MISSOURI PUBLIC SERVICE COMMISSION

DECLASSIFIED STAFF MEMORANDUM

PREVIOUSLY FILED SEPTEMBER 7, 2007

MISSOURI GAS ENERGY,
A DIVISION OF SOUTHERN UNION COMPANY

CASE NO. GU-2007-0480

Jefferson City, Missouri
July 22, 2008

M E M O R A N D U M

TO: Missouri Public Service Commission Official Case File
Case No. GU-2007-0480, Missouri Gas Energy

FROM: Paul R. Harrison, Auditing Department

/s/ Paul R. Harrison 9/06/2007
Utility Services Division/Date

/s/ Robert S. Berlin 9/06/2007
General Counsel's Office/Date

SUBJECT: Staff Recommendation to deny MGE's request for an Accounting Authority Order for costs related to its former manufactured gas plants.

DATE: September 6, 2007

On June 13, 2007, Missouri Gas Energy (MGE or Company), a division of Southern Union Company (Southern Union), filed an Application for an accounting authority order (AAO) authorizing the deferral of costs relating to environmental costs associated with its former manufactured gas plant (MGP) sites. MGE maintains that "an application for an AAO contains a single factual issue – whether the costs, which are asked to be deferred, are extraordinary in nature. *In the matter of the application of Missouri Public Service*, 1 Mo.P.S.C.3d 200, 300-204 (1991). 'By seeking a Commission decision [regarding the issuance of an AAO] the utility would be removing the issue of whether the item is extraordinary from the next rate case. All other issues would still remain, including, but not limited to, the prudency of any expenditures, the amount of recovery, if any, whether carrying costs should be recovered, and if there are any offsets to recovery.' *Id.*" [MGE Application, pages 2-3.]

In addition, in its Application the Company maintains that the Commission has in the past issued AAO's for costs "caused by unpredictable events, acts of government and other matters outside the control of the utility or the Commission.' *In the matter of St. Louis County Water Company's Tariff Designed to Increase Rates*, MoPSC Case No. WR-96-263, p. 13 (December 31, 1996) (emphasis added). The Commission has further stated that it 'has periodically granted AAOs and subsequent ratemaking treatment for various unusual occurrences such as flood-related costs, changes in accounting standards, and other matters which are unpredictable and cannot adequately or appropriately be addressed within normal budgeting parameters.' *Id.* at p. 14." [MGE Application, page 3.]

Finally, in its Application the Company maintains that there are many examples of AAOs based upon government actions and regulation. These instances include "compliance with environmental regulations such as the Clean Air Act (*In the matter of the application of Missouri Public Service*, 1 Mo.P.S.C.3d 200, 203-204 (1991)). In fact, the Commission has granted AAO's to natural gas companies in the past related to environmental activities. *See In the Matter of Laclede Gas Company*, Case No. GR-96-193, 5 Mo. P.S.C. 3d 108 (1996) (Laclede given authority to defer 'costs incurred to comply with Environmental Protection Agency regulations and orders in

connection with: (1) the investigation, assessment, removal, disposal, storage, remediation or other treatment of residues, substances, materials and/or property that are associated with former manufactured gas operations or located on former manufactured gas sites; (2) the dismantling and/or removal of facilities formerly utilized in manufactured gas operations; (3) efforts to recover such costs from potentially responsible third parties and insurance companies; and, (4) payments received by Laclede as a result of such efforts.); *In the Matter of the Application of United Cities Gas Company, a Division of Atmos Energy Corporation, for an Accounting Authority Order Related to Investigation and Response Actions Associated with Its Former Manufactured Gas Plant Site in Hannibal, Missouri,* Accounting Authority Order, Case GA-98-464 (1999).' " [MGE Application, pages 3-4.]

Specifically, by this Application, MGE requests an order which authorizes deferred accounting treatment for costs incurred in connection with environmental compliance activities primarily related to investigation, assessment and remediation of former MGP sites.

History

On January 31, 1994, Southern Union purchased the Missouri gas properties now being operated as MGE from Western Resources, Inc. (Western Resources) for $400,300,000. In its Amended Annual Report to the Securities and Exchange Commission (SEC), Form 10-K/A, filed on September 30, 1994, shortly after its purchase of the Western Resources property, Southern Union described the status of the newly acquired former manufactured gas plant sites:

> Missouri Gas Energy owns or is otherwise associated with a number of sites where manufactured gas plants were previously operated. These plants were commonly used to supply gas service in the late 19th and early 20th centuries, in certain cases by corporate predecessors to Western Resources. By-products and residues from manufactured gas could be located at these sites and at some time in the future may require remediation by the Environment Protection Agency (EPA) or delegated state regulatory authority.
>
> By virtue of notice under the Missouri Asset Purchase Agreement and its preliminary, non-invasive review, the Company became aware prior to closing of eleven such sites in the service territory of Missouri Gas Energy. Based on information reviewed, it appears that neither Western Resources nor any predecessor in interest ever owned or operated at least three of those sites.
>
> Subsequent to the closing of the Missouri Acquisition, as a result of an environmental audit, the Company has discovered the existence of possibly six additional sites in the service territory of Missouri Gas Energy. Southern Union has so informed Western Resources. The Company does not know if

> any of these additional sites were ever owned or operated by Western Resources or any of its predecessors in interest. Western Resources informed the Company that it was notified in 1991 by the EPA that it was evaluating one of the sites (in St. Joseph, Missouri) for any potential threat to human health and the environment. Western Resources also advised the Company on September 15, 1994 that as of that date the EPA had not notified it that any further action was required. Evaluation of the remainder of the sites by appropriate federal and state regulatory authorities may occur in the future. At that time and based upon information available to management, the Company believed that the costs of any remediation efforts that may be required for these sites for which it may ultimately have responsibility will not exceed the aggregate amount subject to substantial sharing by Western Resources.

As part of the purchase transaction, Southern Union and Western Resources entered into an Environmental Liability Agreement (ELA) with respect to future costs associated with the former manufactured gas plants being sold to Southern Union. The highly confidential ELA is attached, as Attachment 1, to this memorandum and describes a five-step tiered approach to the allocation of substantially all liabilities under environmental laws that may exist or arise with respect to the MGE's Missouri properties. The ELA is described as follows in Southern Union's September 30, 1994 SEC Form 10/K-A:

> Southern Union and Western Resources also entered into an Environmental Liability Agreement. Subject to the accuracy of certain representations made by Western Resources in the Missouri Asset Purchase Agreement, the agreement provides for a tiered approach to the allocation of substantially all liabilities under environmental laws that may exist or arise with respect to Missouri Gas Energy. The agreement contemplates Southern Union first seeking reimbursement from other potentially responsible parties or recovery of such costs under insurance or through rates charged to customers. To the extent certain environmental liabilities are discovered by Southern Union prior to January 1, 1996, and are not so reimbursed or recovered, Southern Union will be responsible for the first $3,000,000, if any, of out of pocket costs and expenses incurred to respond to and remediate any such environmental claim. Thereafter, Western Resources would share one-half of the next $15,000,000 of any such costs and expenses, and Southern Union would be solely liable for any such costs and expenses in excess of $18,000,000. The Company believes that it will be able to obtain substantial reimbursement or recovery for any such environmental liabilities from other potentially responsible third parties, under insurance or through rates charged to customers.

Specifically, the ELA established a five-tier approach for the recovery of all environmental costs for the MGE properties. The agreement contemplates Southern Union first seeking reimbursement from insurance carriers; second, through other potentially responsible parties (PRPs); third, through rates charged to customers; fourth, Southern Union would be responsible for the first $3,000,000 of the initial remaining liability; and, finally, Western Resources would share one-half of the next $15,000,000 of any such remaining costs and expenses. The ELA is scheduled to expire on January 31, 2009.

MGE's MGP Costs

Based on the documents received in response to data requests in this case, the Staff calculated that over the period 1994 through July 31, 2007, MGE has incurred a total of $10,232,501 in environmental costs, the bulk of which is specifically related to activities at its former MGP sites. Based also on data request responses, MGE recovered total MGP reimbursements of $8,272,273 through insurance claims and other payments from PRPs. In addition, Southern Union's initial liability for MGP costs as referenced in the ELA will cover an additional $3,000,000 in environmental costs. MGE has indicated to the Staff that it does not intend to charge customers for costs covered by the $3,000,000 liability amount, or to defer costs under this Application that would be covered by this ELA provision. In other words, as of July 31, 2007, taking into account both reimbursement from third parties and the portion of such costs that MGE has agreed not to charge to ratepayers, there has been no net MGP expenses chargeable to MGE's customers to date. As of July 31, 2007, MGE still has an excess of environmental cost recoveries over incurred environmental costs of at least -$1,039,772.

As shown above, MGE has received significant reimbursement of its MGP costs from insurance companies and other PRPs. In addition, MGE expects reimbursements of up to 50% of certain of its MGP costs from Western Resources as discussed above. In a discussing of its MGP costs in SEC Form 424B2 filed on January 10, 1994, Southern Union stated:

> The Company believes that it will be able to obtain substantial if not complete reimbursement or recovery for any such environmental liabilities from other potentially responsible third parties, under insurance or rates charged to customers.
>
> In addition, the Company is aware of the existence of other significant potentially responsible parties from whom contribution for remediation would be sought, and would expect to make claims upon its insurers, Western Resources; other potentially responsible parties (PRP) and would institute appropriate requests for rate relief.

However, thirteen and one half years after it advised the SEC of the above, Southern Union has not sought recovery of any of these costs from Western Resources under the provisions of the ELA. In response to Staff Data Request No. 6, when asked why MGE and/or Southern Union has not attempted to enforce the ELA between Southern Union and Western Resources for the past thirteen and one half years, MGE responded that "To date, there have not been any costs which have not been covered by insurance, PRPs or the $3,000,000 referenced in the agreement." While Southern Union has not sought recovery of these costs from Western Resources, it has taken action to secure ratemaking recovery of these MGP costs from Missouri customers in their last two rate cases and through the filing of this AAO Application. MGE's current gas customers (who had no role in the creation of MGP costs and have no legal or contractual liability for them) are being asked to carry the future financial burden for the cleanup costs of these MGP sites.

Prior Treatment of MGP Costs in MGE Rate Cases

During MGE's last two rate cases (Case Nos. GR-2004-0209 and GR-2006-0422), MGE requested that the Commission establish an environmental response fund (ERF) of $750,000 and $500,000, respectively, to be included in annual rates for their MGP remediation costs. In their ERF proposals, the Company recommended that the ERF fund be treated as a "tracking mechanism" by which MGP costs (of unknown future quantity) would be collected from customers through a separate rate element, and later "trued up" by the Company by comparing the amount of the rate collections to the MGP expense actually incurred by MGE. Any over-recovery or under-recovery of MGP costs, as reflected by the tracking mechanism, would be refunded to/collected from customers at a later date. Also, as part of this proposal, the Company proposed that fifty percent (50%) of any applicable insurance proceeds and/or contributions obtained from Westar Energy (formerly Western Resources) and/or contributions obtained from PRPs, net of costs associated with obtaining such proceeds and/or contributions, should be credited to this fund. The remaining (50%) of these recoveries would be credited to the shareholders as a form of profit. The Company stated that under the terms of the proposed ERF, contributions to and/or proceeds obtained from other parties, net of the cost of obtaining such contributions and/or proceeds, shall be shared evenly between the Company's shareholders (as a form of profit) and customers (as a credit to the ERF). The fund would also be given credit for the accrued liability in the amount of $3,000,000 recorded on Southern Union's books following the acquisition of the Missouri property (which was to become MGE) from Western Resources.

In Case NO. GR-2004-0209, in regard to the ERF proposal, the Commission ruled that:

> In the future, at least until 2009, costs not covered by insurance will be paid, in part, by Western Resources under the Environmental Liability Agreement between those companies. In sum, MGE's proposal to include $750,000 per year in its cost of service for future environmental cleanup costs is based entirely on speculation regarding costs that the company may never incur. Furthermore, the creation of a pre-funded source for the payment of these cleanup costs would remove much of Southern Union's incentive to ensure

> that only prudently incurred and necessary costs are paid. If the money has already been recovered from ratepayers and is being held in the Fund, Southern Union would have little incentive to not pay it out to settle claims brought against it. The Fund would be subject to audit by Staff and Public Counsel and they could seek a prudence adjustment if necessary. But the need for a prudence adjustment is difficult to prove and is not a good substitute for the company's own desire to prudently minimize its costs to improve its bottom line. For these reasons, the Commission finds that MGE's proposal to create an Environmental Response Fund should be rejected. [Order, pages 35-39.]

In Case NO. GR-2006-0422, on the same issue, the Commission ruled that:

> MGE agrees that it is not possible to ascertain the costs of investigation and remediation. That the magnitude of the costs associated with this effort is impossible to know is again noted by MGE. Further, to date, MGE has not paid any costs associated with the environmental clean up. That these costs are not known and measurable precludes their inclusion in rates. Furthermore, the creation of a pre-funded source for the payment of these cleanup costs would remove much of Southern Union's incentive to ensure that only prudently incurred and necessary costs are paid. If the money has already been recovered from ratepayers and is being held in the Fund, Southern Union would have little incentive to not pay it out to settle claims brought against it. Although the Fund would be subject to audit by Staff and Public Counsel and they could seek a prudence adjustment, the need for a prudence adjustment is difficult to prove and is not a good substitute for the company's own desire to prudently minimize its costs to improve its bottom line. For these reasons, the Commission finds that MGE's proposal to create an Environmental Response Fund shall be rejected. [Order, pages 18-20.]

Prior Deferral Treatment of MGP Costs in Missouri

In Case No. GR-94-220, which concluded in a Stipulation and Agreement reached between the parties to the case, the Commission authorized Laclede Gas Company (Laclede) to establish an environmental cost deferral procedure. This deferral procedure became effective September 1, 1994. The authorization to begin deferring MGP related costs was only triggered to the extent that Laclede's costs exceeded the $250,000 of MGP costs reflected in the Laclede's rates. In the event the cumulative liability incurred by the Company for such costs during the deferral period was less than the cumulative amount of such annualized costs reflected in the rates approved in the settlement, Laclede was required to refund the difference. Laclede was also required to file a general rate case within approximately two years of the deferral authorization, or else the deferral authorization would become null and void.

This environmental cost deferral was continued as a result of stipulations and agreements in Laclede's next two rate cases. Laclede's deferral authority for its MGP costs ended on July 31, 1999 as part of the Stipulation and Agreement reached in Laclede's subsequent rate proceeding, Rate Case No. GR-99-315. Since that time, Laclede has not deferred any of its MGP expenses, and those costs have been treated as an ordinary expense in rate cases filed since 1999.

In an AAO issued by the Commission in Case No. GA-98-464, United Cities Gas Company (United Cities), a division of Atmos Energy Corporation, was authorized to defer costs related to its MGP site in Hannibal, Missouri. In this order, as in the Laclede authorization, the Commission imposed a time requirement for filing of a subsequent rate case following the AAO issuance. In the United Cities order, the Commission indicated that the AAO would become "null and void in the event that United Cities does not file tariff sheets proposing a general increase in rates within twenty-four (24) months from the effective date of this order." United Cities did not file a rate case within this period, and ultimately never sought ratemaking treatment of any of its deferred MGP costs, and its authority to defer MGP costs has since accordingly lapsed.

No Missouri utility is currently deferring its MGP or other environmental remediation costs pursuant to a Commission-authorized AAO.

Standards for Deferral

The Commission expressed its general position and standards for deferral of costs incurred outside a rate case test year in its Report and Order in Case Nos. EO-91-358 and EO-91-360, cases file by Missouri Public Service, a division of UtiliCorp United, Inc. (now Aquila, Inc.). In this Order, the Commission expressed its position that costs incurred outside of a rate case test year should be allowed only on a limited basis:

> The deferral of costs from one period to another period for the development of a revenue requirement violates the traditional method of setting rates…. Under historical test year ratemaking, costs are rarely considered from earlier than the test year to determine what is a reasonable revenue requirement for the future. Deferral of costs from one period to a subsequent rate case should be allowed only on a limited basis. [Order, pages 6-7.]

In the Standards for Deferral section of this Report and Order, the Commission described the following criteria for allowing utility companies to defer costs incurred outside of a rate case test year as a regulatory asset:

1. Events occurring during a period that are extraordinary, unusual and unique, and not recurring; and

2. The costs associated with the material event are material.

These criteria, as they apply to MGE's instant Application, will be addressed below. However, before concluding whether or not MGE's MGP costs and its Application in this case have met these criteria, a brief review of how the Federal Energy Regulatory Commission (FERC) Uniform System of Accounts (USOA) defines the term "extraordinary items" in General Instruction No. 7 may be helpful. The FERC USOA for natural gas utilities reads as follows:

> Extraordinary items. It is the intent that net income shall reflect all items of profit or loss during the period with the exception of prior period adjustments as described in paragraph 7.1 and long-term debt as described in paragraph 17 below. Those items related to the effects of events and transactions which have occurred during the current period and which are of unusual nature and infrequent occurrence shall be considered extraordinary items. Accordingly, they will be events and transactions of significant effect which are abnormal and significantly different from the ordinary and typical activities of the company, and which would not reasonably be expected to recur in the foreseeable future. (In determining significance, items should be considered individually and not be in the aggregate. However, the effects of a series of related transactions arising from a single specific and identifiable event or plan of action should be considered in the aggregate.) To be considered as extraordinary under the above guidelines, an item should be more than approximately 5 percent of income, computed before extraordinary items. Commission approval must be obtained to treat an item of less than 5 percent, as extraordinary.

The remainder of this recommendation memorandum will discuss the reasons the Staff believes that MGE's Application to defer environmental costs does not meet the Commission's traditional standard for deferral of costs. In the event the Commission chooses to grant MGE's deferral request, the Staff will also suggest conditions to be placed upon any such approval.

MGE's MGP Costs are not Unusual in Nature

As a natural gas distribution company, it should not be considered unusual for MGE to experience environmental remediation costs, such as costs to clean up former MGP sites. Many natural gas distribution and electric utilities throughout the United States are incurring MGP-related costs. In Missouri alone, MGP-related costs have been incurred by Laclede, United Cities and the Missouri Public Service division of Aquila, Inc., in addition to MGE.

MGE's MGP Costs are not Infrequent in Occurrence

Southern Union has been aware of the existence of potentially significant MGP costs associated with the Missouri gas properties it purchased from Western Resources since at least 1993. In fact, a review of the invoices from environmental contractors and consultants received in response to data requests in this proceeding show that MGE has been experiencing environmental costs each and every year since it came into existence in 1994. Based on the documents received in response to data requests in this case, the Staff calculated that over the period 1994 through July 31, 2007, MGE incurred approximately $10,232,501 in environmental costs, the bulk of which is related to its MGP operations. Therefore, the Staff concludes that MGE's MGP costs are not infrequent in occurrence.

Not only has MGE been incurring MGP-related costs for more than ten years, its own assertions in its Application show that it is likely that it will continue to incur these costs for the foreseeable future. Nor does MGE's Application explain why its future MGP costs will not continue to be largely reimbursable from third parties, as its past MGP costs have been. As such, these costs do not meet the Commission's nonrecurring or "infrequency of occurrence" criteria. Given the industry in which MGE operates, the Staff does not consider environmental costs, such as its MGP costs, to be unusual in nature for MGE.

The Staff agrees with the findings of the Accounting Principles Board in its APB Bulletin No. 30 where the Board stated that "An event or transaction of a type that occurs frequently in the environment in which the entity operates cannot, by definition, be considered as extraordinary, regardless of its financial effect."

MGE's Current MGP Costs Are Not Material

In MGE's last rate case, No. GR-2006-0422, the Staff's last calculation of MGE's net operating income on an adjusted basis was $36,123,186. For comparison purposes, during the same time period, MGE did not incur any MGP costs for which it was not reimbursed through insurance carriers or by other PRPs, or covered by its initial ELA liability of $3,000,000 . (The same point is true for the entire period of 1994 through July 2007.) Obviously, MGE's current and past levels of unreimbursed MGP costs do not meet the 5% net income materiality level used by the FERC, and MGE's past and current level of unreimbursed MGP costs certainly do not "significantly distort" MGE's current and past year's net income levels.

Even if MGE's environmental clean-up costs were to be considered extraordinary, deferral authority should not be granted unless the costs are actually material in nature as well. The Staff believes that materiality should not be judged based upon projected or budgeted future cost levels. It is only appropriate to grant deferral requests per AAO applications when the extraordinary event in question has actually occurred or is certain of occurring, and the financial impact on the utility can be quantified with a high degree of accuracy. In its Application, MGE freely admits that it is "not

possible to predict the timing and magnitude of MGP investigation at this time….there is uncertainty as to the ultimate costs of the remediation efforts" [MGE Application, p. 6.] Without an examination of actual incurred expenses by a utility, it is not possible to judge whether the costs of a particular event or series of events can be handled through normal accounting and rate practices, or whether treatment as an extraordinary item is justified.

The Commission itself has indicated that deferral treatment should not be granted to speculative expense amounts associated with events whose occurrence or timing is uncertain. In its Report and Order in Case Nos. EO-91-358 and EO-91-360, the Commission stated:

> The Commission agrees with Staff that whether the event has occurred or is certain to occur in the near future is a relevant factor. Utilities should not seek deferral of speculative events since it is hard to determine whether an event is extraordinary or material unless there is a high probability of its occurring within the near future. [Order, pages 8-9.]

MGE's Application does not provide any evidence that MGP clean-up costs are certain of occurring within the near future, nor does it assert that the financial impact of these events, when and if they incur, are capable of being accurately quantified at this time. Given the uncertain and speculative nature of MGE's future environmental cost levels at this time, MGE's instant Application is clearly premature.

Deferral Authority, If Granted, Should Only Apply to MGP Costs

MGE's request to defer costs in the instant Application is intended to apply to "costs incurred in connection with environmental compliance activities primarily related to investigation, assessment and remediation of former manufactured gas plant sites." However, MGE's discussions in its Application of these costs are solely concerned with MGP-related costs. Therefore, if the Commission were to grant MGE's requested deferral authority, the Staff recommends that such authority be limited to costs directly associated with investigation, assessment and remediation of former MGP sites.

MGE Should Continue to Seek Recovery of MGP Costs from Western Resources if Deferral Authority is Granted

As discussed above, MGE has the opportunity to seek recovery from Western Resources of a portion of its incurred MGP costs under the terms of the ELA. To date, MGE has not obtained any such recovery from Western Resources, and its ability to do so will expire in early 2009.

In reference to the ELA , the Staff is concerned with the impact upon the Agreement between Western Resources and Southern Union if this AAO is approved. Specifically, if MGE has recovered all costs from three of the four tiers (insurance, PRPs and the $3,000,000 initial liability, as referenced in the Agreement) and is allowed by the Commission to defer all remaining MGP costs to

the next rate case, can this action be interpreted as relieving Western Resources from its legal liability for its share of the remaining costs?

The Staff believes strongly that any deferral authorization or order allowing rate recovery of MGP costs should only be granted after MGE demonstrates that recovery of these costs is not possible from any other source, including insurance carriers, other PRPs and Western Resources under the ELA. Accordingly, the Staff recommends that, in the event the Commission grants MGE's deferral request in this Application, MGE only be allowed to defer 50% of its actual incurred MGP related expenses in order to recognize the portion of such costs potentially eligible for recovery from Western Resources under the terms of the ELA.

A Time Limit Should Be Placed Upon Any Allowed Deferrals if Deferral Authority is Granted

As has been discussed, the Commission's previous authorizations to defer environmental costs (Laclede, United Cities) both contained a time limit requiring the utilities to file a rate case within a period of time, or write-off the deferrals. In fact, most, if not all, deferrals allowed by the Commission through AAO applications have contained a similar rate case filing requirement. The Commission's rationale for such a limit was discussed in the Order for Case Nos. EO-91-358 and EO-91-360:

> The Commission finds that a time limitation on deferrals is reasonable since deferrals cannot be allowed to continue indefinitely. The Commission finds that a rate case must be filed within a reasonable time after the deferral period for recovery of the deferral to be considered… The limitation accomplishes two goals. First, it prevents the continued accumulation of deferred costs so that total disallowance would not affect the financial integrity of the company or the Commission's ability to make the disallowance; and secondly, it ensures the Commission a review of those costs within a reasonable time. If the costs are truly extraordinary, recovery in rates should not be delayed indefinitely. A utility should not be allowed to save deferrals to offset against excess earnings in some future period. [Pages 8-9.]

The Staff believes a requirement that MGE file a general rate case within two years or forfeit its ability to recover such deferrals in rates is reasonable in this instance, if the Commission chooses to allow MGE to defer its MGP costs through this Application.

Any Deferral Order Should Have No Ratemaking Effect

In all past AAOs granted by the Commission that the Staff is aware of, the Commission included language in its orders making clear that the authorization was not determinative in any way on the question of future rate recovery of deferred costs. The Staff believes that similar language is appropriate in any Order in this Application allowing MGE to defer MGP costs.

Staff Recommendations

As described above, the Staff believes that MGE's MGP costs are not extraordinary in nature, nor are its current level of incurred unreimbursed MGP costs material. For these reasons, the Staff believes that this Application does not meet the Commission's standards for AAO approval. Therefore, the Staff recommends that the Commission reject MGE's AAO Application in this case.

If the Commission for any reason issues the requested AAO to MGE, the Staff recommends that the Commission include standard language in the Ordered section of the AAO. This language should include that the AAO would become null and void in the event that MGE does not file tariff sheets proposing a general increase in rates within twenty-four (24) months from the effective date of this order, and state that granting this AAO would have no effect on the subsequent ratemaking treatment of the deferred costs.

Any deferral authority granted to MGE should be limited to 50% of its incurred MGP costs otherwise eligible for sharing with Western Resources under the ELA.

If the Commission issues the requested AAO to MGE, the Staff recommends that the deferral authority be limited to MGE's incurred costs associated with former MGP sites.

In addition, Southern Union has in the past contracted with the same legal firms for Missouri MGP related activities, other types of legal work and MGP costs for other states. Because of this fact, and because legal fees has represented a substantial portion of Southern Union's MGP costs, the Staff requests that the Commission order MGE to require of its legal consultants to include a specific description of the type of work performed for each hour on each invoice presented for costs deferred under this AAO.

If the Commission does approve this AAO request, the Staff recommends the Commission include the following language in its Ordered section of the AAO:

> 1. That MGE is authorized to defer up to 50% of its MGP expenditures that it incurs eligible for potential sharing with Western Resources under the ELA, and 100% of its MGP expenditures not eligible for sharing under the ELA to Account 182.3, Other Regulatory Assets, beginning on October 1, 2007 and continuing through the earlier of September 30, 2009 or the end of the Commission-ordered test year as updated, or true-up period in MGE's next rate case. MGE should immediately reflect as a credit to the deferral any recoveries accrued on its or Southern Union's books and records or received from insurance carriers or other third parties relating to MGP costs previously deferred.

2. That nothing in this order shall be considered a finding by the Commission of the reasonableness of the costs and/or expenditures deferred, and the Commission reserves the right to consider the ratemaking treatment to be afforded all deferred costs and/or expenditures, including the recovery of carrying costs, if any.

3. That MGE is hereby directed to maintain detailed supporting records, work papers, invoices and other documents to support the amount of costs deferred under this AAO, including any related deferred taxes recorded as a result of the cost deferral. In addition, MGE shall provide detailed documentation, including a complete description of the type of work performed, specific MGP site and time spent for each invoice submitted for all legal expenses deferred under this AAO.

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of the Application of Missouri Gas Energy, a division of Southern Union Company, for an Accounting Authority Order Concerning Environmental Compliance Activities	))))	Case No. GU-2007-0480

AFFIDAVIT OF PAUL R. HARRISON

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

PAUL R. HARRISON, of lawful age, on his oath states: that he has participated in the preparation of the foregoing Staff Recommendation in memorandum form, to be presented in the above case; that the information in the Staff Recommendation was developed by him; that he has knowledge of the matters set forth in such Staff Recommendation; and that such matters are true and correct to the best of his knowledge and belief.

Paul R. Harrison
PAUL R. HARRISON

Subscribed and sworn to before me this 6th day of September, 2007.

D. SUZIE MANKIN
Notary Public - Notary Seal
State of Missouri
County of Cole
My Commission Exp. 07/01/2008

D. Suzie Mankin
Notary Public

ENVIRONMENTAL LIABILITY AGREEMENT

ENVIRONMENTAL LIABILITY AGREEMENT (the "Agreement"), dated as of January 31, 1994 between WESTERN RESOURCES, INC., a Kansas corporation ("Seller") and SOUTHERN UNION COMPANY, a Delaware corporation ("Buyer").

WHEREAS, Seller and Buyer have entered into an Agreement for Purchase of Assets dated as of July 9, 1993, (the "Asset Purchase Agreement"), in which this Agreement is incorporated by reference pursuant to Article XIII of the Asset Purchase Agreement; and

WHEREAS, Buyer and Seller desire to provide a framework for the liability of the parties for Environmental Claims and for the sharing of Environmental Costs;

NOW, THEREFORE, in consideration thereof and of the respective covenants, representations and warranties herein contained, the parties agree as follows:

Article 1. ASSUMPTION OF LIABILITY. Except as hereinafter provided, Buyer hereby (a) assumes and agrees to be responsible for all Environmental Claims now pending or that may hereafter arise with respect to the Assets and the Business and (b) agrees to pay, perform and discharge, as and when due and payable, all Environmental Costs with respect to such Environmental Claims. Buyer hereby agrees, except as herein provided, to indemnify and hold Seller harmless from and against all Environmental Claims and Environmental Costs which Buyer has assumed or agreed to be responsible for pursuant to this Article 1. The procedures set

Attachment 1

forth in Section 12.02 of the Asset Purchase Agreement concerning recovery of costs for matters subject to indemnification are incorporated herein by reference and made a part hereof, and Seller and Buyer agree to comply with the procedures set forth in said Section 12.02 in making any claim relating to indemnification. For the purposes of Buyer's assumption of liability, agreement to pay, perform and discharge and to indemnify set forth in this Article 1, Article 2(c)(v) and Article 2(d) only, the term "Environmental Claim" shall include, in addition to those claims which are included within such term as defined in the Asset Purchase Agreement, any and all such claims and other matters hereafter arising which are based in whole or in part upon (A) any amendment or modification which occurs after the Closing Date of any Environmental Law which is extant on the Closing Date; (B) any law, statute, ordinance, rule, regulation, order or determination of any governmental authority or agency enacted or adopted after the Closing Date which would, if such law, statute, ordinance, rule, regulation, order or determination were in effect on the Closing Date, be an Environmental Law; or (C) any change in interpretation of any Environmental Law after the Closing Date by any court or by any governmental agencies having authority to enforce such Environmental Law.

Article 2. DEFINITION OF COVERED MATTERS. (a) Definition. As used herein, the term "Covered Matters" shall mean and refer to all Environmental Claims and Environmental Costs related to the Assets or the Business which (i) arise out of or are based upon

Environmental Laws, and (ii) are not included in Assumed Liabilities.

(b) Newly Discovered Matters. Covered Matters that are discovered by Buyer prior to the date which is two (2) years following the date of this Agreement shall be subject to the cost sharing provisions contained herein. All Covered Matters discovered by Buyer more than two (2) years following the date of this Agreement shall be the sole responsibility of Buyer.

(c) Shared Liability. (i) Insurance First Line of Recovery. Seller shall undertake, at its sole expense, to conduct an Environmental Insurance Archaeology Survey ("Survey") for all Plants and other locations identified on Schedule 6.18 of the Asset Purchase Agreement within thirty (30) days of the Closing Date and promptly thereafter provide Buyer with the results of the Survey. To the extent that Seller may lawfully do so without adversely affecting the insurance coverage disclosed by the Survey, Seller hereby agrees that the insurance coverage disclosed by that Survey shall constitute the first line of recovery. For any Covered Matter discovered by Buyer after Closing, Buyer shall as promptly as possible after the discovery of such Covered Matter provide notice of such discovery, together with all factual information and copies of all notices, environmental assessments, reports and other information, to Seller's Environmental Services Department so as to allow Seller to provide prompt and timely notice to the appropriate insurance carrier or carriers identified in the Survey. The parties thereafter agree to cooperate in the filing and prosecution of

claims with the appropriate insurance carrier(s) in a manner that the parties mutually agree so as to expeditiously prosecute such claims. Amounts recovered from such insurance carrier(s) from the prosecution of such claims shall, after allowance for Seller's post closing outside legal fees and other reasonable out of pocket expenses, be paid to Buyer. In the event insurance recovery is protracted, the parties shall accelerate the shared cost provisions of subparagraphs (c)(ii) through (v), crediting subsequent insurance or PRP contributions to the parties as their interests appear in subparagraphs (iv) and (v).

(ii) Potentially Responsible Party First Line of Recovery. In those instances where other Potentially Responsible Parties (PRPs) are identified for purposes of cost sharing in the remediation of any site, amounts recovered from such PRPs shall, after allowance for Buyer and Seller's post closing outside legal fees and other reasonable out of pocket expenses, be paid to Buyer and credited against the cost incurred with respect to such required remediation. In the event PRP recovery is protracted, the parties shall accelerate the sharing of cost as provided for in subparagraphs (c)(iii) through (v) hereof, crediting subsequent insurance or PRP contributions to the parties as their interests appear in subparagraphs (iv) and (v).. If Seller and Buyer agree to so accelerate the sharing of costs, then Seller shall, prior to the application of any subsequent insurance proceeds or PRP contributions, be entitled to receive reimbursement of amounts advanced under subparagraph (c)(v) for post-closing costs incurred

in connection with Covered Matters as provided herein pursuant to said subparagraph.

(iii) Recovery of Remediation Costs through Regulated Cost of Service. In addition to seeking the relief contemplated under subparagraphs (c)(i) or (ii), Buyer shall request from the appropriate regulatory agency having jurisdiction in the state where any remediation site is located for authority to include the cost incurred by Buyer in connection with the remediation of such site, above that recovered under subparagraphs (c)(i) or (ii), in its applicable rates or other charges for service. Notwithstanding anything to the contrary contained in this Agreement, Buyer shall retain complete discretion as to the timing of any filings with the appropriate regulatory agencies and may seek to recover such amount in rates either before or after the recovery of any amounts pursuant to any other provision of this agreement. Buyer shall be deemed to have recovered in its applicable rates or other charges for service an amount equal to the greater of (A) the amount actually authorized for inclusion in Buyer's applicable rate or other charges for service reflected in tariffs, or (B) the amount which would be recovered if Buyer would have been authorized to include in its applicable rate or other charges for service reflected in tariffs an amount which would have been authorized for such inclusion if Buyer's request for inclusion had been accorded the treatment accorded similar expenditures under similar facts and circumstances by the applicable regulatory agency.

(iv) Buyer's Initial Sole Liability Amount. Upon exhaustion

of relief contemplated under subparagraphs (c)(i), (ii) and (iii), Buyer shall thereafter be solely liable (as between Seller and Buyer) for the payment of costs incurred by Buyer or Seller in connection with Covered Matters in excess of the amounts received by Buyer under subparagraphs (c)(i), (ii) and (iii) in the aggregate amount of Three Million Dollars ($3,000,000.00), without regard to the number of claims concerning Covered Matters required to reach said amount.

(v). Buyer/Seller Shared Liability Amount. Upon exhaustion of relief contemplated under subparagraphs (c)(i) through (iv), Buyer and Seller shall share equally in payment of costs incurred by Buyer in connection with Covered Matters in excess of the amounts received by Buyer under subparagraphs (c)(i) through (iii) (or paid by Buyer under subparagraph (c)(iv)) to a maximum aggregate amount of Fifteen Million Dollars ($15,000,000.00), without regard to the number of claims concerning Covered Matters required to reach said amount. Notwithstanding anything to the contrary herein, Seller's total liability for Covered Matters shall be limited to the amount of Seven Million Five Hundred Thousand Dollars ($7,500,000.00), and Buyer shall indemnify and hold Seller harmless with respect to all claims, costs, demands and liabilities with respect to all other Covered Matters.

(d) Limitation on Seller's Liability. Seller's liability under Subparagraph (c) above shall terminate upon that date (the "Termination Date") which is fifteen (15) years after the Closing Date. From and after the Termination Date, Seller shall have no

further obligations or responsibilities with respect to all other Covered Matters.

(e) Costs Incurred by Buyer and Seller. For the purposes of this Agreement, Seller and Buyer agree that the costs incurred by Buyer or Seller with respect to Covered Matters for which the other party is liable pursuant to Subparagraph (c) above shall include only costs and expenses actually paid to unrelated third parties, and in no event shall Buyer or Seller be responsible for nor shall either party receive credit for (i) pre-closing costs or expenses, or (ii) any costs or expenses paid with respect to any of either party's employees or any of either party's overhead. Each party hereby agrees to use its best reasonable efforts to control costs incurred for which the other party may be responsible and shall provide such other party with quarterly reports of costs incurred.

(f) Duty to Consult. Buyer and Seller shall at all times consult with and keep each other apprised of all activities and costs incurred in connection with Covered Matters, and Buyer and Seller shall indemnify and hold the other party harmless from any unreasonable expense incurred. Each party shall apprise the other party of those respective activities on a quarterly interval on all active Covered Matters.

(g) Standstill Agreement. In the event either Buyer or Seller is notified that they or either of them is asked to respond as a Potentially Responsible Party ("PRP") under any federal, state or local law or regulation with regard to a Covered Matter, the party receiving such notice shall notify the other party of the receipt

of such notice, and shall deliver a copy of all notices and documents received, within ten (10) business days after receipt. With regard to Covered Matters, Buyer and Seller each covenant and agree not to sue the other or attempt in any manner to avoid responsibility as a PRP by seeking or attempting to shift or allocate responsibility to the other. Buyer and Seller agree to cooperate in the identification of all other PRPs for purposes of participation, remediation cost sharing and liability to regulatory agencies.

Article 3. MISCELLANEOUS. (a) Dispute Resolution. No party to this Agreement shall be entitled to take legal action with respect to any dispute relating hereto until it has complied in good faith with the following alternative dispute resolution procedures, provided however, this Article shall not apply to the extent it is deemed necessary to take legal action immediately to preserve a party's adequate remedy.

(i) Negotiation. The parties shall attempt promptly and in good faith to resolve any dispute arising out of or relating to this Agreement, through negotiations between representatives who have authority to settle the controversy. Any party may give the other party written notice of any such dispute not resolved in the normal course of such negotiations. Within twenty (20) days after delivery of the notice, representatives of both parties shall meet at a mutually acceptable time and place, and thereafter as often as they reasonably deem necessary, to exchange information and to attempt to resolve the dispute, until the parties conclude that the

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dispute cannot be resolved through unassisted negotiation. Negotiations extending sixty (60) days after notice shall be deemed at an impasse, unless otherwise agreed by the parties.

If a negotiator for a party hereto intends to be accompanied at a meeting by an attorney, the other negotiator(s) shall be given at least ten (10) business days' notice of such intention and may also be accompanied by an attorney. All negotiations pursuant to this Article are confidential and shall be treated as compromise and settlement negotiations for purposes of the Federal and state Rules of Evidence.

(ii) ADR Procedure. If a dispute with more than $100,000.00 at issue has not been resolved within sixty (60) days of the disputing party's notice, a party wishing resolution of the dispute ("Claimant") shall initiate assisted Alternative Dispute Resolution (ADR) proceedings as described in this Article. Once the Claimant has notified the other ("Respondent") of a desire to initiate ADR proceedings, the proceedings shall be governed as follows: By mutual agreement, the parties shall select the ADR method they wish to use. That ADR method may include arbitration, mediation, mini-trial, or any other method which best suits the circumstances of the dispute. The parties shall agree in writing to the chosen ADR method and the procedural rules to be followed within thirty (30) days after receipt of notice of intent to initiate ADR proceedings. To the extent the parties are unable to agree on procedural rules in whole or in part, the current Center for Public Resources (CPR) Model Procedure for Mediation of Business Disputes, CPR Model Mini-

trial Procedure, or CPR Commercial Arbitration Rules--whichever applies to the chosen ADR method--shall control, to the extent such rules are consistent with the provisions of this Article. If the parties are unable to agree on an ADR method, the method shall be arbitration.

The parties shall select a single neutral third party (a "Neutral") to preside over the ADR proceedings, by the following procedure: Within fifteen (15) days after an ADR method is established, the Claimant shall submit a list of five (5) acceptable Neutrals to the Respondent. Each Neutral listed shall be sufficiently qualified, including demonstrated neutrality, experience and competence regarding the subject matter of the dispute. A Neutral shall be deemed to have adequate experience if an attorney or former judge. None of the Neutrals may be present or former employees, attorneys, or agents of either party. The list shall supply information about each Neutral, including address, and relevant background and experience (including education, employment history and prior ADR assignments). Within fifteen (15) days after receiving the Claimant's list of Neutrals, the Respondent shall select one Neutral from the list, if at least one individual on the list is acceptable to the Respondent. If none on the list are acceptable to the Respondent, the Respondent shall submit a list of five (5) Neutrals, together with the above background information, to the Claimant. Each of the Neutrals shall meet the conditions stated above regarding the Claimant's Neutrals. Within fifteen (15) days after receiving the

Respondent's list of Neutrals, the Claimant shall select one Neutral, if at least one individual on the list is acceptable to the Respondent. If none on the list are acceptable to the Claimant, then the parties shall request assistance from the Center for Public Resources, Inc., to select a Neutral.

The ADR proceeding shall take place within thirty (30) days after the Neutral has been selected. The Neutral shall issue a written decision within thirty (30) days after the ADR proceeding is complete. Each party shall be responsible for an equal share of the costs of the ADR proceeding. The parties agree that any applicable statute of limitations shall be tolled during the pendency of the ADR proceedings, and no legal action may be brought in connection with this agreement during the pendency of an ADR proceeding.

The Neutral's written decision shall become final and binding on the parties, unless a party objects in writing within thirty (30) days of receipt of the decision. The objecting party may then file a lawsuit in any court allowed by this Contract. The Neutral's written decision and the record of the proceeding shall be admissible in the objecting party's lawsuit.

(b) Incorporation By Reference. This Agreement constitutes a part of the Asset Purchase Agreement dated July 9, 1993 between the parties.

(c) Savings Provision. This Agreement, and the terms, provisions, covenants and agreements contained herein, shall

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survive the Closing.

(d) Defined Terms. All terms used herein as defined terms and not defined herein shall have the meaning set forth in the Asset Purchase Agreement.

Article 4. WARRANTIES AND REPRESENTATIONS CONTAINED IN THE ASSET PURCHASE AGREEMENT. Notwithstanding any provision that may be contained in this Agreement or the Asset Purchase Agreement to the contrary, the terms and the conditions of this Agreement shall not affect, or in any way limit, any claim for an Indemnifiable Loss that Buyer may have arising out of any breach of the Seller's warranties and representations contained in the Asset Purchase Agreement, including, but not limited to Section 6.18 thereof, and not withstanding the provisions of Article XII, Loss in the event of a breach of the warranties and representations contained in Section 6.18 in the same manner as provided for other Indemnifiable Losses under Article XII of the Asset Purchase Agreement.

IN WITNESS WHEREOF, The parties hereto have duly executed this Agreement as of the date first above written.

THIS AGREEMENT CONTAINS A BINDING ARBITRATION PROVISION WHICH MAY BE ENFORCED BY THE PARTIES.

SOUTHERN UNION COMPANY

By: _____
Name: R. J. Endres
Title: Sr. V.P.

WESTERN RESOURCES, INC.

By: _____
Name: JOHN C. ROSENBERG
Title: EXEC. VICE-PRESIDENT & GENERAL COUNSEL

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