**BEFORE THE PUBLIC SERVICE COMMISSION**
**OF THE STATE OF MISSOURI**

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| In the Matter of the Application of<br>Missouri Gas Energy, a Division of<br>Southern Union Company, for an<br>Accounting Authority Order Concerning<br>Environmental Compliance Costs. | )<br>)<br>)<br>)<br>) | Case No. GU-2007-0480 |

**BRIEF OF THE OFFICE**
**OF THE PUBLIC COUNSEL**

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This is an important case of first impression for the Missouri Public Service Commission. Southern Union Company ("Southern Union") provides natural gas distribution service to Missouri consumers as Missouri Gas Energy ("MGE"). It seeks authorization to depart from established accounting practices to allow MGE to defer accounting treatment for certain environmental clean-up expenses. MGE wants the Commission to treat these environmental expenses as if they were incurred in the test year period for MGE's next general rate case, rather than in the period in which the expenses were incurred. The pivotal question for the Commission's determination is whether to allow this unorthodox accounting of environmental remediation expenses as truly "extraordinary" costs under the Uniform System of Accounts (USOA). The Missouri Office of the Public Counsel ("Public Counsel") asserts that the environmental costs are not extraordinary and the Application for deferral should be rejected.

MGE's Application and testimony failed to identify or allege any harm that MGE may incur as a result of the environmental cleanup liability and failed to identify or allege any public benefit that could result from the deferral. In May of last year, a mere two months before MGE initiated this case, the Commission approved tariff sheets to allow MGE to increase its revenues by $27.2 million. The Commission reviewed MGE's revenues and expenses and rejected MGE's request for environmental liability recovery. It determined that the additional $27.2 million would allow MGE to recover its revenue requirement while also allowing MGE to earn the approved 10.5% return on equity. In addition, the Commission deviated from decades of rate design principles and gave MGE a new straight fixed variable rate design. This rate design eliminated the risk of weather variability and eliminated the risk of customer conservation, essentially guaranteeing that MGE will recover its revenue requirement. Moreover, the approved revenue requirement includes a return on equity that factors in business risks such as environmental liability, thus allowing MGE to earn a return that directly correlates with this risk. Despite this very favorable treatment in May, 2007, and before the ink had dried on the Commission's Order, MGE came back in wanting more. This time MGE brings its claim in the form of an Accounting Authority Order ("AAO") to defer the recovery of costs that MGE claims are nothing more than normal business expenses.

The record and the applicable law give the Commission no reason to assume that MGE is not earning sufficient revenues to recover its revenue requirement and authorized return; and there is no reasonable basis to find that it will not continue to earn sufficient revenues even with increased environmental remediation expenditures. Even if MGE suggested that its financial integrity were threatened by environmental liability expenses, those arguments do not justify or support the grant of an AAO. The Commission has rejected such threats as a reasonable basis for granting an AAO:

> 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 on 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 the 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.[1]

Here the Commission concluded "it is not reasonable to defer costs to insulate shareholders from any risks." This is precisely what MGE seeks since the vast majority of its traditional business risks, weather variability and conservation, have already been eliminated.

Since MGE seeks an AAO and did not file a request for interim rate relief and did not file a rate case, MGE must be earning the rate of return authorized a little over a year ago. This would not be unexpected given MGE's rate design. But the key question remains unanswered: what harm will MGE experience as a result of the environmental cleanup expenses? The answer is none. As discussed below, MGE has been incurring environmental remediation costs since 1994 and has been successful in avoiding any cleanup expenses through insurance reimbursements and tax savings. MGE is now trying to seize on what it sees as an opportunity to boost profits without a sufficient rationale or evidence to justify this departure from proper accounting practices. Public Counsel asks that the Commission view MGE's request with apprehension and give it careful and skeptical consideration. Approval may encourage utility companies to continue their

[1] *Report and Order*, December 20, 1991, Case Nos. EO-91-358 and EO-91-360, In the matter of the application of Missouri Public Service for the issuance of an accounting order relating to its electrical operations, and In the matter of the application of Missouri Public Service for the issuance of an accounting order relating to its purchase power commitments; ; 129 P.U.R.4th 381; 1 Mo. P.S.C.3d 200.

attempt for piecemeal revenue recovery decisions outside of the established rate case procedure, a process employing consideration of all relevant factors that the Commission has repeatedly found to be in the public interest.

## I. Background

### 1. Former Manufactured Gas Plant

Former Manufactured Gas Plant ("FMGP") are facilities that produced natural gas beginning in the 1800s before the introduction of interstate pipelines and ceased producing natural gas in the early 1900s. FMGP facilities manufactured natural gas through a process that produced and captured gas by heating coal. This manufacturing process also produced coal tar, which was either dumped onto the ground or sold as a useful tar product.

### 2. CERCLA

In 1980, Congress passed the Comprehensive Environmental Response, Compensation, and Liability Act ("CERCLA")."[2] CERCLA is described as "an Act to provide for liability, compensation, cleanup, and emergency response for hazardous substances released into the environment and the cleanup of inactive hazardous waste disposal sites." Section 107 of CERCLA creates liability for the cleanup of hazardous waste sites. Due to hazardous contaminates that leached into the ground from the dumped coal tar at FMGP facilities, the Environmental Protection Agency in 1990 and 1991 identified several FMGP sites of which MGE was identified as a potentially responsible party ("PRP") under CERCLA.

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[2] 42 U.S.C. §§ 9601-9675. CERCLA was amended in 1986 by the Superfund Amendment and Reauthorization Act ("SARA").

Once a hazardous waste site has been identified, PRPs that face potential liability for the costs of cleanup under CERCLA include: 1) current owners and operators of the site; 2) former owners and operators at the time the hazardous substances were disposed; 3) any person arranging for disposal of the hazardous substances; and 4) any person who accepted hazardous substances for transport or disposal. PRPs are potentially liable for the costs of hazardous substance removal and remediation, damage costs, costs of health studies, and any other necessary responsive costs.

Liability under CERCLA is joint and several, making any one PRP potentially liable for the entire cost of site clean-up, regardless of the share of the waste created by that PRP.[3] A PRP who pays remediation costs can then seek contribution from the non-paying PRPs. MGE's customer base, however, is not a PRP and is without recourse to seek contribution from non-paying PRPs.

**3. Environmental Liability Agreement**

In 1994, MGE purchased its Missouri distribution operations from Western Resources, Inc. ("WRI") for $400,300,000. (Ex.9). The purchase agreement includes an Environmental Liability Agreement ("ELA") that outlines how the liability for environmental cleanup would be shared between MGE and WRI. First, MGE agreed to seek reimbursement through insurance claims. Second, MGE agreed to seek recovery from other PRPs. Third, MGE and WRI agreed to seek recovery from MGE's customers through "rates or other charges for service." Under this level of liability, MGE retains "complete discretion as to the timing of any filings" with the Commission. Fourth, "upon exhaustion" of the first three tiers, the ELA states that MGE will be liable for the next $3

[3] United States v. Monsanto, 858 F.2d 160 (4th Cir. 1988).

million of liability. Fifth, MGE and WRI will share equally the next $15 million. Lastly, MGE will be liable for all remaining environmental liability.

MGE knowingly and willingly agreed to accept cleanup liability under CERCLA, and agreed to forgive WRI of all liability associated with the FMGP sites as of January 2009. Consumers, on the other hand, have no voice in releasing a PRP from liability.

**4. Southern Union's Third Bite at the Apple**

This Application is not the first time MGE has tried to impose its environmental remediation obligations onto Missouri consumers. MGE's previous attempts to get Commission approval for charging customers for an environmental expense fund, if approved, would have made consumers pay for environmental expenses that MGE never realized.

In Case Number GR-2004-0209, *In the Matter of Missouri Gas Energy's Tariff Sheets Designed to Increase Rates for Gas Service in the Company's Missouri Service Area*, MGE requested Commission approval to pass $750,000 annual environmental cleanup costs onto Missouri consumers. It also attempted to keep 50% of any insurance recoveries regardless of whether MGE or consumers paid for the environmental liability. The Commission denied the request and concluded:

> 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.

The Commission's rationale in 2004 was based on concerns that have not disappeared and still remain in this application. The Commission rejected the pass through of FMGP cleanup costs to consumers because: 1) The FMGP estimates are "based entirely on speculation" and were not "known and measurable"; 2) Approval would remove MGE's "incentive to ensure that only prudently incurred and necessary costs are paid"; 3) Approval would give MGE little incentive to challenge settlement claims brought against it; and 4) Approval would require a prudence review, which 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." These four reasons continue to be compelling reasons to reject the current AAO request. MGE's cost estimate witness admitted during cross-examination that the cost estimates were based purely on speculation. (Tr. 147). There is no evidence in the record to suggest that after all insurance settlements, tax savings, contributions from WRI, and contributions from other PRPs have been resolved, that MGE will have incurred *any* costs associated with FMGP remediation. Moreover, AAO approval removes MGE's incentive to keep costs to a minimum and removes its incentive to challenge settlement claims brought against it, cost controls that consumers cannot implement.

In the 2006 rate case, Case No. GR-2006-0422, *In the matter of Missouri Gas Energy`s Tariff Sheets Designed to Increase Rates for Gas Service in the Company`s Missouri Service Area*, MGE again tried to garner Commission approval of a fund to collect additional revenue from ratepayers to recover MGE's environmental costs. And again the Commission rejected MGE's request for the same reasons as the Commission found in 2004:

> [T]he 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.

The Commission repeats its concern that the prudency adjustment, which would also follow deferral under an AAO, "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." The Commission concluded again that allowing recovery of these costs would give MGE little incentive to ensure costs are prudent and necessary. Public Counsel knows of no instance where the Commission granted an AAO and did not allow most, if not all, of the deferred amounts in rates. Knowing this, MGE has little, if any, incentive to minimize FMGP remediation costs.

## II. Argument

The first issue identified by the parties asks: <u>Should the Commission grant MGE an AAO to allow it to defer costs associated with the clean-up of FMGP sites?</u> The answer is no. The Commission should reject the deferral for the following reasons:

1) MGE has not met the Uniform System of Accounts standards for deferrals because the costs do not meet the definition of "extraordinary";

2) Granting the AAO would give MGE little incentive to ensure costs are prudent and necessary;

3) Shareholders voluntarily accepted FMGP liability and have been compensated for FMGP expenditures;

4) MGE's delays and attempts to recover costs from its customers has harmed MGE's ability to recover expenses from WRI; and

5) Remediation costs are not incurred because of the gas service MGE provides to current customers.

### 1. Approval of the AAO Would Violate the Uniform System of Accounts

A request for an AAO is a request to allow the utility to defer costs incurred in one period to give the appearance that they were incurred in a different period for purposes of including such costs in a subsequent revenue requirement. Because a regulated utility's rates are set on the basis of costs determined in a designated test period, deferrals of costs from one period to another distort the true cost a company incurs to provide service. The Commission has concluded that this practice violates the traditional method of setting rates, which rarely considers costs before the test year for purposes of determining a reasonable revenue requirement for the future.[4] The Commission has concluded that AAO deferrals from one period to another should only be allowed when events occur during a period that are extraordinary, unusual and unique, and not recurring,[5] and then only under limited circumstances.[6] This finding is consistent with the requirement under Commission rule 4 CSR 240-40.040, requiring MGE and all other gas utilities to comply with the Uniform System of Accounts (USOA). Under the

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[4] 1 Mo. P.S.C.3d 200.
[5] *Id.*
[6] *Report and Order*, Case No. EO-2000-845, p. 8, In the Matter of the Application of St. Joseph Light & Power Company for the Issuance of an Accounting Authority Order, December 14, 2000.

USOA, the Commission can only approve an AAO when the expenses to be deferred are "extraordinary." General Instruction Number 7 under the USOA defines extraordinary:

> 7. Extraordinary items. It is the intent that net income shall reflect all items of profit and 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 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. [emphasis added].

"Extraordinary items" deferred under an AAO must be items related to the effects of events and transactions that:

- Are of significant effect and more than 5% of net income;
- Occurred during the current period;
- Are not typical or customary business activities of the company; and
- Would not be expected to recur in the foreseeable future.

*See*, State of Missouri, ex rel. Missouri Office of the Public Counsel v. Public Service Commission, 858 S.W. 806 (Mo. App. W.D. 1993). Allowing costs to be deferred under an AAO that are not extraordinary violates USOA General Instruction Number 7 and 4 CSR 240-40.040. There is nothing extraordinary about expenses that MGE has incurred since 1994, and which MGE expects to recur in the foreseeable future.

### a. Significant Effect

MGE has offered no evidence to support a finding that MGE incurred extraordinary expenses that have a significant effect on MGE. MGE's own statements and testimony are full of contradictions, such as conflicting expense statements on the status of site remediation and buried tax savings that suggest that the cleanup expenses may have no effect whatsoever.

For example, MGE's witness Mr. Michael Noack discusses offsets from insurance claims and other PRPs, yet fails to disclose the substantial thirty-seven percent (37%) to thirty-eight percent (38%) tax savings that MGE received as a result of its cleanup liability. (Tr. 63-64). MGE's Application and prefiled testimony make no mention of these tax savings and provide no evidence as to the dollar amount that MGE recovered, how that recovery offset any alleged expenses, or how these tax savings would offset any future cleanup costs. Also unanswered is the question of whether MGE's tax savings were based on 37% to 38% of MGE's environmental liability before insurance recoveries and recoveries from other PRPs, or after subtracting those offsets. By concealing these large tax savings from the Commission, MGE's claims as to its expenses are misleading and cannot be relied on to make a finding that MGE's environmental liability expenses will have a significant effect on MGE.

Also raising doubts about whether the expenses incurred will be significant are the contradictions on what sites have incurred or will incur expenses. MGE stated in its Application that the sites at Station A and Station B would require $1 million to $10 million to fully remediate these sites. However, during the evidentiary hearing, MGE's witness testified that Station A was fully remediated and that MGE did not need to do much work at Station A. (Tr. 138-139; 159). Two additional sites, the Joplin site and the Independence site, have not even begun remediation and may never require MGE to incur any expenses. (Tr. 143-144).

When the Commission rejected MGE's 2004 attempt to bill ratepayers for FMGP remediation expenses, the Commission concluded:

> The cleanup costs for which MGE seeks to establish the Fund are not yet known and measurable. Indeed, there is no certainty that Southern Union or MGE will ever have to pay any costs associated with the cleanup effort. Thus far the expenses that Southern Union has paid have been covered by insurance or from money set aside for that purpose at the time Southern Union purchased the MGE system.[7]

Nothing has changed to change the Commission's rationale. MGE introduced no evidence to suggest that the insurance recoveries, other PRPs, and tax savings will not continue to cover all expenses. Just as there was no certainty in 2004 that MGE would "ever have to pay any costs associated with the cleanup effort," the Commission is again facing the same speculation which it already rejected. Once again the costs are not currently "known and measurable" and once again should be rejected.

**b. Five percent of Net Income**

MGE has provided little evidence to support a finding that the amounts to be deferred would be more than approximately five percent (5%) of net income. MGE admitted that its estimates are nothing but speculation, with no clear understanding of how much MGE would recover from insurance, other PRPs, or tax savings, even if the estimates proved to be accurate. (Tr. 147). In all prior years, MGE recovered all cleanup expenses through insurance recoveries and other PRPs, and no evidence was provided to

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[7] *Report and Order*, Case Number GR-2004-0209, In the Matter of Missouri Gas Energy's Tariff Sheets Designed to Increase Rates for Gas Service in the Company's Missouri Service Area, September 21, 2004.

suggest that MGE would not continue to recover all cleanup expenses through insurance recoveries, PRPs, and the newly discovered tax savings. Without attempting to quantify the actual expenses after all offsets, MGE has not provided sufficient evidence to allow the Commission to determine that the amount deferred would be more than approximately 5% of net income.

### c. Typical or Customary Business Activities

MGE's burden of proof under the USOA also includes the burden of proving that environmental remediation activities are not the typical or customary business activities of MGE. MGE failed to satisfy this burden and characterized these costs as "a normal cost of doing business for an LDC these days." (Ex. 12, p.32). MGE employs a full-time environmental specialist to handle FMGP remediation and other non-FMGP remediation activities. Furthermore, MGE has not proven that FMGP expenses are any different from the typical or customary environmental cleanup activities of MGE such as asbestos removal or underground storage tank removal. MGE has been incurring environmental remediation expenses since acquiring the distribution business in 1994. (Ex.10). This is no surprise since CERCLA first became law in 1980 and has been requiring environmental costs to be borne by companies for over twenty-eight (28) years. The facts of this case are far removed from a situation where a *new* law mandates expenditures that the company could not foresee during its most recent rate case. Again, MGE itself has claimed that these environmental remediation costs are the typical or customary business activities of MGE. The evidence in this case does not support a conclusion that there was an extraordinary event or an extraordinary expense related to FMGP remediation that was not a typical or normal business expense.

MGE argued in its testimony that FMGP costs are extraordinary because they are variable and uncertain. (Ex.2, p.2-3). Under this theory, MGE would have the Commission believe any expense that is not fixed from year to year or month to month would be extraordinary and proper for deferral. In another stretched interpretation of the USOA, MGE argues that FMGP remediation costs are "unique" because they are "unique to the gas industry." (Ex.1, p.5). If "unique to the industry" were the standard for deferral under the USOA, the entire gas distribution infrastructure would be extraordinary and subject to deferral anytime a gas-related expenses was incurred. These arguments are nothing more than MGE's attempts to expand the USOA definition of "extraordinary" well beyond a plain and rational reading of extraordinary designation. If MGE's request satisfied the USOA, stretches in interpretation such as these would not be necessary.

**d. Non-Recurring**

To be extraordinary under the USOA and the Commission's rules, an expense must not recur in the foreseeable future. MGE had the burden to prove the expenses are non-recurring. But MGE's witness testified that the costs will continue into the future for an indefinite period. (Tr. 167). MGE now asserts that the USOA should be interpreted to mean that each individual FMGP site should be looked at separately. The Commission considered an AAO request that involved a series of successive projects and concluded that the costs "should be dealt with within the ratemaking process." The Commission stated:

> The record makes it abundantly clear that the Commission should not grant the requested third AAO for infrastructure replacement because the circumstances are recurring, not nonrecurring. The Company has presented ample evidence as to the magnitude of the infrastructure replacement undertaking in terms of cost. However, the record also shows that

> infrastructure replacement will necessarily continue for years as a series of successive projects. This is not an appropriate case for an AAO.[8]

MGE continues to play a game of creative legal interpretations to overcome the shortcomings in its argument that FMGP costs are nonrecurring.

The Commission has a long history of scrutinizing AAO applications to ensure they comply with the requirement that they are truly extraordinary. In 1996, the Commission recognized that the Commission had "granted AAO accounting treatment exclusively for one-time outlays of capital caused by unpredictable events, acts of government, and other matters outside the control of the utility or the Commission."[9] While MGE wants the Commission to believe the "event" is unpredictable, MGE has contradicted that notion with its forecasting of FMGP remediation expenses since its 2004 rate case, and the testimony that MGE has been incurring these expenses annually. (Ex.10). MGE predicted these recurring annual costs since purchasing the system. There is nothing unpredictable about the events or expenses incurred by MGE for FMGP remediation. CERCLA became law in 1980, and MGE was aware of its CERCLA liability when it purchased the distribution assets in 1994. In addition, the expenditures MGE wants to defer would not fit the "one-time" outlay of capital standard annunciated by the Commission. Mr. Noack testified that MGE's FMGP expenses incur over a period of time and include a long list of separate expenses such as research, excavation, analysis,

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[8] *Report and Order,* February 13, 2001, Case No. WO-98-223, In the Matter of the Consideration of an Accounting Authority Order Designed to Accrue Infrastructure Replacement Costs for St. Louis County Water Company.

[9] *Report and Order,* December 31, 1996, Case No. WR-96-263; In the Matter of St. Louis County Water Company's Tariff Designed to Increase Rates for Water Service to Customers in the Company's Service Area, 5 Mo. P.S.C. 3d 341.

disposal, treatment, storage, reporting, and monitoring. (Ex.1, p.3). FMGP site remediation includes expenses that MGE has incurred since acquiring the properties.

Staff's witness Mr. Paul Harrison cites in his testimony to 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." (Ex.7, p.8).

**e. Rate Stability and the Matching Principle**

General Instruction Number 7 under the USOA states that "it is the intent that net income shall reflect all items of profit and loss during the period" it was incurred. A major problem encountered by the use of AAO mechanisms is the impact on rate stability. Rates based on costs pulled from periods other than the test year are harmful to consumers as explained by the Commission in a prior AAO application case:

> Rate stability is a benefit to consumers but deferring costs which could result in additional rate increases in the future to accomplish stability in the short term only will cause greater instability in the longer term. Rates that reflect the current cost of doing business are reasonable and provide more stability than sharp increases caused by improper deferrals of costs to a later period. Requiring a company to operate within the revenue requirement authorized encourages efficiency and prudent decisions.
>
> Avoidance of rate case expense is a beneficial goal since it reduces the cost of doing business, but delaying rate cases just to avoid rate case expense should not be used as an excuse to defer costs which are attributable to normal operations of a company. The benefit gained will not necessarily outweigh the increased rates caused by the deferral.[10]

[10] *Report and Order,* Case No. EO-91-358 and EO-91-360, In the matter of the application of Missouri Public Service for the issuance of an accounting order relating to its electrical operations, In the matter of the application of Missouri Public Service for the issuance of an accounting order relating to its purchase power commitments,

Rejecting the Application and following the *matching principle* will avoid this rate instability. The matching principle was explained by the Commission:

> That principle is an attempt to match cost of capital, rate base, revenues and expenses as of a certain date; setting rates when these variables are not matched could result in a company either over-earning or under-earning, and thereby the Commission would not be setting just and reasonable rates if it did not use the matching principle.[11]

Authorizing deferral of these costs would violate this fundamental accounting principle of public utility regulation, and could result in an unjust and unreasonable over-earning by MGE.

**2. AAO Would Discourage Efficiency and Prudent Decisions**

In the two previous Commission orders rejecting MGE's attempt to bill consumers for MGE's environmental liability, the Commission concluded that allowing recovery of FMGP expenses would be a disincentive to MGE to ensure that only prudent and necessary costs are incurred remediating the sites. Avoiding this disincentive is not a new concern of the Commission, and has been a concern in previous AAO requests. In Case Numbers EO-91-358 and EO-91-360,[12] the Commission made the following conclusion in a 1991 AAO deferral request:

> Rates that reflect the current cost of doing business are reasonable and provide more stability than sharp increases caused by improper deferrals of costs to a later period. Requiring a company to operate within the revenue requirement authorized encourages efficiency and prudent decisions.

These findings are important. They not only show the Commission's concern with ensuring efficient and prudent decisions, but the findings also highlight the Commission's

[11] *Report and Order,* Case No. ER-2006-0314, In the Matter of the Application of Kansas City Power & Light Company for Approval to Make Certain Changes in its Charges for Electric Service to Begin the Implementation of its Regulatory Plan, December 21, 2006.
[12] *Report and Order*, Case Nos. EO-91-358 and EO-91-360, December 20, 1991.

concern that deferring expenses from one period to another will cause greater rate instability. For this reason, the USOA requires expenses to be booked in the period they were incurred, and allows deferrals on a very limited basis to address costs that are truly extraordinary, non-recurring, and not a part of the utility's normal business expenses.

When MGE faces FMGP remediation, MGE will make most if not all of the decisions necessary to select the contractors needed to perform the cleanup work. MGE will monitor the ongoing costs of the cleanup projects. MGE will also make the decisions to pursue other PRPs for reimbursement, the decisions to pursue insurance reimbursement, and the decisions to pursue tax savings. And only MGE will make the decisions to reach settlement agreements regarding liability among other PRPs or agreements with the EPA or DNR regarding MGE's liability. MGE's customers, the Commission, and the Commission's Staff will not have a first-hand ability to ensure any efficient or prudent cost decisions are made. If MGE believes it will be able to recover most or all of its expenses following the next rate case, common sense dictates that MGE will have a decreased incentive to keep costs to a minimum, which includes the incentive to aggressively pursue all potential offsets.

When considering whether consumers or MGE should be responsible for the FMGP costs, it is important to consider the unfavorable position of consumers and their ability to mitigate expenses. If MGE remains liable, MGE has both the incentive and the ability to mitigate costs. Consumers, however, would have an incentive to mitigate but would have no ability to take any action to mitigate their liability. The most effective way to ensure that only prudent FMGP costs are incurred is to require MGE to incur those costs since only MGE has the ability to mitigate costs.

The Commission's prior findings also recognize the difficulty for the Commission's Staff in proving that a certain expenditure or practice was inefficient or imprudent. For example, MGE's incentive to seek out other PRPs for reimbursement could disappear if there is a high probability that MGE will be successful in passing along most of its FMGP-related expenses to its customers. Before a party could prove that MGE's efforts in finding other PRPs were imprudent, that party would likely have to identify other entities and prove that they would be liable under CERCLA – a virtually impossible task for an outside party with limited resources. There is no substitute for MGE's own incentive to identify and pursue reimbursement from all PRPs.

Unfortunately, the Commission and consumers should not expect MGE to seek contributions from any PRP. To date, MGE has not pursued reimbursement from any PRP, and has only identified one lone PRP. (Ex.4, p.5-6). This is not surprising given MGE's belief that **

** That would certainly change if MGE's attempt to push environmental remediation costs onto consumers was rejected.



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Public Counsel is aware of no AAO authorized by the Commission that did not result in including all or most of the deferred costs in rates. MGE is certainly aware of this trend and with an authorized AAO in hand, wherein the Commission has already concluded that the deferred costs are extraordinary, MGE's incentive to minimize cleanup costs would be decreased to the obvious detriment of consumers.

### 3. Shareholders Voluntarily Accepted FMGP Liability and Have and Will be Compensated for FMGP Remediation Expenses

Under the terms of the ELA, MGE voluntarily accepted remediation liability and agreed to absolve WRI from liability. Southern Union's shareholders made the decision that the distribution business would be profitable in spite of the contaminated properties, and they made the decision that the purchase price accounted for the liability they would incur. MGE's Application and request to defer FMGP costs for future recovery fails to identify the many factors suggesting that MGE has already been compensated, is currently being compensated, and will continue to be compensated in the future for environmental remediation expenses.

#### a. Purchase price

In 1994, Southern Union paid $400,300,000 to WRI for the distribution system. (Ex.9). Southern Union and WRI negotiated the purchase price with full disclosure of the FMGP sites. The ELA is specifically "incorporated by reference" into the Asset Purchase Agreement between Southern Union and WRI for "consideration." *Id.* In other words, the purchase price paid by Southern Union takes into consideration the environmental liabilities associated with the FMGP sites. Southern Union's shareholders paid less for the system than they would have paid absent the FMGP sites and the potential cleanup liability. (Ex.12, p.21).

The exact amount of the consideration received for assuming those liabilities is not in evidence. However, even if that consideration amount was insufficient to cover the expenses that will be necessary to fully remediation all FMGP sites, Southern Union and not MGE customers made the decisions that resulted in any insufficient compensation. In Southern Union's Amended Annual Report to the Securities and Exchange Commission, Form 10-K/A, filed on September 30, 1994, Southern Union discusses the FMGP sites:

> 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. [emphasis added].

(Ex.12, p.22). It appears MGE incorrectly determined that the remediation costs would not exceed the amounts subject to the sharing agreement between Southern Union and WRI. Southern Union made that determination, not consumers, and Southern Union's shareholders willingly assumed the risk that MGE's projections were accurate. (Ex.12, p.23) MGE should be required to live with its poor judgment rather than be rewarded by forcing these costs onto consumers.

### b. Risk Premium

When the Commission set MGE's current rates in Case Number GR-2006-0422, the Commission also approved a return on equity (ROE) of 10.5% "that considers the risks specifically associated with Southern Union." One of those potential business risks is MGE's environmental liability. To compensate Southern Union's shareholders for this risk, the ROE paid by consumers includes a risk premium that operates in the same manner as the risk premium paid by the holder of an insurance policy. A policy holder pays a risk premium and in return the insurer assumes the risk of liability. (Tr. 63). The policy holder benefits because they can look to the insurer to pay for liability claims. *Id.* Likewise, rates paid by MGE's customers include a risk premium to compensate MGE for the business risks faced by the company. (Ex.12, p.13) MGE seeking reimbursement from consumers for MGE's environmental liability is akin to an insurance company collecting premiums from a policy holder only to turn around and demand that the policy holder also pay all liability claims. Consumers have already compensated MGE for the environmental liabilities through the risk premium, and allowing MGE to defer these liabilities raises the potential for double-recovery by MGE and retroactive ratemaking should they be recovered in future rates. *Id.*

### c. Insurance Recoveries and other PRPs

Under CERCLA, entities that are potentially liable for remediation costs include current owners of the property as well as former owners and other parties that were fully or partly responsible for the FMGP contamination. These potentially responsible parties, or PRPs, can be held jointly or wholly liable for the costs of remediation. Shared liability from other PRPs, if any exist beyond WRI, could further mitigate expenses.

In the fourteen (14) years that MGE has owned and operated the MGE distribution system, MGE has received significant environmental remediation recoveries from its insurance carriers. (Tr. 80). In 2001 MGE received a $7.5 million credit in insurance recoveries. (Tr. 105). MGE provided no evidence suggesting that MGE would not continue to recover insurance proceeds sufficient to pay all or most of MGE's environmental remediation costs. At the very least, MGE has failed to meet its burden of proving that the difference between environmental expenses and insurance recoveries will be significant. The record lacks sufficient evidence showing the number of insurance policies involved, the terms of those insurance policies, and whether under those terms MGE would be liable for any cleanup expenses.

MGE's Senior Vice President Mr. Dennis Morgan testified that insurance recoveries "could be years down the road." (Tr. 71). When asked to provide an average time period for insurance recovery, Mr. Morgan testified that he could not "come up with any kind of average." (Tr. 71). MGE could potentially receive insurance reimbursements that recover all environmental expenses. However, this will not be known and measurable for years to come. AAO deferrals are not a proper or a normal accounting treatment for non-operating costs that are not known and measurable. (Ex.12, p.6). Consistent with the Commission rationale in rejecting MGE's previous attempts, the present attempt should be rejected because MGE's liability cannot be known and measurable for years.

From the consumer's perspective, MGE should be fully insured to pay the FMGP remediation expenses, and dumping these costs onto consumers should not be an issue. When consumers paid for MGE's and its predecessor's insurance premiums through rates, consumers expected MGE and its predecessor to acquire insurance policies that are sufficient to recover the company's environmental liability. It was MGE's lack of foresight and poor judgment that resulted in MGE being uninsured for the environmental remediation expenses that MGE now wants to force on consumers. MGE and MGE alone made those insurance decisions and should bear the consequence of improperly insuring MGE for environmental remediation.

**d. Tax Savings**

MGE's witness Mr. Michael Noack admitted in cross-examination that MGE received tax savings on its environmental expenses of thirty-seven percent (37%) to thirty-eight percent (38%). (Tr. 63). Combining these savings with MGE's insurance recoveries suggests that MGE has failed to satisfy its burden of proving that MGE could incur *any* environmental expenses, much less environmental remediation expenses that are significant.

The Staff's witness Mr. Paul Harrison identified $11.4 million as the expenses MGE paid in FMGP remediation expenses before reimbursements. (Ex.10) Assuming MGE realized tax savings on this amount, thirty-eight percent (38%) of $11.4 million in environmental expenditures would amount to $4.3 million in tax savings. This evidence raises serious questions of MGE's claims regarding the expenses it has already incurred and the expenses it may incur in the future.

#### e. Value of Property

MGE's liability is the result of Southern Union's ownership interest in certain properties, not because of the regulated service it provides. (Ex.12, p.9). As MGE remediates these sites and removes the liability associated with them, the value of the property will likely increase, thus increasing MGE's assets. MGE and MGE alone will receive all benefits from this increase in value of its asset, including all profits from any future sale of the property. Just as MGE would not share any proceeds from the sale of the properties with consumers, consumers should not be required to help MGE increase the value of its property holdings.

### 4. MGE's Delays and Attempts to Recover Costs from its Customers Has Harmed MGE's Ability to Recover Expenses from WRI

The five hazardous waste sites identified by MGE were first discovered to contain hazardous waste in 1991. (Tr. 141). When Southern Union entered into the ELA with WRI in 1994, MGE knew there would be liability imposed by CERCLA for remediating these sites. However, MGE chose to do little to nothing to remediate the sites for 14 years, despite the fact that under the ELA, any liability of WRI would expire in 2009. Rather than begin remediating these sites at an accelerated pace to ensure that all cleanup would be completed by 2009, MGE simply sat on the sites. It was not until the EPA threatened MGE with "authoritative action" that MGE reluctantly agreed to "voluntarily" cleanup the sites. (Tr. 145). MGE's witness Ms. Callaway testified as follow:

> Q. And in your opinion, did MGE act to remediate these sites as quickly as possible?
>
> A. I guess that would be an opinion. However, Super Fund – actually the Kansas City and the St. Joseph site, Super Fund was gong to take an authoritative action, and MGE made a

> business decision to enter into the voluntary cleanup program instead of going to Super Fund.

For the only two sites for which MGE has any current expenses, MGE did not cleanup these sites at its earliest opportunity, and instead waited until authoritative action was about to be taken by the EPA. For the St. Joseph site, MGE did not make that decision until 2007, a mere *two years* before WRI's liability was set to expire. (Tr. 163). As a result, MGE faces what it claims to be millions of dollars in future environmental remediation expenses, and without significant contributions from WRI since MGE's agreement with WRI lets WRI off the hook for expenses in January 2009. MGE offered little if any explanation as to why MGE's voluntary remediation activities could not have begun much earlier, when MGE would have been guaranteed reimbursement from WRI.

Furthermore, due to MGE's repeated attempts to force FMGP remediation costs onto consumers, and MGE's inability to accept two rejections by the Commission, MGE prevented a resolution of the requirement under the ELA that MGE attempt to pass FMGP remediation costs onto consumers. As discussed above, MGE has twice sought to pass environmental costs onto consumers, and has twice been rejected by the Commission. By continuing different avenues seeking to force FMGP cleanup costs onto consumers, MGE has essentially given WRI another reason to withhold payment. As a result, **____________________________________________

________________________________**.

This issue will be resolved in one of two ways. If the Commission rejects the AAO request, WRI will be immediately liable for compliance costs incurred up until January 2009. If the Commission grants the AAO, **__________________________

________________________________** until the resolution of MGE's next rate case.



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If MGE is allowed to pass FMGP remediation costs onto consumers in that rate case, WRI will be relieved from any liability under the ELA, and consumers will be left holding the check for the entire expense. Even if the Commission determines that shareholders and consumers should split the environmental liability costs, as many state commissions have done, WRI's liability will only be a percentage of the shareholder liability portion. Rejecting the AAO will minimize the combined expenses for shareholders and consumers, and will ensure that WRI does not avoid the liability it agreed to maintain under the ELA.

### 5. The Expenses Incurred are Not for the Provision of Utility Service to Existing Customers

The FMGP remediation expenses are not in any way associated with providing service to existing customers. The benzene and other contaminates at the FMGP sites are the result of practices by private unregulated companies dating back to over 125 years ago. (Ex.12, p.8). According to MGE's Application, some of these sites have been dormant for over a hundred years. Much of the contamination from these sites incurred prior to the existence of the Commission and prior to the regulation of public utilities. Requiring today's customers to foot the bill for customers served over a hundred years ago, by a private company that has provided no benefit to existing customers, is not just and reasonable. §393.130.1 RSMo. To do so would be unjustly discriminatory against today's customers under § 393.140(5) and would violate the regulatory principle that customers are to be charged for the actual expenditures required to furnish natural gas to those customers. § 393.270 RSMo. Remediating these FMGP sites will provide absolutely no benefit to today's customers, and therefore, today's customers should not be billed for liabilities resulting from poor management decisions of private unregulated companies from over a century ago. MGE has argued that requiring shareholders to pay for these environmental liabilities amounts to a "penalty," yet MGE has no problems with forcing this "penalty" onto blameless consumers rather than the MGE's predecessor that created the liabilities. (Ex.12, p.32).

## III. Conclusion

MGE's witness Mr. Noack claimed that other states have overwhelmingly allowed recovery of environmental expenses. (Tr.46). But there is a significant difference between allowing *deferral* of a cost that is not extraordinary from allowing recovery in rates. And ultimately, whether or not the FMGP expenses are extraordinary is the primary issue the Commission must answer to resolve this case. For the reasons explained above, the only way to conclude that MGE's FMGP expenses are extraordinary is to do what MGE had to do and distort the definition of extraordinary. If MGE incurs environmental remediation expenses under CERCLA, for which it is not reimbursed from insurance policies, other parties, or tax savings, the appropriate remedy, should MGE need one, is to request a rate increase.

Respectfully submitted,
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**CERTIFICATE OF SERVICE**

I hereby certify that copies of the foregoing have been mailed, emailed or hand-delivered to the following this 10th day of October 2008:

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