BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Missouri Gas Energy's Tariff Sheets Designed to Increase Rates for Gas Service in the Company's Missouri Service Area.	))))	Case No. GR-2009-0355

INITIAL BRIEF OF THE OFFICE OF THE PUBLIC COUNSEL

Southern Union Company d/b/a Missouri Gas Energy filed a request with the Missouri Public Service Commission ("PSC" or "Commission") on April 2, 2009 to increase rates for the natural gas services it provides as a Missouri local distribution company ("LDC"). Southern Union Company is engaged primarily in the transportation, storage, processing, and distribution of natural gas. Southern Union Company operates two natural gas distribution companies – New England Gas Company in Massachusetts, and Missouri Gas Energy ("MGE") in Missouri.

MGE's initial filing requests a revenue increase of $32.4 million to be recovered through rates. On November 5, 2009, the parties filed a Partial Stipulation and Agreement that resolves the majority of issues raised by MGE's filing, including the resolution of class cost of service, rate base, operating revenues, total operating expenses, depreciation and other miscellaneous issues. The issues that remain unresolved between the parties include: 1) residential rate design; 2) small general service rate design; 3) capital structure; 4) return on equity; 5) cost of capital; 6) risk reduction; and 7) energy efficiency. These issues, exclusive of true-up issues to be addressed in a subsequent brief, are addressed in detail below.

A. RATE DESIGN

1. <u>Residential Rate Design</u>: *What rate design should the Commission adopt for the residential customer class?*

The Commission has established and reestablished the rates charged by Missouri's public utilities throughout the Commission's ninety-six year history. During this time the Commission has repeatedly adopted rate designs that recover a gas utility's margin (non-gas) revenues through a methodology that charges more to consumers that use more gas, and less to consumers that use less gas. This methodology recognizes that margin costs are usage sensitive; the more gas a consumer uses the more long-run distribution costs that consumer causes on the LDC's system. (Ex.74, pp.18-20).

Sometimes labeled a "traditional" rate design, this commonly used rate design uses a longstanding methodology that recovers a portion of margin costs through a fixed "customer" charge, and recovers the remaining margin costs through a separate usage (per unit of gas) rate. (Ex.69, p.8). This Commission and utility commissions across the country have repeatedly found this traditional rate design to be just and reasonable. The traditional rate design gives consumers the ability to control the non-gas portion of their bill by reducing use. (Ex.69, p.3). Low-use customers pay less than high-use customers and Company and customer share the risk associated with weather. (*Id.*).

Revenue decoupling is a relatively new term used in regulatory ratemaking to refer to a manner of structuring rates for a regulated utility that moves away from traditional ratemaking by moving more cost recovery into the fixed monthly charge. (Ex.69, p.8). *Straight-fixed variable* (SFV), as that term has been used before the Commission, is sometimes referred to as a form of revenue decoupling that completely eliminates the linkage between the amount of gas consumed and the margin revenues

recovered by the utility. (*Id.*). It does this by eliminating the volumetric usage rate and moving all non-gas cost recovery into a single fixed monthly charge. (*Id.*). MGE's proposed monthly customer charge is $29.83 per residential customer. As discussed below, the SFV rate design is not a popular or cost based form of rate design. Only a few utility commissions have approved a similar form of rate design.

The SFV rate design was approved by this Commission in 2007 for Atmos Energy Corporation and MGE.[1] Since those decisions, no other Missouri utility has been authorized to use a SFV rate design. The only LDCs that had general rate increases decided since those 2007 decisions are AmerenUE, Missouri Gas Utility (MGU), and Laclede Gas Company.[2] All three utilities agreed to continue with rate designs that maintain a usage-sensitive rate element for recovering non-gas revenues. MGU and AmerenUE each agreed to a rate design that charges residential customers a $15 customer charge and the remaining margin costs are recovered through a volumetric usage rate.[3] Laclede agreed to a rate design that charges Laclede's residential customers a $15.50 customer charge and the remaining margin costs are recovered through a volumetric usage rate.[4] Similarly, the rate design proposed by Public Counsel in this case

[1] The Commission's Atmos decision on SFV was reversed and remanded to the Commission by the Western District Court of Appeals, Case No. WD70219, whereas the Commission's MGE decision on SFV was sustained by the Southern District Court of Appeals, Case No. SD29278.
[2] The Empire District Gas Company currently has a general rate increase pending before the Commission, Case No. GR-2009-0434.
[3] *In the Matter of Union Electric Company d/b/a AmerenUE's Tariffs Increasing Rates for Natural Gas Service Provided to Customers in the Company's Missouri Service Area*, Case No. GR-2007-0003, Order Approving Stipulation and Agreement, March 15, 2007; *In the Matter of the General Rate Increase for Natural Gas Service Provided by Missouri Gas Utility, Inc.*, Case No. GR-2008-0060, Order Approving Unanimous Stipulation and Agreement and Authorizing Tariff Filing, March 24, 2008.
[4] *In the Matter of Laclede Gas Company's Tariff to Revise Natural Gas Rate Schedules*, Case No. GR-2007-0208, Order Approving Unanimous Stipulation and Agreement and Authorizing Tariff Filing, July 19, 2007.

would charge residential customers a $15.18 customer charge and the remaining revenue requirement would be recovered through a volumetric usage rate. (Ex.74. p.26).[5]

a. Traditional Rate Design Properly Assigns Costs

OPC urges the Commission to adopt a rate design that recovers non-gas costs through a two-part rate where a portion of costs are recovered through a fixed charge and a portion of costs are recovered through a volumetric rate. This Commission and regulatory utility commissions across the county have repeatedly found this rate design method to be just and reasonable. OPC recommends that the traditional rate design be structured to recover 55% of residential revenue through the monthly fixed charge, while the remaining 45% of residential costs would be recovered through a uniform volumetric rate. This rate design properly assigns costs by recognizing that low volume users cause MGE to incur fewer costs than high volume users because a significant portion of distribution costs are based on demand. (Ex.73, pp. 13-14). The traditional rate design also provides a more accurate assignment of costs to individual consumers by including the direct costs to serve each customer in the fixed charge, and by assigning the remaining distribution system costs to customer based on the volumetric demand those customers place on the system. (Ex.73, p.12).

The Missouri Court of Appeals for the Western District recently recognized that traditionally, fixed non-gas charges recover direct customer costs that do not vary with usage and variable non-gas charges recover costs that vary with demand. In the Court's Opinion reversing the Commission's order approving the SFV for Atmos Energy, the Court stated:

[5] The $15.18 customer charge recommendation is based on $15 million increase in revenues and would change depending on the amount of any rate increase.

> Under the traditional rate design that Atmos currently employs, non-gas charges include two components. Under the first component, Atmos charges a flat monthly rate to recover its fixed costs that are caused by all customers regardless of the amount of gas they use. Atmos's fixed costs of service include the costs to provide meters, service lines, and regulators. The second component is a volumetric charge, which is based on the amount of gas used by the customer and allows Atmos to recover costs that vary with customer demand.[6]

The Court understood that non-gas rates for LDCs have been traditionally structured to match the manner in which costs are caused with the manner of collecting those costs from ratepayers. The attempt by MGE and Staff to continue recovering all non-gas costs through a fixed charge, including those that vary based on volumes, improperly shifts cost recovery away from tried and true cost recovery principles. Traditional rate design properly assign costs to more closely match an individual customer's bill with the costs that customer caused.

In the past, the Staff and the Commission also recognized that the *direct costs* of serving an individual customer are those costs associated with the provision of a meter, regulator, service line, meter reading and billing, and that these costs are traditionally collected through the fixed customer charge just as OPC is proposing in this case. In MGE's 1996 rate case, MGE attempted to increase its residential customer charge from $9.05 to $15.00. The Staff at that time based its customer charge proposal of $9.81 on the direct cost components listed above. The Commission rejected the customer charge increase proposals and maintained the $9.05 customer charge.[7] In the present case, the Staff's work-papers also indicate that, on a revenue neutral basis, a traditional customer

[6] *State of Missouri ex rel. Public Counsel v. Public Service Commission,* 289 S.W.3d 240 (Mo. App. W.D. 2009).
[7] *In the Matter of Missouri Gas Energy's Tariff Sheets Designed to Increase Rates for Gas Service in the Company's Service Area,* Case No. GR-96-285, Report and Order, January 22, 1997.

charge of $10.40 would recover these direct costs with remaining costs recovered through a volumetric rate. (Ex.73, p.12).

MGE has also taken a position in the past that contradicts its proposal to dump all non-gas costs into a single fixed charge. In MGE's 1998 general rate case, MGE advocated an increase in the residential customer charge from $9.05 to $12.75.[8] "MGE argued that the proposed changes are more equitable to customers because each customer would pay an amount that reflects the costs to serve that customer, independent of the customer usage." (*Id.*). In other words, MGE argued that fixed costs are limited to a subset of non-gas costs, and that a separate volumetric rate based on customer usage would recover the remaining balance of non-gas costs. The Commission rejected MGE's proposal to increase the fixed charge and again continued the $9.05 customer charge, just as the Commission did in MGE's 1996 general rate case. (*Id.*).

Reverting to a traditional rate design will not harm MGE. It will simply continue the rate design that has given MGE an opportunity to earn its authorized return for years. MGE's rate design witness Mr. Feingold testified in favor of the traditional rate design in roughly 100 proceedings, supporting it as a just and reasonable method of designing rates. (Tr. 393). MGE's sister company, New England Gas Company, currently operates under a traditional rate design in Massachusetts that charges residential customers a $9.16 customer charge. (Ex.77, Attachments 3-4). Low-income residential customers of New England Gas are charged an even lower fixed charge of $5.23 for non-heating customers and $4.11 for hearing customers. (*Id.*). Contrast this with the proposal of Southern

[8] *In the Matter of Missouri Gas Energy's Tariff Sheets Designed to Increase Rates for Gas Service in the Company's Missouri Service Area,* Case No. GR-98-140, Report and Order, August 21, 1998.

Union's Missouri LDC to charge *all* residential customers a $29.83 customer charge, and the disregard in MGE's proposal for low-income and low-volume consumers is obvious.

Despite the Staff's support for the SFV, the Staff has also indicated its belief that the traditional rate design, if adopted in this case, can produce just and reasonable rates. (Ex. 100). Staff witness Mr. Dan Beck's response to an OPC data request indicates the Staff's belief that under either the SFV rate design or the traditional rate design, that "customers would be paying fair and reasonable rates under either scenario." (*Id.*). Mr. Beck's answer further states that "a traditional rate design and a SFV rate design that collect the proper level or revenues from a class are both likely to result in fair and reasonable rates." (*Id.*).

The traditional rate design is a just and reasonable method of designing rates because it properly allocates cost responsibility within the residential class and it satisfies customer expectations. The traditional rate design has been determined to be just and reasonable repeatedly in Missouri and elsewhere. The SFV rate design, however, harms consumers and improperly shift costs without justification. Additional problem with the SFV, addressed in greater detail below, are as follows: 1) The SFV discourages conservation and energy efficiency; 2) The SFV disproportionately harms low-volume consumers; 3) The SFV disproportionately harms low-income consumers; 4) Customers oppose the SFV; 5) The SFV lessens MGE's incentives to cut costs; and 6) The SFV proposed by MGE lacks support nationally.

b. SFV Discourages Conservation and Energy Efficiency

An apparent drawback of the SFV rate design is that it discourages energy efficiency and conservation by removing an incentive from the traditional rate design that

encourages consumers to conserve energy. (Ex.76, p.5; Ex.72, p.4). When a customer can see the impact of their conservation efforts in both the gas and the non-gas portions of their bill, consumers have more price signals encouraging them to conserve than they do under a SFV rate design which includes the price signal only in the gas cost portion of the bill. (Ex.75, pp.4-5).

Five years ago this Commission rejected MGE's attempt to implement a high fixed charge rate design proposal because of the harmful impacts such rate design has on a consumer's ability to see the benefits of energy efficiency improvements and conservation efforts. In MGE's 2004 general rate case, Case No. GR-2004-0209, the Commission addressed the impact of assigning more non-gas costs into the fixed charge:

> High fixed monthly customer charges tend to defeat customer efforts to reduce their bill by conserving natural gas. As a result, the Commission finds that the public interest is best served by setting customer charges as low as reasonably possible… The Commission finds that current ratio between fixed and volumetric rate elements, whereby MGE recovers approximately 55% of its residential distribution revenues from fixed elements, is appropriate. In order to be fair to the company and to its ratepayers, the Commission will order that the customer charge for the residential and small general service classes may be increased to an amount sufficient to maintain the current ratio between volumetric rate elements and fixed charges elements.[9]

The same rationale from 2004 should apply to today's request to assign *all* non-gas costs into a high fixed monthly customer charge. It defeats a customer's efforts to reduce their bill by conserving gas.

More recently, the Commission determined that a fixed bill pilot program proposed by Aquila was not just and reasonable because it would not give consumers

[9] *In the Matter of Missouri Gas Energy's Tariffs to Implement a General Rate Increase for Natural Gas Service,* Case No. GR-2004-0209, Report and Order, pp. 55-56, September 21, 2004.

proper price signals and would encourage the wasteful consumption of energy.[10] This "may result in unnecessary increases of Aquila's residential load, causing harm to Aquila's customers as well as to the public." (*Id.*). The same rationale applies to MGE's request to continue a fixed charge proposal.

Federal authorities have also recognized the impact a SFV rate design has on consumption. The Federal Energy Regulatory Commission (FERC) recognized that a SFV rate design *encourages* consumption of energy. The FERC adopted a SFV rate design for use by the gas pipeline industry in FERC Order 636.[11] The FERC determined that its "adoption of SFV should maximize pipeline throughput over time" and that designing rates "to influence consumption of gas is a traditional regulatory technique of the Commission." (*Id.*). Encouraging consumption of natural gas is moving in the wrong direction and away from a sound energy efficiency policy for Missouri. (Ex.75, p.7).

Missouri's energy policy goals for pricing of utility services were addressed in 2006 by the Action Plan created by the Missouri Energy Task Force. (*Id.*). One goal of the Missouri Action Plan is for the Commission to "consider rate designs that reward customers for conservation efforts." (*Id.*). This policy objective is echoed on the national level by the American Recovery and Reinvestment Act of 2009 (H.R. 1)(ARRA), which states that a general policy of the Act is to sustain or enhance "a utility customer's incentives to use energy more efficiently." (Ex.11, Sch. RJH-4). By reinstating the traditional rate design and implementing OPC's Lost Margin Revenue Recovery

[10] *In the Matter of Aquila, Inc. d/b/a Aquila Networks-MPS and L&P for authority to file tariffs offering electric customers a Fixed Bill Pilot Program in the Aquila Networks-MPS and L&P area*, Case No. EO-2007-0395, Report and Order, December 20, 2007.
[11] FERC Order 636, Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation; and Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, 18 CFR Part 284, April 16, 1992.

Mechanism (LMRRM) proposal, the Commission would achieve the objectives of the Missouri Energy Task Force's plan and the ARRA because it would enhance a consumer's incentives and would align the interests of utilities and consumers. Continuing the SFV rate design, on the other hand, fails these objectives because it restricts the incentives that encourage customers to be energy efficient.

MGE's objections to OPC's evidence regarding a LMRRM proposal, which would allow MGE to recover all energy efficiency expenses including lost margins caused by such programs, suggests that MGE's goals have nothing to do with energy conservation. (Ex.75, pp. 8-9). Instead, this suggests that MGE's goals in proposing a SFV rate design is to continue shifting risks to consumers.

If the Commission wishes to achieve the policy objective of maximizing the energy efficiency and conservation incentives for residential consumers, the traditional rate design is the best proposal before the Commission to achieve this goal. If the Commission wishes to align the consumer's interest in conserving energy with the financial interests of MGE, the LMRRM proposal would align those interests without losing that price signal. These recommendations provide the Commission with a sound energy policy and are consistent with the findings of the Missouri Energy Task Force and the American Recovery and Reinvestment Act.

c. SFV Harms Low-Volume Consumers

There is no dispute among the parties that the SFV rate design places more non-gas distribution cost responsibility on low-volume gas consumers. The dispute in regards to low-volume consumers is whether this shift to low-volume consumers is cost justified. OPC asserts that this shift is not cost justified because high volume users cause MGE to

incur greater system costs than low volume consumers, and under a traditional rate design, this difference in cost causation is recognized and allocated to customers according to the costs they cause. (Ex.72, pp.8-9). Understanding *demand costs* is a key element to understanding these different positions on cost causation.

Demand costs are costs that vary with the capacity requirement of plant or equipment. (Ex.72, p.22). Demand costs reflect the capacity necessary to serve demand during peak periods. (*Id.*). They include production, transmission, storage, and distribution costs. (*Id.*). OPC is not the only party recognizing demand costs – all parties have recognized that a portion of costs vary with demand. (Ex.73, p.13). MGE's study shows that over 20% of the cost of serving residential customers is demand related. (Ex.72, p.9). MGE's class cost of service witness F. Jay Cummings recognizes demand costs in his cost study and testified that "the sizing of the mains depends on the expected usage of the customers during peak periods, i.e., the demand-related component of the investment." (Ex.3, pp.9-10). Mr. Cummings also testified that only 38.41% of mains costs are customer related. (Ex.3, p.15). The clear language from MGE's tariff proves that "the size of pipe required for specific installations will be determined by the quantity of gas required, the length of the pipe and pressure loss." (Tr. 397-398; MGE Tariff Sheet No. R-35, paragraph 4.03). In other words, when MGE replaces distribution piping, the usage characteristics of that portion of the system are influenced by peak day demand requirements, and those customers that contributed more towards those requirements have caused greater costs than those that contributed less.

In the prior Atmos Energy Corporation rate case, MGE and the Staff argued the shift to low-volume users is cost justified because low-volume consumers subsidize high-

volume consumers under a traditional rate design.[12] MGE and Staff alleged this subsidization occurs because the cost to serve each residential customer is the same. (*Id.*). In the Missouri Court of Appeals Western District decision reversing the Commission's adoption of a SFV rate design for Atmos Energy Corporation, the Court reversed in part because the only evidence relied on to support the subsidization claim was a class cost of service study. (*Id.*). The Court concluded that a class cost of service study cannot support a claim of subsidization within a class. (*Id.*). The Court specifically referenced the testimony evidence of Staff witness Ms. Anne Ross and concluded that Ms. Ross' testimony does not constitute competent and substantial evidence because it only proves that the costs of the meter, regulator and service line are the same and that these costs were already recovered under a traditional rate design in the fixed customer charge. (*Id.*). The Court concluded that "the Commission failed to consider a multitude of costs that go beyond the meters and pipes installed on a residential customer's premises." (*Id.*). The essence of the Court's reversal was the failure by the Commission, and Staff, to consider all costs, including those costs that vary based on demand.

Imposing additional costs onto low-volume users is not justified by the record before the Commission. MGE and Staff continue to ignore demand costs because to recognize their impact on cost causation principles and rate design would derail their attempt to continue the SFV rate design. OPC's proposed rate design properly recognizes that the fixed customer charge should recover those costs that are directly attributable to an individual customer, just as the traditional rate design has done for decades by recovering the costs of the meter, regulator, and service line in the customer charge.

[12] *Public Counsel v. Public Service Commission,* 289 S.W. 3d 240 (Mo. App. 2009).

A rate design that ignores demand costs and assumes all residential customers incur identical costs has the effect of overcharging low-volume users that cause a smaller impact on long-run distribution costs. (Ex.74, pp.18-20). There is a significant difference in the amount of gas consumed by customers within the residential class. (Ex.72, p.11). Usage by consumers within the residential class ranges from "0" usage to thousands of Ccfs. (*Id.*). An average customer during the test year used just under 70 Ccfs per month. (*Id.*). Under the SFV rate design, customers that use less than 70 Ccfs on average will pay more under the SFV rate design than under the traditional rate design, whereas customers with greater than average usage will see increasing savings the more they consume. (*Id.*). Based on test year numbers, the result is that the SFV shifts a significant amount of costs to only 18% of MGE's customers; all low-volume users. (Ex.63, Schedule 1-1). This shift is not cost justified and can have a harmful impact on low-volume users, especially low-income consumers.

d. SFV Harms Low-Income Consumers

The evidence before the Commission proves that low-income consumers on average use below average amounts of gas, and therefore, a rate design that forces more costs onto low-volume consumers has a disproportionate impact on low-income consumers. A 2001 and 2005 analysis by the U.S. Department of Energy concludes that higher income households consume more gas and that they live in larger housing units that require more energy for heating. (Ex.74, pp.2-3). These results are consistent with other studies by the U.S. Department of Health and Human Services and the U.S. Department of Labor, Bureau of Labor Statistics. (*Id.*).

MGE would prefer that the Commission ignore these studies and rely solely on a single study that simply compares aggregated consumption data by zip codes from 1999. MGE witness Dr. Thompson's conclusions from his study contradict national studies that conclude otherwise, and they defy common sense. Low-income consumers live in smaller homes and for obvious reasons simply cannot afford to consume more than average amounts of gas. (Ex.74, p.3).

Dr. Thompson submitted the same zip code study in MGE's 2006 rate case, but he has not testified on his low-income usage theory before any other state commission. (Tr. 624). The first error with Dr. Thompson's study is that he fails to disaggregate the data so that his study focuses on low-income consumption. (Ex.74, p.2). Dr. Thompson's study blends characteristics of high volume and low volume, and therefore, should not be relied upon to determine the usage levels of low-income consumers. (Ex.74, p.2; Tr. 632). Only two or three data points from the study include income levels that are at or below the Federal Poverty Guidelines for the United States. (Tr. 630). This study should not be relied upon to reach any relevant conclusion regarding low-income usage patterns.

A rate design that forces more costs onto low-volume users has a negative impact on MGE's most vulnerable population. This is especially true for our low-income elderly population, a population that does not have the ability to increase their income to overcome increases in gas costs caused by the SFV rate design. These concerns were raised by the testimony of MGE's customers during the local public hearings. During the local public hearing in St. Joseph, consumers expressed concerns that with the current state of the economy, high gas bills for those on limited and low fixed incomes would come at a time when many consumers are already struggling. (Vol. 4, Tr. 12-14; Tr. 42).

An elderly MGE consumer in Lee's Summit testified that senior citizens on social security will not see their usual increase to their social security benefits due to a federal freeze on increases. (Vol. 6, Tr. 51-52). These hardships should not be worsened by designing rates in a manner that unnecessarily requires these elderly and low-income Missourians to shoulder more than their fair share of distribution costs. It is not just and reasonable to design rates in a manner that requires low-volume, low-income consumers to pay the demand costs incurred by high-volume consumers. This is prohibited by the § 393.130.2 RSMo requirement that utilities not discriminate in the charges demanded from customers. The result could be more consumers dropping off the system, which will cause substantial problems for those individuals, and will increase the distribution costs for all consumers. (Tr. 483).

e. MGE's Customers Oppose a High Fixed Charge

One of the more contentious issues raised in this rate case is whether the SFV rate design has been accepted or opposed by MGE's residential customers. The evidence in the case shows that MGE's customers oppose a SFV rate design that includes a high fixed charge. After the SFV was adopted by the Commission in 2007, the Commission's Consumer Services Department experienced a sharp increase in customer complaints. (Tr. 775).

During the local public hearings, customers that testified in regards to the high fixed charge overwhelmingly opposed it.[13] This negative customer response is corroborated by the opposition to MGE's rate increase and high fixed charge in the 12,000 customer comments. (Ex. 106). The Commission's Consumer Services Manager

[13] Local Public Hearing transcripts: Vol. 2, Tr. 16-17, 19-20, 21-22, 31-32; Vol. 4, Tr. 15-16, 57-58; Vol. 5, Tr. 14-15, 23-24, 34-35, 38-40; Vol. 6, Tr. 9.

Ms. Gay Fred testified that her department received and read all of the comment cards, and that Ms. Fred personally read about 9,000 of the 12,000 comments. (Tr. 801, 815). Ms. Fred further testified that "I would say based on public comments or emails – that we received, it appears that they're unhappy with the adverse effect of the new rate design." (Tr. 796). The overall customer reaction to the SFV rate design according to Ms. Fred has been "negative." (Tr. 806).

Ms. Fred also testified that the Consumer Services Department received a lot of calls complaining of the SFV, but did not receive a single call in support of the high fixed charge rate design. (Tr. 798-801). In other words, ratepayers that raised the rate design issue are 100% opposed to the high fixed charge. The negative public reaction to a high fixed charge is indicative of the negative impact a high fixed charge has on rate affordability, and MGE's proposal is not responsive to ratepayers.

f. SFV in Other Jurisdictions

The unpopularity of the SFV rate design should be a testament to its negative aspects. MGE's witness Mr. Feingold identified only five states that he claims approved a SFV rate design: Georgia, Missouri, North Dakota, Ohio and Oklahoma. (Tr. 394). Following is a brief synopsis of rate design decisions in those states, and an additional sampling of other state commission decisions regarding the SFV rate design. As more and more utilities request SFV rate designs from their state commissions, OPC expects the list of state commissions that reject the SFV to continue rising.

Arizona: In 2008 the Arizona Corporation Commission (ACC) rejected a "full decoupling" proposal from Southwest Gas Corporation that was very similar to a SFV

rate design. Instead of adopting a SFV rate design, the ACC decoupled rates by simply moving more cost recovery into the fixed charge as follows:

> We will therefore adopt Staff's recommended customer charges for all customer classes and volumetric commodity charges commensurate with Staff's rate design, as modified by the revenue requirement adopted hereinabove. For rate class G-5 (single-family residential), the basic monthly charge will be set at $ 10.70 per month with a single block commodity base rate of $ 0.57070 per therm. For rate class G-6 (multi-family residential), the basic monthly charge will be increased to $ 9.70 per month with a commodity base rate of $ 0.55343 per therm. Low-income-customer basic monthly charges will increase to $ 7.50 with the same $ 0.55343 commodity base rate.[14]

Not only did the ACC reject the full decoupling proposal, but the ACC also recognizes the struggles faced by low-income consumers by establishing a separate low-income rate. This ACC decision highlights the types of rates being approved that continue to maintain low customer charges while also moving towards decoupling. Compared to the low-income rate charged in Arizona, MGE's proposed $29.83 customer is 397% higher than the rate approved for low-income customers of Southwest Gas in Arizona.

Florida: The SFV was also considered and rejected in 2008 by the Florida Public Service Commission (FPSC). The FPSC concluded:

> A shift of most of the Company's base rate costs from the variable per therm charge to a large fixed customer charge would unduly penalize small-use customers who may not benefit from the correspondingly lower therm charge resulting from such a shift. It also sends a price signal that could discourage growth of the customer base on SJNG's system, which witness Stuart Shoaf has identified as vital to the Company's long term success.
>
> We believe a fairer approach is to set the customer charge to minimize the impact on very low users and let the therm charge capture the balance of the class revenue requirement, because that is what the customer can control. The rates we approve will recover a greater proportion of the base rate costs

[14] *In the Matter of the Application of Southwest Gas Corporation for the Establishment of Just and Reasonable Rates and Charges Designed to Realize a Reasonable Rate of Return on the Fair Value of its Properties Throughout Arizona*, 2008 Ariz. PUC LEXIS 237, Opinion and Order, December 24, 2008.

> through the customer charge than current rate design as a step towards recognizing the operating characteristics of LDCs while providing some stability to customer rates and minimizing impacts on low users.

In re: Petition for rate increase by St. Joe Natural Gas Company, Inc, 2008 Fla. PUC LEXIS 319, Order Granting Rate Increase, July 8, 2008, pp. 34-35.

Kansas: In 2008 the Kansas Corporation Commission (KCC) conducted a general investigation regarding cost recovery and incentives for energy efficiency programs. The KCC's November 14, 2008 Final Order addressed the KCC's concerns with the SFV rate design and in particular, the KCC's concerns that "a remaining issue with straight fixed-variable rates is their potential negative impact on low-income or fixed income customers."[15] The KCC also suggested that the SFV rate design would cause bad debts to increase, which would be harmful to all residential consumers. (*Id.*). Addressing the SFV rate design, the KCC concluded that it "will not approve a rate design proposal that, as a whole, harms low-income and fixed-income customers or disproportionately negatively affects such customers." (*Id.*). The KCC's Staff also questioned the SFV and "suggested a straight fixed-variable rate design would not encourage energy efficiency". (*Id.* p. 21).

Georgia: The first state commission identified by Mr. Feingold as adopting a SFV rate design was the Georgia Public Service Commission. (Tr. 389). Mr. Hack identified the company as Atlanta Gas Light (AGL). (Tr. 79). A review of the order approving AGL's rate design shows the drastic differences between the rate design requested by MGE and the rate design approved for AGL. AGL was authorized to implement a SFV rate design with a $9.05 monthly customer charge and a separate

[15] *In the Matter of a General Investigation Regarding Cost Recovery and Incentives for Energy Efficiency Programs,* 2008 Kan. PUC LEXIS 1664, Final Order, p.33.

demand charge based on a customer's demand on AGL's system.[16] Even MGE witness Mr. Feingold recognized that the SFV approved by the Georgia PSC recognized a variation in demand. (Tr.394-395).

Moreover, the SFV has hardly been a success in Georgia following its adoption. AGL has twice been ordered to reduce revenues. In 2002 the Georgia PSC ordered that AGL's rates be reduced by $10,000,000 after the Georgia PSC staff determined that AGL was earning an extremely high return on equity of 15% to 17%. (*Id.*). AGL's over-earning continued, and in 2005 the Georgia PSC again reduced AGL's rates again, this time by $21,922,000.[17]

Another distinguishing aspect of the Georgia SFV from MGE's proposal is that the Georgia PSC recognized the difficulties faced by Georgia's low-income senior citizens and established a discount up to the total amount of the customer charge. (*Id.*). This example only highlights the complete lack of consumer protections contained in MGE's version of a SFV rate design.

North Dakota: The North Dakota Public Service Commission was also identified by MGE as having a SFV rate design. (Tr. 389). The North Dakota PSC approved a rate design settlement agreement for Xcel Energy that eliminated the volumetric rate and that charges gas customers an $18.48 fixed customer charge.[18] Noteworthy in this settlement is the absence of a separate consumer representative in

[16] *In re: Earnings Review To Establish Just And Reasonable Rates for Atlanta Gas Light Company*, 2002 Ga. PUC LEXIS 34, Order, April 29, 2002.
[17] *In re: Atlanta Gas Light's 2004/2005 Rate Case,* 2005 Ga. PUC LEXIS 64, Opinion, April 27, 2005.
[18] *Application of Northern States Power Company, a Minnesota corporation and wholly owned subsidiary of Xcel Energy, Inc., for Authority to Increase Rates for Natural Gas Service in North Dakota*, 2007 N.D. PUC LEXIS 13, Order Adopting Settlement, June 13, 2007.

North Dakota – the settlement agreement is between only Xcel Energy and the North Dakota PSC Staff. (*Id.*).

Ohio: Mr. Feingold also identified Ohio as a state that adopted a SFV rate design. Mr. Feingold was likely referring to the Public Utility Commission of Ohio (PUCO) decision adopting a SFV rate design for Columbia Gas of Ohio (CGO) where Mr. Feingold testified in support of the SFV.[19] In the CGO case the PUCO employed the concept of "gradualism" by starting with an initial customer charge of $12.16 per month with a $0.7911 per Ccf usage charge, and eventually moving to eliminate the volumetric charge and increase the customer charge to $17.81 per month. The PUCO also ordered the utilities to implement a low-income program that reduces the monthly charge by $4.00 for low-income, low-use consumers. (*Id.*). This reduced customer charge would only charge low-income, low-use ratepayers a $13.81 customer charge, considerably less than the $29.83 customer charge requested by MGE. (*Id.*).

The PUCO also adopted a "modified" SFV rate design for Duke Energy and Dominion East Ohio.[20] The modified SFV recovers most non-gas costs in a high fixed charge, but maintains a low usage charge unlike the MGE proposal. (*Id.*). The PUCO also ordered the utilities to implement the same low-income program ordered in the CGO case that reduces the monthly charge by $4.00 for low-income, low-use consumers. (*Id.*).

[19] *In the Matter of the Application of Columbia Gas of Ohio, Inc., for Authority to Amend Filed Tariffs to Increase the Rates and Charges for Gas Distribution Service*, 2008 Ohio PUC LEXIS 736, Opinion and Order, December 3, 2008.

[20] *In the Matter of the Application of The East Ohio Gas Company d/b/a Dominion East Ohio for Authority to Increase Rates for its Gas Distribution Service*, 2008 Ohio PUC LEXIS 655, Opinion and Order, October 15, 2008; *In the Matter of the Application of Duke Energy Ohio, Inc. for an Increase in Rates*, 2008 Ohio PUC LEXIS 323, Opinion and Order, May 28, 2008.

These modified SFV decisions are currently on appeal before the Supreme Court of Ohio and a decision is pending.[21]

Oklahoma: MGE witness Mr. Feingold asserted that a SFV rate design is being used in Oklahoma. In 2008, in what appears to be the most recent gas rate increase order from the Oklahoma Corporation Commission (OCC), the OCC authorized new rates for West Texas Gas, Inc. that recovers non-gas costs from residential customers through an $8.00 monthly customer charge, and a volumetric component that charges $3.75 for the first hundred cubic feet (Ccf) of gas and $0.5257 for each additional Ccf.[22]

In 2005 the OCC approved a rate design for Oklahoma Natural Gas that gives customers a choice of rate designs to recognize differences between low-volume and high-volume consumers as follows:

> Pursuant to the proposed rate structure, lower volume usage customers in each rate class would pay a lower service fee with a higher per-dekatherm delivery fee (Option A), while the higher volume usage customers would pay a higher service fee with a lower per-dekatherm delivery fee (Option B). Upon the tariffs becoming effective, Oklahoma Natural will make the initial assignment of customers to the rate option that matches the customer's annual historical average usage. Customers may elect a different option at any time after the initial assignment, but must remain on the selected option for twelve months.[23]

Oklahoma Natural Gas offers an even lower customer charge in a separate rate design for LIHEAP recipients. (*Id.*). The residential rate designs for Oklahoma Natural Gas and West Texas Gas, Inc. are distinctly different from the SFV advocated by MGE.

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[21] Supreme Court of Ohio, Case nos. 2008-1837 and 2009-0314.

[22] *In The Matter of the Application of West Texas Gas, Inc. for a Review and Change or Modification In Its Rates, Charges, Tariffs, and Terms And Conditions of Service*, 2008 Okla. PUC LEXIS 167, Final Order of the Merits, December 3, 2008.

[23] *In The Matter of the Application of Oklahoma Natural Gas Company, a Division Of Oneok, Inc. for Review and Change or Modification In Its Rates, Charges, Tariffs and Terms and Conditions of Service*, 2005 Okla. PUC LEXIS 201, Final Order, October 4, 2005, p.334.

FERC: The last jurisdiction that OPC wishes to briefly discuss that adopted a form of SFV is the Federal Energy Regulatory Commission. As discussed previously, the FERC first introduced the SFV to natural gas regulation in 1992 by adopting it for the pipeline industry through FERC Order 636.[24] It should be noted that the FERC form of the SFV rate design collects variable costs through a variable charge and fixed costs through a fixed charge. (Tr. 404). The rates pipeline customers pay under the FERC version of the SFV is based in part on demand. (*Id.*).

These cases help the Commission recognize that some form of a SFV has been accepted only in a few jurisdictions. The vast majority of jurisdictions have not eliminated the usage rate that allocates demand costs. Furthermore, these cases highlight the consistent concerns by other jurisdictions towards low-volume and low-income consumers, and efforts by those jurisdictions to address these concerns.

h. Residential Rate Design Conclusion

The Commission should question the rate design testimony of MGE witness Mr. Feingold regarding customer impacts of the SFV rate design. Mr. Feingold's schedules showing impact data for April 2007 through April 2009 intentionally omitted summer months when comparing the traditional rate design to the SFV rate design. (Ex.7, Schedule RAF-6; Ex.73, p.15). When summer months are added to Mr. Feingold's analysis, the schedule shows that MGE collected $2,943,647 more through the SFV than it would have collected through a traditional rate design. (Ex. 73, p.15 and Sch. 4). Mr. Feingold's attempt to distort the impacts of the SFV rate design should speak loudly against the merits of that rate design and the persuasiveness of Mr. Feingold's analysis.

[24] FERC Order 636, Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation; and Regulation of Natural Gas Pipelines After Partial Wellhead

Historically, the Commission, the Staff, OPC, and MGE have all supported a traditional rate design. MGE's rate design witness Mr. Russell Feingold has testified in support of a traditional rate design roughly 100 times, while only proposing a SFV rate design in four states: Missouri, Ohio, Kentucky and Georgia. (Tr. 389). The Commission's Staff has repeatedly supported a traditional rate design, and has offered expert testimony that opposes moving more costs into a high fixed charge. Staff witness Dr. Michael Proctor testified in Case No. GR-2002-356 that "while the Staff favors using rate design as a weather mitigation measure, because of the detrimental impact on small users, the Staff was not willing to recommend recovering all of the non-gas costs in either the customer charge, first block rate or a combination of these rate components…" (Ex. 72, p.15). OPC urges the Commission to recognize Dr. Proctor's concerns and to adopt a rate design that gives MGE an opportunity to earn its authorized return without punishing low-volume and low-income consumers. The only proposal before the Commission that accomplishes these goals is a rate design that keeps the customer charge reasonable and maintains a volumetric rate.

The rate design ordered to be implemented by the Commission must be just and reasonable. § 393.130 RSMo. The residential rate design proposed by MGE is not just and reasonable because it forces cost responsibility onto the most vulnerable low-volume, low-income consumers with no cost justification whatsoever. The evidentiary support for OPC's recommended rate design, however, is substantial. OPC urges the Commission to order MGE to implement a traditional rate design that uses a fixed customer charge to recover the directly attributable fixed costs and that recognizes demand costs by recovering the demand portion of non-gas costs through a volumetric rate. The precedent

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Decontrol, 18 CFR Part 284, April 16, 1992.

showing this to be a just and reasonable manner of designing rates is well established in Missouri and throughout the country.

2. <u>Small General Service Rate Design</u>: What rate design should the Commission adopt for the small general service customer class?

OPC also requests that the Commission maintain the traditional rate design for the Small General Service (SGS) class for the same reasons the traditional rate design is appropriate for the residential class. Considering the current recession, and high unemployment rates, the financial struggles of small businesses is obvious. (Ex.69, p.22). Now is not the time to force small businesses, especially those that use small volumes of gas, to shoulder a larger and unjustified burden of distribution costs.

B. RATE OF RETURN, CAPITAL STRUCTURE, and COST OF CAPITAL

1. <u>Capital Structure</u>: *What capital structure should be used for determining MGE's rate of return?*

The overall cost of capital is the sum of the weighted average cost rates of various sources of capital. (Ex.69, p.47). The most significant relationship in any capital structure is the debt to equity ratio. (*Id.*). The advantage of debt in the capital structure is that debt costs less than equity. (*Id.* p.48). Thus, the more debt in the capital structure the lower the cost of capital will be. (*Id.*).

MGE is an operating division of SUC and has no separate existence from SUC. (Ex.69, p.19). SUC's management decisions determined SUC's capital structure. Accordingly, the most equitable capital structure for MGE is the actual capital structure of SUC, as ordered by the Commission in MGE's last two rate case. Using SUC's actual capital structure is preferred over using the hypothetical capital structure proposed by MGE because the hypothetical capital structure would allow MGE to recover revenues in

excess of costs. (Ex.69, p.50). This would be the result because employing MGE's proposed hypothetical capital structure would allow MGE to earn an equity return on some capital that was financed by debt. (*Id.*). Employing MGE's proposed hypothetical capital structure would result in higher earnings of $4.8 million based on "phantom equity." (*Id.* at 51). To prevent ratepayers from paying this $4.8 million, the Commission should employ the actual capital structure of SUC as follows:

ACTUAL CAPITAL STRUCTURE			
DESCRIPTION	RATIO	COST	WEIGHTED COST
Long-Term Debt	56.16%	6.258%	3.514%
Short-Term Debt	3.26%	5.920%	0.193%
Preferred Equity	1.92%	7.758%	0.149%
Common Equity	38.66%	10.000%	3.866%
Total	100.00%		7.722%

The Commission has repeatedly determined that SUC'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.[25]

MGE appealed the Commission's decision to the Missouri Court of Appeals Western District and the Court affirmed the Commission's decision. *State ex rel. Missouri Gas Energy v. Public Service Commission,* 186 S.W.3d 386 (Mo. App. W.D. 2005). MGE did not give up on the issue and again attempted to use a hypothetical capital structure in MGE's next rate case in 2006. In the Report and Order resolving that case, the Commission again rejected MGE's attempt to utilize a hypothetical capital structure. The Commission concluded:

> 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.[26]

Once again MGE appealed the Commission's capital structure decision, only this time MGE shopped for a different forum and filed its appeal in the Missouri Court of Appeals Southern District on the same day the Commission denied rehearing. Despite MGE's arguments in favor of a hypothetical capital structure, the Southern District affirmed the Commission's decision, thus establishing consistent precedent in both the

[25] In the Matter of Missouri Gas Energy's Tariffs to Implement a General Rate Increase for Natural Gas Service, Case No. GR-2004-209, Report and Order, pp. 12-13, September 21, 2004.
[26] In the Matter of Missouri Gas Energy's Tariffs Increase Rates for Gas Service Provided to Customers in the Company's Missouri Service Area, Case No. GR-2006-0422, Report and Order, p.9, March 22, 2007.

Western District and Southern District affirming the Commission's decision to deny MGE's request to employ a hypothetical capital structure.[27]

The reasons the Commission has repeatedly denied MGE's attempt to adopt a hypothetical capital structure should be repeated again in this case. SUC's management decisions are the reasons for its actual capital structure, and to impose a hypothetical capital structure would serve no purpose other than boosting MGE's profits by $4.8 million at the expense of ratepayers.

2. <u>Return on *Equity* (ROE)</u>: *What return on common equity should be used for determining MGE's rate of return?*

OPC recommends 10.0% as a just and reasonable return on common equity (ROE) for MGE. However, if the Commission adopts MGE's rate design proposal to recover all non-gas costs in a single fixed customer charge for Residential and SGS customers, the reduction in risk associated with ensuring recovery of non-gas should be offset through a 50 basis point reduction to ROE, or a $1,842,034 reduction in cost of service. If the Commission adopts a traditional rate design, OPC's testimony supports a 10.0% ROE without offsets.

OPC's ROE witness, Mr. Daniel Lawton, explains in detail in his testimony how he employed a twelve company comparable group as a proxy. (Ex.69, p.26). 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). (Ex.69, pp.26-45). 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.

[27] *State of Missouri ex rel. Missouri Office of the Public Counsel v. Public Service Commission,*

MGE's witness Mr. Hanley, on the other hand, advocated for an astounding 15.25% ROE in Direct Testimony as an alternative to his 11.25% ROE recommendation, then subsequently threw out his prior testimony and reduced his ROE recommendation to 13.9% and 10.5% respectively. Mr. Hanley's methods of calculating ROE are suspect in that Mr. Hanley provides arbitrary adjustments with little or no explanation. During the evidentiary hearing, Commissioner Davis recognized these problems with Mr. Hanley's arbitrary adjustments when he stated during his questioning of Mr. Hanley:

> …my impression from reading your direct testimony is that you plug in a bunch of numbers, you don't like the results, so then you make subjective adjustments to those numbers to achieve the desired outcome.

Tr. 157. Commissioner Davis' impression of Mr. Hanley's testimony is understandable given Mr. Hanley's subjective adjustments that support the impression that Mr. Hanley simply backed into the numbers he wished to achieve.

Mr. Hanley used three equity return models, and then eliminated one result and estimated a midpoint between the remaining results. (Ex.70, p.8). Mr. Hanley's DCF analysis is consistent with Mr. Lawton's 10.0% recommendation. (*Id.*). 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%. (Ex.13, FJH-15, p.6). Mr. Hanley 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%. (*Id.*). 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. (*Id.*). Mr. Lawton testified in response to Mr. Hanley's Direct Testimony analysis that he is not aware of any regulatory authority

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293 S.W.3d 63 (Mo. App. S.D. 2009).

in the United States that has relied on an equity risk premium at the levels proposed by Mr. Hanley. (Ex.70, p.10). Furthermore, Mr. Lawton is not aware of any investor services, analyst estimates, or any credible forecasting entity that is suggesting that investors will earn equity returns of 28.85% over the next three to five years. (*Id.*). 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. (*Id.* at pp. 10-11). The result is that Mr. Hanley's risk premium analysis is substantially overstated and cannot be relied upon for establishing ROE for MGE. (*Id.*).

Mr. Hanley's Rebuttal Testimony only substantiates the arbitrary numbers that result from Mr. Hanley's analysis. Now Mr. Hanley is calculating an enormous annual market return to investors of 17.09% over the next three to five years. Whereas Mr. Hanley's Direct Testimony applied a 20% weighting to his calculated investor expected returns, in his Rebuttal Testimony Mr. Hanley now applies a 40% weighting. These weightings are not based on analysis, research, or rigorous investigation – rather they are based simply upon Mr. Hanley's arbitrary judgment with no basis in financial economic or any other theory. (Ex.71, p.5). MGE's analysis cannot be supported as a sound basis for setting just and reasonable rates. (*Id.*).

In surrebuttal testimony, 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. (Ex.71, p.6). 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. Mr. Murray recommends an ROE of 9.5%. If the Commission were to average Mr. Murray's 9.5% recommendation, Mr. Lawton's 10.0% recommendation, and Mr. Hanley's corrected 9.5% (removing the inflated 17% forecasted return), the average of these three would yield an ROE of 9.66%.

The only reliable evidence before the Commission on ROE is the testimony evidence of OPC and Staff. Neither Mr. Lawton nor Mr. Murray applied arbitrary adjustments, and neither needed to update their analysis and abandon the analysis in their direct testimony. Accordingly, the Commission has a clear evidentiary basis for concluding that an appropriate ROE for MGE is somewhere between 9.5% and 10.0%.

3. <u>Cost of Debt</u>: *What long term and short term cost of debt should be used for determining MGE's rate of return?*

The appropriate long term and short term cost of debt for determining MGE's rate of return was discussed previously under the discussion of an appropriate capital structure. For the reasons discussed previously, OPC believes the most appropriate long term and short term debt should be the actual long term and short term debt employed by SUC as follows:

ACTUAL CAPITAL STRUCTURE			
DESCRIPTION	RATIO	COST	WEIGHTED COST
Long-Term Debt	56.16%	6.258%	3.514%
Short-Term Debt	3.26%	5.920%	0.193%

4. <u>Rate Design Risk</u>: ***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 risk? If the answer is "yes," should that reduced risk be recognized in the determination of either cost of capital or the revenue requirement?***

A rate design that recovers all non-gas costs in a fixed customer charge would significantly reduce MGE's risk of recovering its costs. As explained in the testimony of OPC witness Mr. Daniel Lawton, this risk reduction can be recognized through either a reduction to MGE's authorized return on equity of 50 basis points, or through a $1,842,034 reduction to MGE's revenue requirement.

If the Commission were to continue with the SFV rate design for residential customers, and move to the SFV for Small General Service (SGS) customers, MGE would be virtually assured that it would recover 91.87% of its annual revenue requirement through fixed charges. (Ex.69, pp. 9-10). Under the SFV, MGE's fixed charges would not be subject to variations in volumes associated with weather, declining usage, economic change, or conservation. (Ex.69, p.10). The only possible revenue impact under a SFV rate design is the unlikely possibility of negative growth. (*Id.*).

OPC's evidence shows that an appropriate ROE adjustment to account for the risk reduction would be a 50 basis point reduction to ROE. (Ex.69, p.11). In MGE's last rate case, MGE recognized the need to reduce ROE to account for the risk reductions, and proposed a 35 basis point reduction. (*Id.*). The Commission also recognized the need to reduce ROE as a result of the SFV, and reduced MGE's ROE by 32.5 basis points.[28] In the present case, where MGE is proposing to expand the SFV into the SGS class, a larger

[28] *In the Matter of Missouri Gas Energy's Tariffs Increasing Rates for Gas Service Provided to Customers in the Company's Missouri Service Area,* Case No. GR-2006-0422, Report and Order, March 22, 2007, p.31.

equity reduction is justified to account for the further reduction in business risks if the Commission adopts the SFV for both the residential and SGS classes. (Ex.69, p.11). This is due to the fact that implementation of the SFV rate design assures that the authorized non-gas revenues, which include MGE's authorized return on investment, will be collected. (Ex.79, p.15).

The Commission has two mechanisms available for recognizing this shift in risk from company to consumers. The first mechanism is the 50 basis point reduction discussed above. The second mechanism, and the one advocated by OPC, is that the Commission should reduce MGE's cost of service by $1,842,034. According to Mr. Lawton, "this adjustment is conservative, ties to risk changes expected from decoupling, is consistent with risk measures and considerations of rating agencies, and is consistent with a 50 basis point reduction discussed earlier." (Ex.69, pp.13-14). It is also consistent with 50 basis point reductions adopted by other state commissions.[29]

C. ENERGY EFFICIENCY

1. <u>Relationship to rate design</u> - *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?*

The Commission should order MGE to implement energy efficiency programs regardless of the rate design approved by the Commission. MGE's attempt to link the

[29] Ex.69, p.14; *In The Matter Of The Application Of Potomac Electric Power Company For Authority To Revise Its Rates And Charges For Electric Service And For Certain Rate Design Changes*, Case No. 9092, 2007 Md. PSC LEXIS 13, July 19, 2007; *In The Matter Of The Application Of Delmarva Power And Light Company For Authority To Revise Its Rates And Charges For Electric Service And For Certain Rate Design Changes*, Case No. 9093, 2007 Md. PSC LEXIS 14, July 19, 2007.

continuation or expansion of the SFV to MGE's willingness to offer energy efficiency programs reaches way beyond what is necessary to hold MGE harmless from the usage reductions that would result from energy efficiency programs that benefit customers.

MGE's sister company, New England Gas Company (NEGC) in Massachusetts, operates under a traditional rate design rather than a SFV rate design. (Ex.77, Attachments 1-5). NEGC's rate design consists of a $9.16 residential customer charge and volumetric rates that vary by season. (*Id.*). Despite not having a SFV rate design, NEGC offers a list of energy efficiency programs. (*Id.*).

If the Commission is concerned that MGE's incentives to offer such programs should be more aligned with the interests of consumers, OPC's proposed Lost Margin Revenue Recovery Mechanism provides MGE with a mechanism to recover lost revenues caused by such programs. (Ex.76, pp.8-9). In Massachusetts, NEGC recovers energy efficiency program expenses, including lost margins, under a recovery mechanism that is essentially the same as the LMRRM proposed by OPC witness Mr. Ryan Kind. (Ex.77, p.6, Attachment 5).

MGE is simply attempting to coerce the Commission into adopting the SFV rate design by claiming MGE is unwilling to administer energy efficiency programs without its preferred rate design. If the Commission believes implementing energy efficiency programs is an important objective for Missouri consumers, the Commission should not be mislead into believing that any perceived link between SFV and energy efficiency programs is imperative before the Commission can order MGE to implement such programs.

2. ***<u>Funding source</u> - 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?***

Funding for energy efficiency programs should not be included as an ongoing expense in rates. OPC believes the Commission should first make a $750,000 adjustment to MGE's revenue requirement to remove the annual funding for MGE's residential energy conservation programs. (Ex.75, p.3). Next, the Commission should direct MGE to create a regulatory asset account for MGE's residential energy conservation programs that would initially have a negative balance of approximately $1 million with interest to reflect the surplus of unspent funds already collected from ratepayers. (*Id.*). The regulatory asset account would allow MGE to track energy efficiency expenditures and costs for future recovery in MGE's next rate case. (*Id.*). Separate regulatory asset accounts would be appropriate to book separately the expenditures for residential and SGS classes because the $1 million of surplus funds were intended for residential customers and should not be directed towards other customer classes. (*Id.* p.6). This type of deferral account for energy efficiency cost recovery is used by most other utilities regulated by the Commission. (Ex.75, p.5).

3. ***<u>Funding amount</u>: What should the annual funding level be and how should the funding level be determined?***

The Commission should not order an annual funding level to be recovered in rates, and should instead make an adjustment to remove from rates the $750,000 annual funding amount for MGE's existing residential energy conservation programs. As

explained above, OPC proposes that the Commission direct MGE to create a regulatory asset account that would initially have a negative balance of approximately $1 million to $1.2 million to reflect the surplus of unspent residential energy efficiency funding plus interest previously collected from ratepayers.

Currently, MGE's residential efficiency programs are funded at a level of about $420,000 per year. (Ex.75, p.6). Assuming the regulatory asset account has an initial balance of $1 million to $1.2 million and MGE's energy efficiency programs increase to a level of $600,000 per year, the negative balance will begin to turn positive at the beginning of the third year following the conclusion of this case. (*Id.*).

4. *Funding interest: Should interest be applied to unspent residential energy efficiency funds and, if so, at what rate?*

OPC believes ratepayers should be properly compensated when they supply monies to the utility via the regulatory process. It is OPC's position that 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. (Ex.80, pp.5-7).

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. (Ex.80, p.6). 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. (*Id.*). OPC witness Mr. Russell Trippensee 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 would earn an AFUDC rate that was higher than the short-term debt rate, thus increasing the Company's earnings.

(*Id.*). OPC simply believes these ratepayer supplied funds should be treated similar to how other ratepayer supplied funds are treated. Mr. Trippensee explained:

> 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.

(*Id.* p.7). MGE has provided no legitimate reason to treat these ratepayer supplied funds differently from how such funds are typically treated.

5. <u>Continuation/Form of Collaborative</u> - 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?

OPC believes the consensus decision making collaborative ordered in Case No. GT-2008-0005 should continue to ensure that all stakeholders have sufficient input into the design and implementation of energy efficiency programs. 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. (Tr. 734-735). MGE benefited greatly from the experience of Staff, DNR and OPC during the collaborative process. (Ex.76, p.2). 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. (*Id.*). OPC encourages the Commission to maintain the collaborate as a voting group because MGE has not proven that its experience will ensure the programs are administered in a manner that provide ratepayers with the most value for their contributions to MGE's energy efficiency programs.

D. CONCLUSION

OPC asks the Commission to listen to the concerns raised by MGE's customers regarding high fixed charges, the current state of the economy, high unemployment, a freeze on social security increases, and other concerns that the Commission has not heard before from MGE's customers to the same extent that those concerns were brought to the Commission in this case. Ratepayers living on fixed incomes are not afforded the luxury of filing with the Commission for an increase in income. The Commission should carefully examine MGE's proposals and deny changes that fail to serve the public. While it is true that the law requires the Commission to employ ratemaking principles that give the utility a reasonable opportunity to earn a fair return on its shareholder's investments, the foremost purpose of the Commission is to serve and protect ratepayers. *State ex rel. Capital City Water Co. v. P.S.C.,* 850 SW2d 903 (Mo. App. W.D. 1993). The protection given the utility "is merely incidental." *State ex rel. Electric Co. of Missouri v. Atkinson,* 204 SW 897 (Mo. 1918). The public is not served by a Commission decision that guarantees revenue recovery for the utility while providing no benefits to ratepayers.

Respectfully submitted,

OFFICE OF THE PUBLIC COUNSEL

By: **/s/ Marc D. Poston**

Marc D. Poston (#45722)
Deputy Public Counsel
P. O. Box 2230
Jefferson City MO 65102
(573) 751-5558
(573) 751-5562 FAX
marc.poston@ded.mo.gov

CERTIFICATE OF SERVICE

I hereby certify that copies of the foregoing have been mailed, emailed or hand-delivered to the following this 18th day of December 2009:

General Counsel Office
Missouri Public Service Commission
200 Madison Street, Suite 800
P.O. Box 360
Jefferson City, MO 65102
GenCounsel@psc.mo.gov

Shemwell Lera
Missouri Public Service Commission
200 Madison Street, Suite 800
P.O. Box 360
Jefferson City, MO 65102
Lera.Shemwell@psc.mo.gov

Finnegan D Jeremiah
Central Missouri State University (CMSU)
3100 Broadway, Suite 1209
Kansas City, MO 64111
jfinnegan@fcplaw.com

Young Mary Ann
Constellation NewEnergy-Gas Division, LLC
2031 Tower Drive
P.O. Box 104595
Jefferson City, MO 65110-4595
MYoung0654@aol.com

Steinmeier D William
Constellation NewEnergy-Gas Division, LLC
2031 Tower Drive
P.O. Box 104595
Jefferson City, MO 65110-4595
wds@wdspc.com

Woodsmall David
Midwest Gas Users Association
428 E. Capitol Ave., Suite 300
Jefferson City, MO 65101
dwoodsmall@fcplaw.com

Conrad Stuart
Midwest Gas Users Association
3100 Broadway, Suite 1209
Kansas City, MO 64111
stucon@fcplaw.com

Woods A Shelley
Missouri Department of Natural Resources
P.O. Box 899
Jefferson City, MO 65102-0899
shelley.woods@ago.mo.gov

Callier B Sarah
Missouri Department of Natural Resources
P.O. Box 899
Jefferson City, MO 65102
sarah.callier@ago.mo.gov

Cooper L Dean
Missouri Gas Energy
312 East Capitol
P.O. Box 456
Jefferson City, MO 65102
dcooper@brydonlaw.com

Swearengen C James
Missouri Gas Energy
312 East Capitol Avenue
P.O. Box 456
Jefferson City, MO 65102
LRackers@brydonlaw.com

Hale C Vivian
Oneok Energy Marketing Company
100 W. 5th
Tulsa, OK 74102
vhale@oneok.com

Hatfield W Charles
Oneok Energy Marketing Company
230 W. McCarty Street
Jefferson City, MO 65101-1553
chatfield@stinson.com

Finnegan D Jeremiah
Superior Bowen Asphalt Company, LLC
University of Missouri-Kansas City (UMKC)
3100 Broadway, Suite 1209
Kansas City, MO 64111
jfinnegan@fcplaw.com

/s/ Marc Poston