5.

[215] Hack Rebuttal, Ex. 11, p. 3, at Sch. RJH-2.

[216] Commission File No. GW-2004-0452.

[217] Hack Rebuttal, Ex. 11, p. 4, Sch. RJH-3.

MGE's Proposed SGS and LGS Class Restructuring

119. MGE will restructure the SGS class from customers whose usage does not exceed 10K Ccfs in any one month to a new SGS class where usage is less than 10K Ccfs annually.[218]

120. The proposed SGS class requirements provide a more homogenous customer class. Load size is not the cost driver in the restructured SGS class.[219]

121. The average residential customer buys approximately 800-825 Ccf/year and the average new SGS class customer buys 114 Ccf/month or 1362 Ccf/year.[220]

122. Residential and new SGS customer class usage levels, in contrast to the LGS class, are far below the LGS usage levels of 22,118 Ccf/year or 1.843 Ccf/month.[221]

123. MGE installs the same size meter, regulator service line, and distribution main to serve virtually all SGS customers regardless of the monthly or annual volume of gas they use. The same situation exists for the Company's residential customers. This means that the size of the delivery service facilities is independent of gas volume and should, by Public Counsel's own standard, be recovered through an SFV rate structure.[222]

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[218] Staff Class Cost of Service Report, Ex. 43, p. 13.

[219] *Id.* at p. 14.

[220] Feingold Direct, Ex. 7, Sch. RAF-1, pp. 1-4; Noack cross, Tr. Vol. 15, pp. 1162-67.

[221] Feingold Direct, Ex. 7, Sch. RAF-7, pp. 7-8.

[222] Feingold Rebuttal, Ex. 8, p.7.

Conclusions of Law

MGE has the burden of proof to show that its proposed tariffs are just and reasonable, *including* the reasonableness of its rate design.[223] Just because a company derives a higher rate of return from one class than another does not necessarily render those rates unjust or unreasonable.[224]

Class cost of service is often considered but a starting point in quantifying what part of the revenue responsibility is afforded to each customer class.[225] Indeed, class costs of service studies are often considered more art than science.[226] Other factors should be considered when establishing rates.[227] It is up to the Commission to evaluate the testimony of expert witnesses and accept or reject any or all of any witness's testimony.[228]

The Energy Independence and Security Act of 2007 addresses revenue decoupling in conjunction with its directive that utilities develop energy efficiency programs. Section 532(b)(6)(A) of that law states that "the rates allowed to be charged by a natural

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[223] *See, e.g., State ex rel. Monsanto Company v. Public Service Commission,* 716 S.W.2d 791 (Mo. 1986) "Laclede filed the tariffs here in question using the existing rate design. In the suspension order and notice of proceedings dated January 18, 1983, the Commission noted that the Company bore the burden of proof before the Commission and ordered the Company 'to provide evidence and argument sufficient for the Commission to determine . . . the reasonableness of the Company's rate design.'" *Id.* at 795. See also *In re Empire District Electric Company*, Commission Case No. ER-2004-0570, Report and Order (March 10, 2005).

[224] *Midwest Gas Users Ass'n v. Kansas SCC,* 595 P.2d 735, 747 (Kan. App. 1979).

[225] *Shepherd v. City of Wentzville*, 645 S.W.2d 130, 133 (Mo. App. 1982)

[226] *Associated Natural Gas Co.*, 706 S.W.2d at 880 (*citing United States v. Federal Communications Commission*, 707 F.2d 610, 618 (D.C.Cir. 1983).

[227] *State ex rel. Associated Natural Gas Co. v. Public Service Commission of Missouri*, 706 S.W.2d 870, 879 (Mo. App. 1985) (*citing Southwestern Bell Telephone Company v. Arkansas Public Service Commission,* 593 S.W.2d 434, 445 (Ark. 1980); *Shepherd v. Wentzville,* 645 S.W2d 130 (Mo. App. 1982); *State ex rel. City of Cape Girardeau v. Public Service Commission*, 567 S.W.2d 450 (Mo. App. 1978); *Midwest Gas Users' Ass'n v. State Corp. Com'n, 595 P.2d 735* (Kan. App. 1979); *Central Maine Power Company v. Public Utilities Commission, 382 A.2d 302* (Me. 1978); *St. Paul Area Chamber of Commerce v. Minn. Public Service Commission*, 251 N.W.2d 350 (Minn. 1977); and *American Hoechest Corporation v. Department of Public Utilities*, 399 N.E.2d 1(Ma.1980).

[228] *Id.* (*citing In Re Permian Basin Area Rate Cases*, 390 U.S. 747,800, 88 S.Ct.1344,1377, 20 L.Ed.2d 312, (1968)).

gas utility shall align utility incentives with the deployment of cost-effective energy efficiency."[229]

In addition, the Act further directs each state utility regulatory authority to consider "separating fixed cost recovery from the volume of transportation or sales service provided to the customer."[230] Also, the Act orders the authority to consider providing utilities incentives for the success management of energy efficiency, and to consider adopting rate designs that encourage energy efficiency.[231]

In deciding whether to approve a Straight Fixed Variable rate design, some factors the Commission should consider are: 1) whether high-use consumers will stop paying a disproportionate share of the operating expenses; 2) month-to-month volatility of bills will be reduced; 3) consumers will still retain control over a majority of t heir monthly natural gas costs; 4) ratepayers' interests will be aligned with the utility's shareholders because of the removal of the disincentive for the utility to encourage natural gas conservation.[232]

Decision

The Commission finds this issue in favor of MGE. With SFV, high-use consumers will stop paying a disproportionate share of MGE's operating expenses. Month-to-month volatility of bills will be reduced. Consumers still retain control over a majority of their monthly natural gas costs. Ratepayers' interests will be aligned with the interests of the

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[229] 15 U.S.C. § 3203(b)(6)(A).

[230] *Id.* at (b)(6)(B)(i).

[231] *Id.* at (b)(6)(B)(ii), (iv).

[232] *State ex. rel. Missouri Office of Public Counsel v. Public Service Commission of Missouri*, 293 S.W.2d 3d 63, 72ff (Mo.App. S.D. 2009).

shareholders because of the removal of the disincentive for the utility to encourage natural gas conservation. MGE shall continue administering its Straight Fixed Variable rate design to its residential customers, and shall administer it to its Small General Service customers.

Energy Efficiency – 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 recovers all non-gas costs through a fixed customer charge?

Findings of Fact

The Findings of Fact supporting the Commission's decision are under the Rate Design section of this Report and Order.

Conclusions of Law

There are no additional Conclusions of Law.

Decision

The continuation (for residential customers) and implementation (for small general service customers) of energy efficiency programs should be contingent on the adoption of a rate design that recovers all non-gas costs through a fixed customer charge.

Energy efficiency -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?

Findings of Fact

124. MGE has agreed to initially fund an annual amount of $1 million per year for its EE programs, beginning when rates go into effect in this case. This annual funding amount would initially not be included in MGE's rates. This amount would be subject to increase if warranted by the programs' continued growth and success. This would be a topic to be addressed by the EEC.[233]

125. MGE's annual funding amount would be deferred and treated as a regulatory asset with a ten year amortization period. The amortization would begin with the effective

[233] Initial Post-Hearing Brief of Missouri Gas Energy, pp. 28-30 (filed December 18, 2009). See also Boudreau, Tr. Vol. 12, pp. 680-81.

date or any rates resulting from the next general rate case. Any amounts would be included in MGE's rate base in the next general rate case.[234]

126. Funds will be divided proportionally between classes (the new SGS class would receive up to 10% of the funding, Residential will receive up to 90%).[235]

127. MGE would assign the same short term interest rate determined in this case to any unspent amounts previously collected in rates on a going forward basis.[236]

128. MGE wishes to retain the EEC, but modify its structure to an advisory capacity.[237]

129. MGE will spend currently unspent energy efficiency funds prior to contributing additional amounts to Residential programs.[238]

130. EE programs would be set forth in a tariff.[239]

131. The SGS Energy Efficient Natural Gas Equipment Incentive Program would be designed to encourage more effective utilization of natural gas by encouraging energy efficiency improvements through the replacement of less efficient natural gas equipment with high efficiency Energy Star qualified natural gas equipment and other high efficiency equipment and measures. MGE would solicit input from the EEC on specific programs and incentive levels. Depending on the results of the programs MGE may in the future request permission from the Commission to expand the program to include other program options

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[234] *Id.*
[235] *Id.*
[236] *Id.*
[237] *Id.*
[238] *Id.*
[239] *Id.*

after dialogue with the EEC. The incentive could include but would not be limited to the following Energy Star qualified appliances:

> Natural gas forced air furnaces
> Natural gas water heater
> Natural gas boiler systems
> Natural gas combination systems
> Commercial natural gas utilization equipment, such as
> Modulating burners
> Venturi steam traps
> Kitchen exhaust hoods
> Waste heat recovery
> Heat exchangers.[240]

132. The EEC will continue to provide input and suggestions on MGE's EE programs. MGE will continue to provide quarterly report on its EE programs.[241]

133. Unless otherwise ordered by the Commission, on an annual basis, the EEC will review MGE's annual funding amount to and expenditures for its EE programs. The EEC (or the members, if agreement cannot be reached) may submit a recommendation to the Commission to increase or decrease MGE's annual funding amount. The recommended increase or decrease to the annual amount of funding may be contested by any member of the EEC.[242]

134. Energy efficiency programs that are designed to reduce natural gas consumption by its customers can lead to the reduction of wholesale natural gas prices as well as generating direct cost savings to natural gas customers, which will be reflected in rates.[243]

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[240] *Id.*

[241] *Id.*

[242] *Id.*

[243] Buchanan Direct, Ex. 87, p. 6.

135. According to a recent study completed by the American Council for an Energy- Efficient Economy (ACEEE), reductions in natural gas consumption could result in wholesale natural gas price reductions.[244]

136. Because of the very tight and volatile U.S. natural gas market, a reduction of about 1 percent per year in total U.S. gas demand could potentially result in wholesale natural gas price reductions of 10 to 20 percent.[245]

137. The study identifies new energy policies and additional funding for energy efficiency programs necessary to achieve savings significant enough to reduce the wholesale price of natural gas as well as to generate direct cost savings to natural gas consumers.[246]

138. The study estimated an annual energy efficiency investment by each of the 8 Midwest states, including Missouri, based on each state's proportional allocation of total projected regional natural gas savings in 2010.[247]

139. From a regional perspective, in order to reduce natural gas demand sufficiently to pressure wholesale prices downward, the study roughly estimated that Missouri would be required to expend approximately $12 million per year for natural gas related energy efficiency programs through the year 2020.[248]

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[244] *Id.*
[245] *Id.*
[246] *Id.*
[247] *Id.*
[248] *Id.*

140. The study estimates that the dollar savings impact of the associated natural gas price reductions from this level of investment would be approximately $921 million for Missouri by 2015 and an additional $847 million by the year 2020.[249]

141. While MGE should be commended for addressing and responding to the energy efficiency needs of its residential and Small General Service natural gas customers, MGE's current energy efficiency funding levels will not result in sufficient savings to contribute to lower wholesale natural gas prices. A more significant level of investment in energy efficiency is required to potentially pressure natural gas wholesale prices lower.[250]

142. The Commission recognizes that MGE alone cannot have a significant impact on wholesale prices through its energy efficiency programs. But MGE can and should contribute in a more meaningful way toward a regional reduction in natural gas consumption.[251]

143. In addition to the American Council on an Energy-Efficient Economy study, the National Action Plan for Energy Efficiency sponsored by the USDOE and the United States Environmental Protection Agency and prepared by 50 leading organizations, including a variety of natural gas companies, noted the most effective energy efficiency projects were funded at a level equal to a minimum range of 0.5 to 1.5 percent of a natural gas utility's annual operating revenue.[252]

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[249] *Id.*

[250] *Id.*

[251] Buchanan Direct, Ex. 87, pp. 6-7.

[252] *Id.* at 7.

144. Based on the 2008 annual operating revenues reported by MGE, the minimum goal of annual energy efficiency program investments should be approximately $4 million, using MGE 2008 annual gross operating revenue.[253]

145. MGE has not expended the amount it has collected in rates on energy efficiency programs.[254]

146. However, MGE has not been implementing a variety of programs, and the programs it currently is implementing are all relatively new.[255]

147. Once MGE's energy efficiency programs become established, and it initiates additional, cost-effective programs, it will be possible for MGE to spend significantly more.[256]

148. Mr. Buchanan, DNR's witness, persuasively explained how.[257]

149. An initial target for annual energy efficiency program expenditures (so long as this level of expenditure is expected to be cost-effective) is necessary to assist MGE in identifying and adopting a series of cost-effective energy efficiency programs.[258]

150. A prescribed budget would help facilitate the evaluation of energy programs as well as assist in the design and implementation of the number and type of cost-effective programs that could be offered by MGE.[259]

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[253] *Id.* at 8.

[254] Hack, Tr. Vol. 8, p. 66; Kind, Tr. Vol. 13, p. 850.

[255] Hendershot, Tr. Vol. 12, pp. 690-92.

[256] Buchanan Surrebuttal, Ex. 89, p. 4; Tr. Vol. 12, pp. 709-710.

[257] Buchanan Surrebuttal, Ex. 89, p. 4.

[258] Buchanan Rebuttal, Ex. 88, p. 12.

[259] *Id.*

151. That target level of energy efficiency funding based on MGE's annual gross operating revenues, and established as a condition for allowing a higher fixed customer charge, would assure that MGE would implement a slate of cost effective energy efficiency programs considered to be significant in size and sufficient to help customers reduce the most substantial component of their monthly utility bill.[260]

152. Ratepayers should be properly compensated when they supply monies to the utility via the regulatory process. The overall cost of capital is the appropriate rate to use when calculating interest on the energy efficiency funds so that all ratepayer supplied funds are treated consistently with all other monies supplied by ratepayers in the regulatory process.[261]

153. MGE proposes to compensate ratepayers by an interest amount equal to the short-term debt rate which traditionally has the lowest cost of any component of the capital structure.[262] Allowing compensation at this low rate would allow MGE to leverage this process by using these funds to replace short-term debt, thus improperly increasing MGE's earnings.[263] As OPC witness Russell Trippensee persuasively explained:

> Furthermore, short-term debt is also assumed to be used for construction work in progress (CWIP) on which the utility is allowed to record an earnings rate referred to as the Allowance for Funds Used During Construction (AFUDC). The AFUDC rate includes not only short-term costs but also other higher cost capital to the extent short-term debt is less than the needed capital to support the construction projects. Therefore, [MGE's] proposal would allow MGE to leverage this process by using these [energy efficiency] funds to replace short-term debt thus reducing balances of short-term debt in the AFUDC calculation. The result would be that the monies invested in CWIP

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[260] *Id.* at 12-13.

[261] Trippensee Surrebuttal, Ex. 80, pp. 5-7.

[262] *Id.* at 6.

[263] *Id.*

> would earn an AFUDC rate that was higher than the short-term debt rate, thus increasing the Company's earnings.
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> All other monies supplied by ratepayers in the regulatory process are recognized in the determination of cash working capital and its related components and included in the rate base. To the extent ratepayers provide this money before the utility uses the monies, and average balance is used to reduce rate base. Thus the ratepayers effectively are compensated at the overall cost of capital on the monies the ratepayers supplied. The inclusion of monies as a reduction to rate base would have the same impact as not recognizing the EEF monies as a rate base offset and paying interest on those monies equal to the overall cost of capital.[264]

154. The break-even point for residential customers who benefit from Straight Fixed Variable versus customers who benefit from traditional rate design is approximately 824 Ccf annually.[265]

155. Regardless of which rate design MGE has, different customers will fare better under different designs, as it is not cost effective or practical to determine cost of service for every individual customer.[266]

156. 824 Ccf usage annually is average for an MGE residential customer.[267]

157. Approximately 43% of MGE's residential customers use less than the average amount of 824 Ccf.[268]

158. Approximately 6-7% of those 43% of MGE residential customers who have below 824 Ccf annual usage are not space heating customers.[269]

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[264] *Id.* at 6-7.

[265] Noack, Tr. Vol. 15, pp. 1163-64, 67. See also MGE Chart, Ex. 120.

[266] Meisenheimer, Vol. 10, pp. 439-41.

[267] *Id.*

[268] Noack, Tr. Vol. 15, p. 1164.

[269] *Id.* at 1162.

159. Therefore, approximately 36-37% of MGE's residential customers who have below 824 Ccf annual usage are space heating customers, and fall within a usage range of 400-824 CCf annually.[270]

160. Possible explanations for residential customers' higher usage include poorly insulated homes or inefficient appliances.[271]

161. MGE is willing to try alternative energy efficiency methods.[272]

Conclusions of Law

There are no additional conclusions of law for this issue.

Decision

Funding Level and Distribution of Energy Efficiency Resources

The Commission finds that DNR's position is persuasive in that energy efficiency funding should be tied to MGE's annual gross operating revenues. The Commission further finds that DNR's request that .5% of MGE's annual gross operating revenues should be allocated for energy efficiency funding and that it is an appropriate goal or benchmark in expenditures for natural gas utilities. The Commission finds that the EEC should take all steps necessary to work toward implementation of cost-effective energy efficiency programs to reach this goal to maximize benefits. However, immediately increasing annual energy efficiency expenditures from today's allocation of $1.5 million to .5% or

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[270] *Id.*

[271] Meisenheimer, Tr. Vol. 10, p. 466.

[272] Hendershot, Tr. Vol. 12, p. 716; Warren, Tr. Vol. 12, p. 737.

approximately $4 million is too ambitious at this time. The Commission expects that EEC keep the Commission informed of steps taken to reach this goal or to bring before the Commission disputes among parties in the EEC.

MGE will initially fund an annual amount of a minimum of $1.5 million per year for its energy efficiency program. This amount shall be subject to increase toward the goal of .5% of gross operating revenues at the time the EEC has a comprehensive plan for the increased expenditure level. Increased expenditures shall be dependent upon programs' continued growth and success. If the EEC is unable to reach consensus or agreement for increased expenditures, any party may petition the Commission for further direction toward that goal. The Commission expects all programs to be tracked for cost effectiveness and prudence. Further, MGE shall continue to provide quarterly reports on its EE programs.

Funds shall be divided proportionally between classes (the new SGS class would receive up to 10% of the funding, Residential will receive up to 90%) MGE will assign an interest rate equivalent to the overall cost of capital determined in this case to any unspent amounts previously collected in rates on a going forward basis. EE programs would be set forth in a tariff.

The Commission orders that MGE's annual funding amount shall not be included as an ongoing expense in rates. MGE shall provide upfront funding using approximately $1 million of surplus, unspent funds for residential energy efficiency programs included in past rates. Expenditures above the initial investment of $1 million shall be deferred in a regulatory asset account for potential recovery in a future case.

Energy Efficiency Collaborative

The EEC shall continue to provide input and suggestions on MGE's EE programs. On an annual basis, the EEC shall review MGE's annual funding amount to and expenditures for its EE programs. The EEC (or the members, if agreement cannot be reached) may submit a recommendation to the Commission to increase or decrease MGE's annual funding amount. The recommended increase or decrease to the annual amount of funding may be contested by any member of the EEC.

MGE and the EEC shall develop a plan that will annually increase the amount of funding from the base level of $1.5 million towards the goal of .5% of gross operating revenues. As discussed *supra,* the Commission is not mandating .5% of annual gross operating revenues be expended immediately on EE programs. However, the Commission believes that MGE and the EEC should work towards reaching that goal in the near future.

SGS Energy Efficient Natural Gas Equipment Incentive Program

The SGS Energy Efficient Natural Gas Equipment Incentive Program shall be designed to encourage more effective utilization of natural gas by encouraging energy efficiency improvements through the replacement of less efficient natural gas equipment with high efficiency Energy Star qualified natural gas equipment and other high efficiency equipment and measures. MGE shall solicit input from the EEC on specific programs and incentive levels. Depending on the results of the programs MGE may in the future request permission from the Commission to expand the program to include other program options after dialogue with the EEC. The incentive could include but would not be limited to the following Energy Star qualified appliances:

Natural gas forced air furnaces
Natural gas water heater
Natural gas boiler systems
Natural gas combination systems
Commercial natural gas utilization equipment, such as
Modulating burners
Venturi steam traps
Kitchen exhaust hoods
Waste heat recovery
Heat exchangers.

Residential Space Heating Customers

The EEC shall design a program for MGE's residential space heating customers that are negatively impacted by the Straight Fixed Variable rate design, which are customers who annually use between approximately 400 and 824 Ccf. MGE shall identify such customers and the EEC shall determine appropriate funding levels and program terms to: 1) address the adverse impact of the rate design, and 2) address specific energy efficiency programs that apply to this group of customers. In addition, OPC shall propose specific EE programs or other programs to assist these customers. MGE shall provide quarterly reports detailing its progress on reaching consensus with the EEC in this regard.

Green Impact Zone & Stimulus Funds

The EEC shall detail in the quarterly report how it plans to budget financial resources and how it will work to support the objectives of the "Green Impact Zone." As part of MGE's quarterly reports, MGE shall report its stimulus[273] investment information to the Commission.

[273] Funds received as authorized by the American Recovery and Reinvestment Act of 2009.

Energy Efficiency 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?

Findings of Fact

162. MGE wishes to have complete control over all decision-making of the collaborative, despite MGE having the least amount of experience in energy efficiency programs of any of the collaborative members.[274]

163. MGE benefited greatly from the experience of Staff, DNR and OPC during the collaborative process.[275]

164. Without the collaborative that resulted from MGE's last rate case, MGE would have had a much smaller offering of residential energy efficiency programs without the support and guidance it received from the other experienced collaborative members.[276]

Conclusions of Law

There are no additional Conclusions of Law for this issue.

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[274] Warren, Tr. Vol. 12, pp. 734-735.

[275] Kind Rebuttal, Ex. 76, p. 2.

[276] *Id.*

Decision

The energy efficiency collaborative formed after MGE's most recently concluded rate case should remain a consensus group, and should not be modified to an advisory group.

Rate of Return Conclusion

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?

Findings of Fact

There are no additional findings of fact for this issue.

Conclusions of Law

There are no additional conclusions of law for this issue.

Decision

The Commission's adoption of MGE's proposed rate design would reduce MGE's business risks. The Commission has already addressed to what extent the rate design would reduce MGE's business risks in the Findings of Fact and Conclusions of Law of the Return on Equity section of this Report and Order.

True-Up Issues

The Commission sets rates based upon a "test year", either ordered by the Commission or agreed to by the parties. That "test year" is normally a recent calendar year for the parties to refer to so that in planning their cases, they may match revenue requirement items for the same period. A "true-up" of revenues and expenses often occurs in rate cases, which reflects known and measurable events after the conclusion of the test year, but during the pendency of the rate case.

Prepaid Pension Asset

Two prepaid pension asset issues are before the Commission. The first is a timing issue. That is, whether the amortizations of the prepaid pension assets created in Files Nos. GR-2004-0209 and GR-2006-0422 should begin the month after the true-up date in those cases, or with the effective date of the Report and Order in each case. The second issue concerns Staffs proposed application of a capitalization ratio. This question is whether a capitalization ratio should be applied to the prepaid pension asset, which would reduce the amount of that asset included in rate case. Also, the issue concerns whether to apply the capitalization ratio to the prepaid asset expense.

Findings of Fact

165. The Order Establishing True-Up[277] indicates that the rate base will be trued-up for "prepaid pension asset and pension tracker assets" "pensions and OPEBs" and "depreciation and amortization expense."

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[277] Order Establishing True-Up, File No. GR-2009-0355 (September 15, 2009).

166. Also, the Partial Stipulation and Agreement states that "prepaid pensions" will be a part of the true-up in this case in regard to rate base" and that "depreciation expense" will be a part of the true-up in this case in regard to total operating expenses."[278]

167. The prepaid pension asset reflects the difference between the amount of pension expense included in the cost of service and the actual level of pension expense incurred.[279]

168. That is, it is the difference between the pension expense included in rates and the amount funded by the company.[280]

169. If the actual pension expense exceeds the amount included in rates, MGE records the difference as a regulatory asset. The asset is included in rate base, and the difference will be recovered through amortization of the asset in subsequent rate cases.[281]

170. If the actual pension expense is less than the amount included in rates, MGE records a regulatory liability. That difference would be booked as regulatory liability that is deduced from rate base, and that will be refunded to customers through amortization of the liability in subsequent rate cases.[282]

171. Determining the amount of the prepaid pension assets created in Files Nos. GR-2004-0209 and GR-2006-0422 requires a calculation that depends, in part, upon

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[278] Partial Stipulation and Agreement, pp. 3-4, File No. GR-2009-0355 (November 5, 2009).

[279] Noack True-Up Rebuttal, Ex. 108, p. 6.

[280] Partial Stipulation and Agreement at 10.

[281] *Id.*

[282] *Id.*

when the amortization of the asset is deemed to have started. Staff states that the amortization should have started the month after the true-up period in those cases.[283]

172. Under Staff's approach, amortization would begin before the effective date of the Report and Order. But on its books, MGE began amortizing the prepaid assets on the effective date of the respective Commission Orders in those cases.[284]

173. The true-up period in this case ended on September 30, 2009.[285] For ratemaking purposes, Staff suggests that the amortization of this asset should start the month after the balance has been established, which is October, 2009.[286] Thus, using Staff's theory, MGE should already be amortizing the asset created by a case that will not conclude for another two months.

174. In October, November, December of 2009 and, in all likelihood, January and February of 2010, MGE charged, and will continue to charge, the rates that were set by the Commission in File No. GR-2006-0422.[287] Those rates have no provision or consideration of the prepaid pension expense associated with this case.[288]

175. Only after the effective date of the Commission's Report and Order will MGE be able to charge rates that provide recovery for this amortization. Staff's approach would require MGE to amortize this asset for five moths, even though, as Staff admits, there is no consideration in MGE's rates related to this amortization expense.[289]

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[283] Foster True-Up Rebuttal, Ex. 113, p. 2.

[284] Noack True-Up Rebuttal, Ex. 108, p. 7.

[285] Foster, Tr. Vol. 14, p. 973.

[286] *Id.* at 975.

[287] *Id.* at 974.

[288] *Id.* at 975.

[289] *Id.*

176. Staff has reduced the balance of the prepaid pension assets created in File No. GR-2006-0422 and this case by applying an expense capitalization ratio to the balance.[290]

177. A capitalization ratio is generally applied to expenses in the income statement to reflect that some payroll and benefit costs relate to construction work, and therefore should be capitalized.[291]

178. The ratio should not be applied to the asset itself, which is a rate base item.[292] Reducing the prepaid pension assets in this fashion would be inconsistent with the history of the process, and with the amortization that have been established in this case.

179. The Partial Stipulation and Agreement also provides compelling evidence of the parties' intent regarding the prepaid pension asset. The Partial Stipulation and Agreement provides that "the rates established in this case include recovery of the amortization of prepaid pension assets established in prior cases and the amortization of the prepaid pension asset established in this case as follows:

a. $1,139,310 – GR-2004-0209;
b. $803,300 – GR-2006-0422;
c. $2,828,673 – GR-2009-0355.[293]

180. Simple multiplication of these annual amortizations shows that there could be no intent to reduce the asset by a capitalization ratio. The asset for File No. GR-2004-0209

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[290] Noack True-Up Rebuttal, Ex. 108, p. 8.

[291] *Id.*

[292] *Id.*

[293] Partial Stipulation and Agreement, p. 10.

was to be amortized over seven years. $1,139,310 times seven equals about $7,975,181.[294]

181. The asset from File No. GR-2006-0422 was to be amortized over five years. $803,300 times five equals $4,016,500.[295]

182. The asset for this case is also to be amortized over five years. $2,828,673 times five equals about $14,143,364.[296]

183. These numbers track the base asset amounts used by MGE.[297]

184. They also track the base asset amounts used by Staff for Files Nos. GR-2004-0209 and GR-2006-0422.[298]

185. Further, if the prepaid pension asset is reduced by a capitalization ratio as suggested by Staff, the amortization would far exceed the value of the asset. Accordingly, the prepaid pension asset should reflect the calculation of that asset without the application of a capitalization ratio.[299]

Conclusions of Law

There are no additional conclusions of law for this issue.

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[294] Noack, Tr. Vol. 14, p. 965.

[295] *Id.* at 965-66.

[296] *Id.* at 966.

[297] Noack True-Up Rebuttal, Ex. 108, Sch. MRN-4.

[298] Foster True-Up Rebuttal, Ex. 113, p. 4.

[299] Noack True-Up Direct, Ex. 107, Sch. MRN-2.

Decision

The Commission decides this issue in favor of MGE. To avoid any further confusion in these matters, the Commission encourages the signatory parties to this Stipulation to specify the start date for such amortizations when negotiating such agreements in the future, especially if they believe the amortizations should begin prior to the effective date of the Report and Order.

Land Rights Depreciation

The true-up depreciation issue concerns the proper depreciation rate for a single depreciation account, which is Account 374.2 (Land Rights). Staff suggests that the rate for this account should be zero percent. MGE believes that the rates should be equal to the rate that has been ordered by this Commission in past cases, which is 2.09%.

Findings of Fact

186. The second ordered paragraph in the Commission's Order Granting Waiver in File No. GE-2010-0030 states:

> Missouri Gas Energy, a division of Southern Union Company, shall retain the current depreciation rates, as listed in Schedule A to Staff's Recommendation, and as agreed upon in the Partial Nonunanimous Stipulation and Agreement in Commission Case No. GR-2006-0422.[300]

[300] Noack True-Up Rebuttal, Ex. 108, Sch. MRN-2.

187. Thus, the Order sought to "retain the current depreciation rates" as described in the Schedule of Rates and as "agreed upon in the Partial Nonunanimous Stipulation and Agreement in Commission File No. GR-2006-0422."[301]

188. The Partial Nonunanimous Stipulation and Agreement in File No. GR-2006-0422 stated in part "the depreciation rate for Land Rights (Account 374.2) shall be 2.09%"[302]

189. Also, the Partial Stipulation and Agreement in this case maintains the results of File No. GE-2010-0030. It states in relevant part:

> The conditions ordered by the Commission in Case No. GE-2010-0030 shall also remain in effect, as well, for purposes of this Stipulation and Agreement.[303]

190. MGE has consistently used 2.09% as the depreciation rate for its filings in this case.[304]

Conclusions of Law

There are no additional conclusions of law for this issue.

Decision

The Commission finds this issue in favor of MGE. To avoid any further confusion in matters of this nature, the Commission encourages the signatory parties to the Stipulation

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[301] The Partial Nonunanimous Stipulation and Agreement in Commission Fie No. GR-2006-0422 was approved by the Commissioner's Order Approving Stipulation and Agreement, issued January 30, 2007.

[302] Noack True-Up Rebuttal, Ex. 108, Sch. MRN-3.

[303] Partial Stipulation and Agreement, File No. GR-2009-0355, p. 8.

[304] Noack Direct, Ex. 30, Sch. MRN-1; Noack Updated Test Year Direct, Ex. 31, Sch. MRN-1; Noack True-Up Direct, Ex. 107, Sch. MRN-6; Tr. Vol. 14, p. 953.

to specifically include any changes in depreciation rates or similar schedules when negotiating such agreements in the future. Hopefully, this will encourage the parties to have a true meting of the minds and not to just assume the absence of a specific rate or number means that rate or number should be changed to zero.

Rate Case Expense

This issue is what amount of additional expert fees and legal fees accrued during the true-up period, if any, should be included in rates.

Findings of Fact

191. The Partial Stipulation and Agreement also contemplates a true-up of rate case expense (to be updated through September 30, 2009, to include an estimate for the remainder of the case) and establishes that the base amount of rate case expense from which to measure the true-up adjustment is $72,382.[305]

192. MGE strives to hire outside consultants and experts at competitive rates.[306]

193. It also conducts a competitive request-for-proposal ("RFP") process in which it evaluates both the estimated fees along with the experience of outside experts for each rate case.[307]

194. MGE has determined that contracting with additional counsel on an as-needed basis and for peak periods is less expensive for MGE and its customers.[308]

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[305] Partial Stipulation and Agreement at 9.

[306] Noack Rebuttal, Ex. 32, p. 20.

[307] *Id.*

[308] *Id.* at 16-22.

195. MGE has made a management decision to use its legal representation and consultants on an "as needed" basis, and only pay them when needed, rather than hiring persons that would necessarily receive a salary and benefits each and every year.[309]

196. Since MGE's personnel already have full-time jobs, OPC's position would encourage MGE to staff for "peak" periods, an approach that would be more expensive for both MGE and its customers.[310]

197. In addition to cost savings associated with MGE's approach, MGE is generally able to take advantage of personnel with a wider range of both technical and practical race case experience than in-house employees would have.[311]

198. The history of MGE's rate case expense shows that it has decreased over the last three cases.[312]

199. In this very case, OPC engaged two consultants to review and address issues related to cost of capital and depreciation.[313]

200. But for the regulatory framework, a utility, like the seller of any unregulated commodity, would have the right to change its rates without government approval.[314]

201. It is only the existence of the regulatory scheme itself that requires MGE to incur a rate case expense in the first place.[315]

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[309] *Id.* at 18-19.

[310] *Id.* at 18, 22.

[311] *Id.*

[312] Foster Rebuttal, Ex. 49, p. 4.

[313] Noack Rebuttal, Ex. 32, p. 19.

[314] Noack Rebuttal, Ex. 32, p. 21.

[315] *Id.*

Conclusions of Law

While a utility has the burden of proof, there is initially a presumption that its expenditures are prudent. The Commission has previously cited the following description of this process as found to apply to the Federal Energy Regulatory Commission:

> The Federal Power Act imposes on the Company the "burden of proof to show that the increased rate or charge is just and reasonable." Edison relies on Supreme Court precedent for the proposition that a utility's cost are [sic] presumed to be prudently incurred. However, the presumption does not survive "a showing of inefficiency or improvidence." As the Commission has explained, "utilities seeking a rate increase are not required to demonstrate in their cases-in-chief that all expenditures were prudent . . . However, where some other participant in the proceeding creates a serious doubt as to the prudence of an expenditure, then the applicant has the burden of dispelling these doubts and proving the questioned expenditure to have been prudent."[316]

The Commission has interpreted this process as follows:

> "In the context of a rate case, the parties challenging the conduct, decision, transaction, or expenditures of a utility have the initial burden of showing inefficiency or improvidence, thereby defeating the presumption of prudence accorded the utility. The utility then has the burden of showing that the challenged items were indeed prudent. Prudence is measured by the standard of reasonable care requiring due diligence, based on the circumstances that existed at the time the challenged item occurred, including what the utility's management knew or should have known. In making this analysis, the Commission is mindful that "[t]he company has a lawful right to manage its own affairs and conduct its business in any way it may choose, provided that in so doing it does not injuriously affect the public."[317]

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[316] *In the Matter of Union Electric Company*, 27 Mo.P.S.C. (N.S.) 183, 193 (1985) (*quoting Anaheim, Riverside, etc. v. Federal Energy Regulatory Commission*, 669 F.2d 779, (D.C. Cir. 1981)).

[317] *State ex rel. City of St. Joseph v. Public Service Commission*, 30 S.W.2d 8, 14 (Mo. banc 1930)." *In the Matter of Missouri-American Water Company's Tariff Sheets*, Report and Order, Case No. WR-2000-281 (August 31, 2000).

The Commission has also previously stated as follows concerning attacks on the recovery of rate case expense:

> The Commission does not want to put itself in the position of discouraging necessary rate cases by discouraging rate case expense. This is a particularly treacherous area for the Commission to be addressing in that the Commission cannot be viewed as having a dampening effect up on a regulated company's statutory procedural rights to seek out a rate increase when it believes that facts so justify it. Disallowing prudently incurred rate case expense can be viewed as violating the company's procedural rights.[318]

Decision

In this case, we are inclined to deem MGE's rate case expense to be prudent. The record supports this determination. Having made this determination, however, there are several additional points that need to be considered.

OPC's assertion that both the company and the ratepayers benefit from rate case expense has merit in that shareholders do receive a portion of the benefits and should be willing to pay for a portion of the company's rate case expense. The record is not developed on the issue, but there is a strong public policy argument that requiring the company to bear some portion of the rate case expense would incentivize the company to more aggressively manage its rate case expenses.

The ratemaking process necessarily and appropriately requires the regulator to make decisions as to expenses that are appropriately borne by the utility's shareholders and those that are appropriately borne by the ratepayer. Rate case expense is no exception. MGE posits that, but for the regulatory process, the utility would be free to

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[318] *In re St. Joseph Light & Power Company*, 2 Mo. P.S.C. 3d 248, 260 (1993); *see also In re St. Joseph Light & Power Company*, 3 Mo. P.S.C. 3d 207, 214 (1994).

change rates without Commission permission, just as any seller of unregulated commodities. But this misses the point and mischaracterizes the nature of the relationship between monopolies and their regulators. Rather than viewing the regulatory process as a burden that the utility must bear, the utility would do well to remember that it is not like any ordinary seller of unregulated commodities. It is not selling ordinary widgets. And the consumer, in this instance, has nowhere else to go for this essential commodity.

Unfortunately, in this case, the parties have not fully developed the record on this point. More detailed cost study, comparisons to other jurisdictions, and other testimony on the nature and propriety of certain rate case expenses may be helpful in determining how to apportion rate case expense. Such information is encouraged and would be welcomed by this Commission.

In conclusion, this Commission wants to make clear to MGE and other utilities that rate case expense is not simply a blank check and if certain rate case duties can be performed "in-house" by existing personnel more cheaply, we expect the utility to do so. On the issue of rate case expense, we urge MGE and other utilities to recognize that rate case expense may not be reflexively and automatically passed on to the ratepayers in the future. This Commission disallowed certain rate case expenses (attorney fees) in the 2006 MGE rate case and the Commission will not hesitate to do so again should the evidence support such a decision.

The Commission finds this issue in favor of MGE.

THE COMMISSION ORDERS THAT:

1. All pending motions and requests for relief not otherwise granted herein are denied.

2. The Partial Stipulation and Agreement is approved.

3. All signatories to the Partial Stipulation and Agreement shall comply with its terms.

4. The proposed tariff sheets filed by Missouri Gas Energy, a division of Southern Union Company, on April 2, 2009, Tariff No. YG-2009-0714, are rejected.

5. Missouri Gas Energy, a division of Southern Union Company, shall file tariffs that comport with this Report and Order no later than February 17, 2010.

6. The Staff of the Commission shall file a recommendation regarding the tariffs ordered in paragraph 5 no later than February 18, 2010. Any party that wishes to object to the tariffs ordered in paragraph 3 shall do so no later than February 22, 2010.

7. This Report and Order shall become effective on February 20, 2010.

BY THE COMMISSION

Steven C. Reed
Secretary

(S E A L)

Clayton, Chm., concurs, with separate
concurring opinion attached;
Davis, C., concurs, with separate
concurring opinion to follow;
Jarrett, Gunn, and Kenney, CC., concur;
and certify compliance with the provisions
of Section 536.080, RSMo.

Dated at Jefferson City, Missouri,
on this 10th day of February, 2010.