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 the Kansas Property Tax for Gas in Storage.	))))))	Case No. GU-2005-0095

STAFF'S BRIEF

Staff has recommended to the Commission in this case that it grant MGE an Accounting Authority Order (AAO) permitting it to defer, for possible future rate case consideration, amounts it pays to the State of Kansas for property tax on gas held in storage. Staff recommends that the Commission require MGE to begin amortizing any such deferrals to property tax expense in the month following a final determination from the appropriate appellate court. The Office of the Public Counsel opposes the first recommendation, and MGE opposes the second.

A. Nature of Accounting Authority Orders

Missouri local distribution companies, including Missouri Gas Energy, keep their records in accord with the Uniform System of Accounts (USOA). (4 CSR 240-40.040; Ex. 7, Bolin Rebuttal, p. 3, 21-25). That is, for regulatory purposes the utility records its revenues and expenses as directed by the USOA. The utility may keep its records in other forms for purposes of income taxation or for reporting to shareholders and the financial community.

In rate cases, the utility and other parties make adjustments to test year revenues to, among other things, account for significant fluctuations in items from year-to-year (normalization adjustments), or to account for permanent changes to items that occur within the

test year (annualization adjustments). These adjustments are in keeping with the regulatory paradigm of matching test year revenues and test year expenses to provide a going-forward basis for just and reasonable rates.

The USOA itself recognizes that extraordinary events will occur from time to time. For these events, the USOA provides for accounting treatment other than the usual immediate recognition in the income statement. The USOA provides that these unusual items do not have to be charged to expense in the current period, but recorded as a deferred charge and amortized to expense in future periods.

This deferral and later amortization (charge to expense on the income statement) is the primary benefit of an AAO. It prevents all of the cost from being charged in one year – the current year – and therefore protects the utility from a one-time significant drop in earnings. This benefit was recognized by the Commission in its November 10, 2004, Report and Order on Remand in Case No. WO-2002-273, Missouri-American Water Company:

> The immediate and primary benefit of an AAO to the utility is that the deferred item is booked as a regulatory asset rather than as an expense, thereby improving the financial picture of the utility during the deferral period. The regulatory asset is amortized over a prescribed interval and a portion is recognized as an expense each month.

In the utility's subsequent rate case, if the Commission determines that this extraordinary costs should be directly included in utility rates, this miscellaneous deferral becomes a regulatory asset on the utility's balance sheet (Ex. 7, Bolin Direct, p. 9, 12-19). It is at this time, and only at this time, that the Commission considers the ratemaking implications of an AAO deferral. As the Commission clearly stated in its Report and Order on Remand in Case No. WO-2002-273, the ratemaking impact of an AAO deferral is a remote benefit in an AAO case:

> A secondary and more remote benefit of an AAO is that, during a subsequent rate case, the Commission may permit recovery in rates of some portion of the amount deferred.

> However, it is well-established that the mere granting of an AAO does not guarantee recovery of any amount of the deferral.

The USOA states in its definition of "Extraordinary Items":

> It is the intent that net income shall reflect all items of profit or loss during the period.
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> 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.
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> 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.
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> To be considered 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. (See accounts 434 and 435.)
> (Exhibit 16, page 11.)

This Commission has applied these USOA standards for different treatment of extraordinary items on many occasions. The Commission has granted deferral of the costs of refurbishing a coal-fired electric generation plant *In the matter of the application of Missouri Public Service for the issuance of an accounting order relating to its electric operations* (the Sibley case), Case No. EO-91-358, 1 MPSC 3d 200 (1991); for complying with SFAS 106 (accounting treatment for other post-employment benefits), *In Re Union Electric Company*, EO-92-179, 1 MOPSC 3d 328 (1992); for costs incurred dealing with floods, Case No. EO-94-35, St. Joseph Light & Power; and costs incurred dealing with ice storms, Case No. EU-2002-1053, Aquila, Inc. .

Commission practice on the deferral of extraordinary costs has been consistent over the past 15 years. In the Sibley case, the Commission stated, 1 MPSC 3d, 205:

> The decision to defer costs associated with an event turns on whether the event is in fact extraordinary and nonrecurring. The Commission finds that these are decisions that are best performed on a case by case basis. Factors such as those proposed by Staff as criteria can influence that decision but the primary focus is on the uniqueness of the event, either through its occurrence or its size.

The issue the Commission must resolve in this case is the application of these well-established principles to the facts of this case.

B. The Facts of This Case

The facts of this case are not disputed; rather, the parties dispute the import of the facts.

In 2001 the State of Kansas sought to enforce a property tax on natural gas stored in Kansas. MGE joined with others and challenged the lawfulness of the tax. (Ex 10, Kansas S.Ct. Opinion, pp. 1-2). Although MGE eventually succeeded in its challenge – and never actually paid any of the tax – Staff recited the tax as a line-item reason for its settlement of the MGE's 2001 rate case, GR-2001-292. (Ex 15, p. 6, 13-20).

MGE received notice in July of 2004 from the Kansas Department of Revenue that the Kansas General Assembly had recently enacted a property tax on natural gas stored in Kansas. (Ex. 12, Petition, ¶6). In the routine operation of its system, MGE stores natural gas in Kansas both on Southern Star Central and on Panhandle Eastern Pipeline. Although it did not know either the amount of its assessment (returns were not due to the Department until August 1, 2004), nor its tax bill, MGE asked in the true-up of its then-pending rate case to recover this new tax in rates. (Ex. 1, Noack Direct, p. 4, 5-16). For a number of reasons, the Commission denied the request. (Ex. 1, Noack Direct, p. 5, 7-11).

MGE has begun the process of challenging the lawfulness of the Kansas tax. MGE expects a hearing before the Kansas Board of Tax Appeals in June, 2005, and a final ruling from the Kansas courts by summer, 2006. (Ex. 2, Noack Rebuttal, p. 3, 10-11).

In December, 2004 Kansas issued a property tax bill in the amount of approximately $1.7million. (Ex. 1, Noack Direct, p. 3, 3-4). Because it is appealing the assessment, MGE has not yet been required to pay the first installment of the tax. (Tr., p. 54, 6-15). However, MGE has been accruing the tax on its books, and expects that Kansas will require payment after the administrative ruling this summer. (Tr., p. 31, 10-15).

MGE alleges, and no other party denies, that $1,700,000 per year in expense is a material amount to MGE.

C. Argument

1. Why the Commission should grant the AAO.

The first issue for the Commission to decide is whether the initial imposition of the Kansas property tax on gas stored underground (the property tax) is an extraordinary event. To qualify as "extraordinary" the initial imposition of the tax must be "unusual in nature and infrequent occurrence." Staff suggests that it is.

The record is clear that the Kansas legislature on two prior occasions has attempted to impose such a tax, and has been twice denied by the Kansas Supreme Court as beyond the constitutional power of that body. (Ex. 10, Kansas S.Ct. Opinion). MGE, with others, is challenging the third attempt. However, Staff believes that two unsuccessful attempts, and the pending 2004 attempt, in fifteen years does not constitute a normal and recurring event.

The Commission should also consider that the property tax has twice been rejected. (Ex. 10, Kansas S.Ct. Opinion). MGE has never paid the tax, and it has never been included in test year expense when setting MGE's rates. That is, the property tax has never been so normal and regular an occurrence that it has been captured when setting rates.

Another aspect of the property tax suggests that this initial imposition is an extraordinary event. From a regulatory perspective, taxes imposed on a utility are normal, recurring expenses whose recovery is routinely permitted in rate cases. However, such is not the case with this tax. In this instance, there was no test year expense to analyze, and adjust if necessary. (Ex. 14, Revised Staff Accounting Schedules, Sch. 10-27, Adjustment S-71.3; Ex. 15, p.6, 13-20). Further, although the tax is now measurable for rate setting purposes by virtue of receipt of tax bills, the tax is not yet a known item. The tax will not become a known item until final disposition of the legal challenges to the tax now pending in the courts. (Tr. 171, 12 to 172, 9; Tr. 215, 11 to 216, 3). Thus, even though the USOA provides an account for recording property taxes, recording this property tax in that account is premature at this time given the uncertainty that the tax will ultimately be lawfully collected from MGE.

When will the property tax cease being an extraordinary item, and become a normal, recurring item to be recorded in MGE's current accounts pursuant to the USOA? Staff suggests that the answer is if and when the courts decide that the tax is lawful. Prior to such a pronouncement, the tax remains doubtful. Afterwards, and only afterwards, will the tax become a lawful, normal, and recurring liability of MGE.

After a period of time, a new cost loses its extraordinary nature and becomes a normal recurring cost. In this case, once the lawfulness of the property tax is finally determined all parties will know if it is a normal and recurring event. Moreover, at that time MGE's

management will adjust to the new expense and file for a rate increase if existing revenues are not sufficient to recover these ongoing expenses and earn a reasonable rate of return on invested capital. (Ex. 6, Hyneman Surrebuttal, p. 2, 14-20).

2. Why the Commission should require amortization to begin promptly when the lawfulness has been determined.

The deferral of the costs of an extraordinary event permits a utility to avoid charging the entire cost against current revenues (and earnings), and permits the possibility of future direct recovery from ratepayers. Conversely, deferral means that ratepayers face the possibility of subsequent charges for out-of-period costs. The Commission's charge under the Public Service Commission Law is to balance the opposing interests of utilities and ratepayers. §386.610. The start of the amortization of deferrals, if permitted by the Commission, requires the Commission to make such a balancing judgment.

MGE asks the Commission to postpone amortizing any deferral of the property tax until MGE can recover all of the tax directly from ratepayers in a future rate case, if it files one by May 31, 2008 (Ex. 2, Noack Rebuttal, p. 4, 13-16). Staff and OPC suggest that the Commission order the amortization to begin promptly, once the deferral is both known and measurable. (Ex 5, Hyneman Direct, p. 7, 8-12; Ex. 7, Bolin Rebuttal, p. 12, 20 to p. 13, 7).

Staff believes that its recommendation better balances the interests of utility and ratepayer, and is more in keeping with regulatory principles**.** Under either MGE's "stockpile costs" or the Staff's prompt amortization, MGE's management has full control over the amount of property tax deferrals it will directly include in rates through its decision on when to file a rate case.

In the Sibley Order the Commission addressed the issue of how deferrals should be treated after the issuance of an AAO:

> 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. For purposes of this case, the Commission finds that twelve months is a reasonable period.
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> This 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.
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> 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.

MGE's position contravenes the Commission's Sibley decision. MGE wants the property tax deferrals to remain untouched on its balance sheet and not amortized to expense until they are fully and directly included in rates in MGE's next rate case, which it may not file until May 2008. (Ex. 2, Noack Rebuttal, p. 4, 13-16). Property tax deferrals from 2004 through May 2008 could result in a total deferral of approximately $7.7 million dollars (annual charge of $1.7 million times 4.5 years). (Ex. 6, Hyneman Surrebuttal, p. 12, 17-22).

In essence, MGE proposes that it be allowed to delay the amortization and "stockpile" the deferrals on its balance sheet for four and one-half years to ensure 100 percent (or more) rate recovery. (Ex. 6, Hyneman Surrebuttal, p.12, 17 to p. 13, 7).

The Staff's position of immediate amortization once the property taxes become known and measurable addresses the concerns raised by the Commission in the Sibley Order. First, it does not allow for an excessive accumulation of deferrals because the deferrals will be amortized (reduced) as soon as they are finally known. And while the Staff's position on this matter does not call for MGE to file a rate case within a certain period of time, MGE may file a rate case and

seek rate recovery if it finds that its current revenues are not sufficient to recover its total costs of providing service.

Importantly, amortizing the deferral as soon as the courts rule on its lawfulness is also a better match of MGE's incurring the cost with recognizing the expense than is an additional two years of delay. Although AAOs by their very nature distort the matching principle, starting the amortization process as soon as possible minimizes the mismatch of customers benefiting from the cost (if any Missouri ratepayer benefits from the Kansas tax), from those paying it. (Ex. 6, Hyneman Surrebuttal, p. 8-9).

Amortizing the deferrals earlier better balances the effects of regulatory lag between customers and MGE. As the Commission observed in the Sibley Case, 3 MPSC 3d, at 207:

> Lessening the effect of regulatory lag by deferring costs is beneficial to a company but not particularly beneficial to ratepayers. Companies do not propose to defer profits to subsequent rate cases to lessen the effects of regulatory lag, but insist it is a benefit to defer costs. Regulatory lag is a part of the regulatory process and can be a benefit as well as a detriment. Lessening regulatory lag by deferring costs is not a reasonable goal unless the costs are associated with an extraordinary event.
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> Maintaining the financial integrity of a utility is also a reasonable goal. The deferral of costs to maintain current financial integrity, though, is of questionable benefit. If a utility's financial integrity is threatened by high costs so that its ability to provide service is threatened, then it should seek interim rate relief. If maintaining financial integrity means sustaining a specific return of equity, this is not the purpose of regulation. It is not reasonable to defer costs to insulate shareholders from any risks. If costs are such that a utility considers its return on equity unreasonably low, the proper approach is to file a rate case so that a new revenue requirement can be developed which allows the company an opportunity to earn its authorized rate of return. Deferral of costs just to support the current financial picture distorts the balancing process used by the Commission to establish just and reasonable rates. Rates are set to recover ongoing operating expenses plus a reasonable return on investment. Only when an extraordinary event occurs should this balance be adjusted and costs deferred for consideration in alter period.

The Commission recognizes that a balance of the effects of regulatory lag on both ratepayers and shareholders is important when providing extraordinary treatment for extraordinary events. Guaranteeing full direct recovery of deferrals in rates is not an appropriate criterion in establishing amortization of deferred costs. (Ex. 6, Hyneman Direct, p. 11).

Beginning the amortization earlier will also reduce the impact of stockpiling costs if subsequent regulatory action requires writing of all or a portion of the deferrals. *MGE v. Public Service Commission,* 978 S.W.2d 434 (Mo. App 1998). In that case MGE accrued carrying costs at 10.54% per year, but in a subsequent rate case was permitted to recover based upon a rate of 4% and 6% for two other years. MGE complained that it suffered a loss because of the Commission's action. 978 S.W.2d at 436, 440. The Court rejected MGE's claims, noting that "the AAO and other orders of the PSC left no doubt that the PSC was not bound to use the 10.54% figure in the rate case." 978 S.W.2d at 440. Beginning the amortization period earlier will help minimize the impact on MGE of any subsequent limit on recovery, if any. (Ex. 6, Hyneman Surrebuttal, p. 12).

Finally, the Kansas property tax will become a normal and recurring event when and if upheld by the final court on review. MGE anticipates a final order in the summer of 2006. (Ex. 2, Noack Rebuttal, p. 3, 10-11; Tr. 79, 6-12). Once the tax is a normal and recurring event, known and measureable, it is no longer an extraordinary event subject to extraordinary accounting treatment. The amortization should begin at that time to recognize the change in status. As the Commission has noted, if the cost is such as to reduce MGE's earnings below what it considers reasonable at that time, it should file a rate case to rebalance revenues and expenses in rates.

WHEREFORE, the Staff respectfully asks the Commission to grant MGE an Accounting Authority Order to defer the Kansas property tax on natural gas in storage for tax years 2004 and 2005, and to begin to amortize any such deferrals beginning in the month following a final judicial determination of the lawfulness of the tax.

Respectfully submitted,

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Certificate of Service

I hereby certify that copies of the foregoing have been mailed, hand-delivered, or transmitted by facsimile or electronic mail to all counsel of record this 26th day of April, 2005.

/s/ Thomas R. Schwarz, Jr.