

MEMORANDUM

TO: Missouri Public Service Commission Official Case File
File No. GU-2011-0392, Missouri Gas Energy

FROM: Amanda C. McMellen, Auditing Department
Mark L. Oligschlaeger, Auditing Department

/s/ Mark L. Oligschlaeger 08/19/11
Utility Services / Date

/s/ Amanda C. McMellen 08/19/11
Utility Services / Date

/s/ Thomas M. Imhoff 8/19/11
Utility Operations / Date

/s/ Sarah Kliethermes 08/19/11
Staff Counsel's Office / Date

SUBJECT: Staff Recommendation to approve in part and deny in part MGE's request for an Accounting Authority Order for certain accounting procedures for costs related to Joplin tornado on May 22, 2011.

DATE: August 19, 2011

Authority Requested in MGE's Application

On June 10, 2011, Missouri Gas Energy (MGE) filed an Application for an Accounting Authority Order (AAO) requesting accounting treatment for what it characterized as extraordinary and unusual costs resulting from the Joplin tornado that occurred on May 22, 2011. MGE requests authority to defer these costs to Uniform System of Accounts (USOA) Account 182.3, Other Regulatory Assets, and amortize them over a five-year period commencing with the effective date of rates set in MGE's next general rate proceeding. MGE states in its Application that it may incur approximately \$5 to \$10 million of incremental costs to rebuild and repair the damages to its system directly related to the tornado and severe weather. MGE states that it will seek recovery of these deferred amounts in future rate proceedings.

As part of its request, MGE seeks authority to defer certain incremental operations and maintenance (O&M) expenses it has incurred related to the tornado. These O&M expenses include labor and material costs to make repairs to its system in the immediate aftermath of the storm.

MGE also requests authority to defer the capital-related costs associated with new infrastructure placed into service as it rebuilds its system in the area affected by the tornado. Capital-related costs in this context refer to depreciation expense and carrying charges associated with capital expenditures once they are considered operational and used for service.

MGE claims that the May 22, 2011 Joplin tornado either damaged or destroyed up to an estimated 8,000 MGE customer locations. [MGE Application, page 4.] So, in addition to its

ATTACHMENT A

requests for authority to defer the tornado-related O&M expenses and capital costs, MGE also requests authority to defer “the lost fixed cost recovery from its distribution rates” resulting from what it alleges will be lower customer usage due to the tornado.

In summary, in this Application, MGE is seeking deferral treatment of:

- Incremental O&M costs incurred and to be incurred
- Incremental capital-related costs incurred and to be incurred
- Alleged financial impact of the tornado on sales (lost fixed cost recovery or “lost revenues”)

Background for AAO Deferral Requests

In past AAO cases, the Missouri Public Service Commission (“Commission”) has granted authority for utilities to defer costs in a number of circumstances, almost always involving the occurrence of “extraordinary events” of various types. By allowing deferral of these costs, the Commission gave the utilities the **opportunity to seek future recovery** of the extraordinary costs in a subsequent rate proceeding.

Some deferral requests pertain to incremental O&M expenses associated with extraordinary events or natural disasters. When the Commission granted these requests, the expenses were booked as an asset on the company’s balance sheet, and subsequently amortized to expense on the income statement over a period of time, normally five years.

Other deferral requests pertain to incremental capital expenditures entered into by a utility as a result of an extraordinary event. When granted, the Commission authorized the company to defer the depreciation expense and carrying charges associated with the capital expenditures once the plant was considered operational and used for service. The normal accounting treatment associated with capital related AAO deferrals ordered by the Commission is to amortize these costs to the utility’s income statement over ten years.

Commission Staff (“Staff”) has not found any prior instances where the Commission granted an AAO allowing deferral of the fixed cost components of the Company’s rates, or “lost revenues,” resulting from lower customer usage due to the extraordinary event or natural disaster.

Standard for Deferral Authorization

In its Report and Order in Case Nos. EO-91-358 and EO-91-360, cases filed by Missouri Public Service, a division of UtiliCorp United, Inc. (now KCP&L Greater Missouri Operations Company) (“Order”), the Commission stated its criterion for deferral of costs incurred outside a rate case test year. The Commission has consistently used this same criterion since those cases. In that Order, the Commission stated:

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 the 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 recurring¹; and
2. The costs associated with the material event are material.

¹ The Commission has adopted the Uniform System of Accounts. The Federal Energy Regulatory Commission (FERC) USOA defines the term “extraordinary items” in General Instruction No. 7. 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.

Application of Extraordinary and Material Standard to MGE's Requests

Staff concludes that the May 22, 2011 tornado was an extraordinary event for purposes of MGE's requests to defer tornado-related O&M costs and related capital-related costs. Staff also concludes that the tornado was of a material nature for purposes of MGE's requests to defer tornado-related O&M costs and tornado-related capital costs. The remainder of this section will consider only these items of relief requested in MGE's Application. Staff will separately discuss MGE's lost revenues request in the section "Authority to Defer Lost Revenues Should Not Be Granted."

Staff obtained from MGE updated quantifications of its actual incurred tornado-related costs and estimated future costs associated with the May 22, 2011, tornado. Based upon data request responses received from MGE, through July 28, 2011, MGE has incurred approximately \$99,500 in capital related costs and approximately \$1.042 million in additional O&M expenses associated with the tornado.

Based solely upon the costs incurred by MGE through July 28, 2011, Staff estimates the deferral that could be booked by MGE, if the Commission approves this Application, would be approximately \$1.042 million for O&M expenditures and \$5,500 for capital related cost, for a total first year deferral amount of \$1,047,500. Based upon MGE's projection of total tornado-related costs, including projected costs past July 28, 2011, Staff estimates that the deferral MGE could book would be approximately \$1.042 million for O&M expenditures and \$497,000 (annualized amount) for capital related costs, for a total annualized deferral of \$1,539,000. While O&M costs would be in essence deferred "once" as they are incurred, capital related costs would continue to be deferred until such time as those amounts are considered for rate treatment in future MGE rate proceedings.

Given the extent of damage relative to the size of MGE's system, the May 22, 2011 tornado was an extraordinary event. Further, from the evidence presented by MGE in its Application and obtained through later discovery, Staff has come to the conclusion that the required O&M expenditures and the capital-related costs associated with those expenditures have had and will have a material impact on MGE's financial position. For these reasons, Staff recommends that MGE's request to defer O&M expenses and related capital-related costs resulting from the tornado be granted subject to the conditions described in the "Staff Recommendation" section of this Memorandum. These conditions are summarized below.

The Carrying Charge Rate Should be Set Equal to the AFUDC Rate.

When deferral of capital related expenses is allowed, current Commission practice is to set the carrying cost rate equal to the Company's ongoing Allowance for Funds Used During Construction (AFUDC) rate, as calculated in accordance with the Commission's USOA. The Staff recommends that this practice continue if authority to defer capital related costs is granted to MGE.

A Ten-Year Amortization Period Is Appropriate.

Because a majority of the projected total costs related to the tornado are capital expenditures, Staff recommends that this deferral be treated in a similar fashion to prior capital expenditure deferrals. Past Commission practice has been to utilize a ten-year period for purposes of amortizing capital expenditure deferrals. MGE requested a five-year amortization period, which the Commission has more typically used for deferral of non-capital related extraordinary costs.

Amortization of Deferrals Should Begin Reasonably Close in Time to Cost Incurrence.

MGE's Application included the request that it begin to amortize any deferrals at the time rates go into effect in its next rate proceeding. Staff opposes this aspect of MGE's Application as being unreasonable. While granting of the deferral will allow MGE to avoid charging the majority of the financial impact of the tornado to expense in the year incurred (i.e., 2011), and instead spread that impact over subsequent years, it is not reasonable or appropriate for a utility to "hoard" such deferrals for an extended period in its balance sheet and not charge any of the costs to expense until years after the precipitate cause of the deferred costs occurred. The AAO is already a departure from usual accounting practices. Staff has consistently recommended that amortizations to expense for deferred costs should begin shortly after the incremental costs associated with the extraordinary item have been incurred. In this case, Staff recommends that any deferral authorized by the Commission in this case should be amortized over 120 months (ten years), beginning January 2012.

Any Deferral Order Should Have No Ratemaking Effect.

In all past AAOs granted by the Commission, of which the Staff is aware, 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 recommends that similar language is appropriate in any order related to this Application allowing MGE to defer costs.

Any Insurance or Government Reimbursements Should Offset Deferral Amount.

Staff recommends that any insurance or government proceeds applicable to incremental O&M expense or capital related costs be used to offset the total amount of deferred expense. It is not appropriate for MGE to have the opportunity to double-recover these costs.

No Recovery of Tornado Related Capital Expenditures Through ISRS.

It is possible that some portion of MGE's tornado related capital expenditures may be eligible for rate recovery through the Infrastructure System Replacement Surcharge (ISRS) mechanism. Because the ISRS mechanism provides for expedited rate recovery of certain capital related costs incurred by natural gas utilities, it would not be appropriate for MGE to seek ISRS rate treatment of any capital costs related to the tornado for which depreciation and carrying charges are being deferred through an AAO.

MGE Must Maintain Materials for the Subsequent Audit of Any Deferrals.

MGE should maintain detailed supporting records, work papers, invoices and other documents to support the amount of costs deferred under any AAO, including any related deferred taxes recorded as a result of the cost deferral. Such records should include documentation of the controls in place to ensure all expenditures were reasonable and not utilized to take advantage of the situation, detailing of food and lodging costs, labor and material costs, procedures and verification for expense versus capitalization determinations, and determination of incremental levels of such costs versus normal ongoing levels of costs. Such records should be made available for review by the Commission Staff, The Office of the Public Counsel, and other intervenors, pursuant to 4 CSR 240-2.085 and Section 386.480.

Authority to Defer Lost Revenues Should Not Be Granted

In its Application, MGE seeks authority to defer the "loss of the fixed cost recovery provided by the Company's distribution rates incurred by MGE and related to the events surrounding the May 22, 2011 tornado and severe weather..." Based on subsequent information from MGE, to clarify exactly what relief MGE seeks through this particular request: MGE is not seeking to defer certain "fixed costs" that would normally be included in its income statement. Instead, MGE seeks to defer the financial impact of not receiving a certain level of revenues from its customers that it assumes it would have received but for the tornado. In a data request response, MGE estimated that the annualized amount of lost revenues due to the tornado would be approximately \$1 million.

MGE's request to defer and obtain the opportunity to seek subsequent recovery of lost revenues associated with an extraordinary event is unprecedented in this jurisdiction. Though many prior natural disasters in Missouri (for example floods, wind, and ice storms) resulted in a loss of customer load by the affected utility for a period of time, at no time in the past have these utilities included lost revenues (or "loss of fixed cost recovery") as a financial item for which deferral treatment was requested.²

² Staff was unable to find a similar request for lost revenues in other states in a survey of cases for the last 25 years. Staff invites MGE to alert it and the Commission to any request it may have overlooked, or from a further time period.

Application of the standard outlined above for deferral of costs from one period to another period to MGE's lost revenues request indicates that deferral of lost revenues is not appropriate. Notwithstanding MGE's characterization of this aspect of its request as seeking to defer "the fixed cost recovery provided by the Company's distribution rates," the information provided to Staff in this proceeding indicates that MGE has billed revenues sufficient to fully recover its fixed costs even after the tornado occurred³. Consequently, the impact of allowing MGE the relief it seeks by deferring "the fixed cost recovery from its distribution rates" would be to provide MGE the opportunity to earn an increased level of return on equity (ROE), in subsequent periods to compensate it for the alleged decreased level of ROE it asserts it is currently earning due to the tornado. Staff asserts that it is not reasonable for the Commission to permit the AAO mechanism to be used to prop up a utility's profit levels following an extraordinary event.

Further, there is a clear distinction between allowing deferral treatment of extraordinary expenditures incurred by a utility to make repairs and restore service following a disaster, and allowing deferral treatment of a certain level of revenues that is allegedly foregone due to a disaster. When considering the former category of financial impact associated with a disaster, it is vitally important and in the public interest for a public utility to make expenditures as necessary to repair damages to its system and restore service to customers as quickly as possible in an emergency situation following a natural disaster. Since this type of cost is not normally allowed in a utility's rates as part of ongoing expense, Staff believes, and the Commission has long held, that a utility should be allowed the opportunity to subsequently recover at least a portion of these unanticipated and extraordinary costs in its rates, through a "sharing" of these costs between customers and shareholders. "Lost revenues" are different from these extraordinary repair and restoration costs in that they are an estimation of "specific sales not made" due to the emergency event. As a substitute for competition, it is not reasonable for regulation to offer a utility a financial guarantee it will receive all of its assumed "normal" customer usage or sales and, further, Staff asserts that the return on equity allowance included in a utility's rates is intended to compensate a utility for the risk of any fluctuations in sales or revenues from the level previously assumed in setting that utility's rates.

Finally, as a practical matter, any recognition of lost revenues in an AAO deferral requires some baseline estimation of what the utility's revenues would have been absent the extraordinary event; i.e., a "what-if" scenario must be relied upon. Accordingly, any "lost revenues" deferral will necessarily be an estimate and not a verifiable and auditable financial quantification.

³ Staff does not concede that failure to fully recover fixed costs would constitute a lawful basis to authorize the deferral of lost revenues.

Staff Recommendation

As described above, the Staff concludes that MGE's tornado-related O&M costs and related capital-related costs are extraordinary in nature and are material. Therefore, the Staff recommends that, in this case, the Commission grant MGE's AAO Application in part.

Specifically, the Staff recommends that the Commission grant MGE's AAO request as described below:

That:

1. MGE be authorized to defer actual incremental O&M expenses associated with repair and restoration activities associated with the May 22, 2011, tornado, and depreciation and carrying charges equal to its ongoing AFUDC rates associated with tornado-related capital expenditures, to Account 182.3, Other Regulatory Assets.
2. Nothing in the Commission's 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.
3. Any and all offsets including, but not limited to, insurance claim proceeds or government payments or credits applicable to incremental operation and maintenance expense or capital expenditures shall be used to offset the total amount of costs to be deferred.
4. MGE shall not seek to recover any tornado related capital costs for which it is deferring depreciation and carrying charges pursuant to this AAO through its Infrastructure System Replacement Surcharge rate mechanism.
5. MGE shall begin, as of January 1, 2012, ratably amortizing to expense, over a ten-year (120-month) period, the appropriate amount of all costs it is authorized to defer, which are directly related to the May 2011 tornado. Thus, the ten-year amortization period will conclude December 31, 2021.
6. MGE shall 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. Such records shall be made available for review by the Commission Staff, The Office of the Public Counsel and other intervenors, pursuant to 4 CSR 240-2.085 and Section 386.480.

7. MGE's request for authority to defer the fixed cost components of the Company's rates resulting from sales lost due to the tornado be denied.

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI


In the Matter of the Application of Missouri Gas)
Energy for the Issuance of an Accounting)
Authority Order Relating to its Natural Gas)
Operations and for a Contingent Waiver of the)
Notice Requirement of 4 CSR 240-4.020(2))

Case No. GU-2011-0392

AFFIDAVIT OF MARK L. OLIGSCHLAEGER

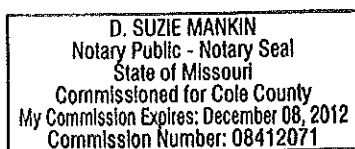
STATE OF MISSOURI)
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COUNTY OF COLE) ss.

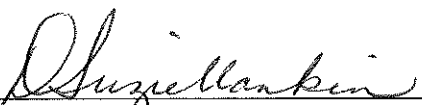
COMES NOW Mark L. Oligschlaeger, being of lawful age, and on his oath states that as a Utility Regulatory Auditor V, in the Auditing Department of the Utility Services Division, he has the knowledge of matters as follows: Amanda C. McMellen is a Utility Regulatory Auditor IV in the Missouri Public Service Commission's Auditing Department. Amanda C. McMellen of lawful age, on her oath states: that she 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 her; that she has knowledge of the matters set forth in such Staff Recommendation; and that such matters are true and correct to the best of her knowledge and belief.



Mark L. Oligschlaeger

Subscribed and sworn to before me this 19th day of August, 2011.





Notary Public

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

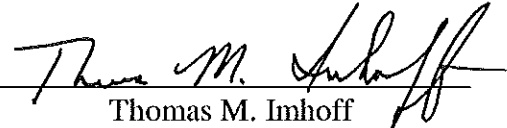
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Case No. GU-2011-0392

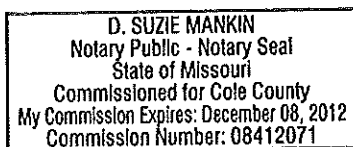
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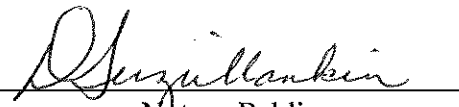
STATE OF MISSOURI)
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COUNTY OF COLE) ss.

Thomas M. Imhoff 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.


Thomas M. Imhoff

Subscribed and sworn to before me this 19th day of August, 2011.




Notary Public


BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of the Application of Missouri Gas)
Energy for the Issuance of an Accounting) Case No. GU-2011-0392
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AFFIDAVIT OF MARK L. OLIGSCHLAEGER

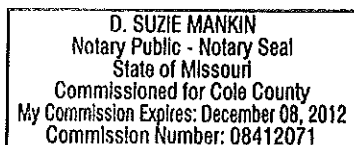
STATE OF MISSOURI)
) ss.
COUNTY OF COLE)


Mark L. Oligschlaeger 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.



Mark L. Oligschlaeger

Subscribed and sworn to before me this 19th day of August, 2011.





Notary Public