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

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

# STAFF'S BRIEF

**COMES NOW** the Staff of the Missouri Public Service Commission (Staff) and for its Brief states as follows:

## WHAT IS AN ACCOUNTING AUTHORITY ORDER (AAO)

In Missouri American Water Case No. WO-2002-273, the company sought an AAO for its post 9/11 security costs. In its Report and Order on Remand, the Commission provides its definition of an AAO and tells how it relates to future rate recovery:[1]

> An AAO is an order of the Commission pursuant to Section 339.140(8) authorizing an accounting treatment for a transaction or group of transactions other than that prescribed by the USOA.[25] It is an accounting mechanism that has most often been used to permit deferral of costs from one period to another.[26] 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.[27] The regulatory asset is amortized over a prescribed interval and a portion is recognized as an expense each month. 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.[28] However, it is well-established that the mere granting of an AAO does not guarantee recovery of any amount of the deferral:
>
> > In the *Public Counsel* case, the court made it clear that AAOs are not the same as ratemaking decisions, and that AAOs create no expectation that deferral terms within them will be incorporated or followed in rate application proceedings. The whole idea of AAOs is to defer a final decision on current extraordinary costs until a rate case is in order. At the rate case, the utility is allowed to make a case that the deferred costs should be included, but again

[1] *In the Matter of the Joint Application of Missouri-American Water Company, St. Louis County Water Company, s/b/a Missouri-American Water Company, and Jefferson City Water Works Company, d/b/a Missouri-American Water Company, for an Accounting Authority Order relating to Security Co*sts, Case No. WO-2002-273, Report and Order on Remand issued November 10, 2004, pp. 19-20.

there is no authority for the proposition put forth here that the PSC is bound by the AAO terms.[29]

This Commission has said that AAOs should be used sparingly because they can result in ratemaking consideration of items from outside the test year:[30]

The deferral of cost from one period to another period for the development of a revenue requirement violates the traditional method of setting rates. Rates are usually established based upon a historical test year which focuses on four factors: (1) the rate of return the utility has an opportunity to earn; (2) the rate base upon which a return may be earned; (3) the depreciation costs of plant and equipment; and (4) allowable operating expenses.

[25] Some of the Commission's AAO orders emphasize that they are issued pursuant to the Commission's authority at Section 393.140(4) rather than Section 393.140(8) and that, consequently, neither notice nor a hearing are necessary before the Commission determines an AAO request. *See e.g. Sibley* at 204. This assertion has not been either approved or rejected by the courts. One court has held that, so long as the Commission did in fact hold a hearing, it doesn't matter which statute the Commission claimed as authority. *See St. ex rel. Missouri Office of the Public Counsel v. Public Service Commission of Missouri,* 858 S.W.2d 806, 812 (Mo. App., W.D. 1993).

[26] *Sibley* at 202.

[27] *Id.*

[28] This benefit exists only where the AAO permits ratemaking consideration of transactions that occurred outside of the test year.

[29] *Missouri Gas Energy v. Public Service Commission*, 978 S.W.2d 434, 438 (Mo. App., W.D. 1998) (internal citation omitted), *referring to St. ex rel. Missouri Office of the Public Counsel v. Public Service Commission of Missouri*, 858 S.W.2d 806 (Mo. App., W.D. 1993).

[30] *Sibley* at 205, *citing State ex. rel. Union Electric Company v. Public Service Commission*, 765 S.W.2d 618, 622 (Mo. App., W.D. 1988).

## BACKGROUND

On June 13, 2007, Missouri Gas Energy[2] filed its Application seeking an AAO for Commission approval to defer its costs of environmental compliance activities related to its Former Manufactured Gas Plant (FMGP or MGP) sites. The Commission issued its Order Setting Procedural Schedule on April 17, 2008. Pursuant to that Order, the parties held a settlement conference on July 15th and were unable to resolve their issues. The Order culminated

[2] Missouri Gas Energy is also referred to as MGE, Southern Union, and Company.

in a hearing held on August 11, 2008. Because of the unexpected illness of an MGE witness, the hearing was continued to September 10, 2008.

The AAO sought by MGE, if granted, will allow the Company to defer costs to investigate and remediate FMGP-impacted soil and groundwater at its Station A and Station B sites in Kansas City. MGE's St. Joseph FMGP site will also be subject to related investigation, assessment, and likely remediation activities, and these costs would also be subject to deferral under the Company's application. FMGP sites in Joplin and Independence have not yet been addressed by MGE.[3]

The costs proposed for deferral include those related to records and historical maps research, excavation test trenching, installation of soil borings, installation of groundwater monitoring wells, soil and groundwater lab analysis, evaluation of field and laboratory data and site condition, excavation and hauling of impacted soil and debris, landfill disposal, water pumping, storage, treatment and disposal, building demolition, report preparation and submittal of completed documentation to regulatory agencies.[4] FMGP-related legal fees also make up a substantial portion of the Company's incurred costs to date and are sought for deferral.[5]

MGE estimates the cost of investigation, assessment, and remediation efforts for these 3 FMGP sites will exceed several million dollars. [6]

**COMMISSION TREATMENT OF FMGP COSTS IN MGE RATE CASES GR-2004-0209 and GR-2006-0422**

In its past two general rate cases, MGE has sought to collect monies from its customers for environmental costs even though it had not yet incurred any costs above the Company's initial liability and third party reimbursements.

[3] Ex 5, Callaway Dir p 6 lns 14-19.
[4] Ex 1, Noack Dir. p 3 ln 9 – p 4 ln 3.
[5] Ex 7, Harrison Reb p.2 ln 22 and p 14 lns 1-3.
[6] Ex 1, Noack Dir. p 4 lns 5-6.

In both cases, MGE requested permission to set up an environmental response fund (ERF). The ERF proposal included a tracking mechanism by which MGP costs of unknown future amount would be collected from customers through a separate rate element to be trued up later by the Company. A salient feature of the ERF allowed MGE an incentive to keep for its shareholders fifty percent (50%) of any insurance proceeds or contributions obtained from PRPs and Western Resources, Inc.[7] The Commission rejected the ERF proposal in both cases.

In 2004, MGE sought to include $750,000 per year in cost of service. In its Order, the Commission ruled the clean up costs were speculative and that the creation of a pre-funded source of clean-up costs would reduce the Company's incentive to seek cost recovery from other sources because it would have already recovered costs from its ratepayers. Although the fund would be subject to audit by Staff and Public Counsel, the Commission noted 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.

In 2006, MGE again proposed an ERF, this time for $500,000. Again, the Commission rejected it for the same reasons it did in 2004. However, the Commission also noted MGE had not yet paid any environmental clean-up costs of its sites. [8]

**FMGP COSTS SOUGHT FOR DEFERRAL BY MGE**

Staff witness Paul Harrison calculated MGE incurred environmental costs of $11,463,917 during the period 1994 through March 31, 2008. However, MGE has recovered total MGP reimbursements of $8,345,088 through insurance claims and other payments from PRPs.[9]

[7] Western Resources, Inc. is now known as Westar Energy and is referred to as Westar in this brief.
[8] Ex 9, Declassified Staff Memorandum, Prior Treatment of MGP Costs in MGE Rate Cases, "App. A" pp 5-6.
[9] Ex 7, Harrison Reb p 9 lns 5-12 and Ex 11, Harrison Sched 3. Note, MGE has incurred $727,995 of non-MGP related cleanup costs in which MGE is not seeking re-imbursement or deferral in this application.

Schedule 3 "FMGP Expenditures & Recoveries by Year" (Ex 11) was jointly developed by Mr. Harrison and MGE witness Mike Noack.[10] This schedule lays out the history of the Company's FMGP expenses over a fourteen year period from 1994 through end of March 2008. At hearing Mr. Noack testified he added a handwritten portion to Schedule 3 that shows other expenditures and MGE's budgeted costs of $3 million for the period July through December 2008.[11]

When Southern Union purchased its Missouri property from Western Resources (now Westar) in 1994, it assumed an initial environmental liability of $3 million, which MGE has since stated it will not seek recovery of from ratepayers. Taking into consideration this initial $3 million of liability under its Environmental Liability Agreement[12] (ELA) with Westar, the $727,995 of non-MGP related environmental costs (not sought for deferral) and the $8,345,088 of insurance reimbursements, MGE has yet to incur a positive amount of MGP costs. In other words, MGE's reimbursements had exceeded its incurred costs at the time of the Staff's testimony filing in this proceeding. This meant three things:

(1) As of March 31, 2008, MGE had retained an excess of at least $609,166 in MGP recoveries and liability retention over the amount of its actual incurred expenses.[13]

(2) At hearing Mr. Noack testified that because MGE had run a "credit" through March 31, 2008, the Company had nothing to claim against Westar for reimbursement under the cost-sharing provisions of its ELA with Westar.[14]

(3) Because of the $609, 000 "credit", MGE had no costs to defer under an AAO.

[10] Tr. Vol 2 p 38 ln 21 – p 39 ln 1.
[11] Tr. Vol 2 p 47 lns 1-20.
[12] The Environmental Liability Agreement (ELA) between Southern Union and Westar is located at Ex 3, Noack Surreb Sched MRN-1, pp 1-12. The ELA is discussed later in this brief.
[13] Ex 7, Harrison Reb p 9 ln 5 to p 10 ln 1.
[14] Tr. Vol. 2, p 43 lns 5-14.

By end of June 2008, MGE reported this situation had changed. Mr. Noack later testified at hearing the Company no longer had a "credit" but in fact had a net MGP-only incurred cost of $845,233 after recoveries.[15]

On July 9, 2008, Southern Union sent its first demand letter to Westar informing them it had made a net payment of $1,514,975.43 above its initial $3,000,000 liability amount required under the ELA. Citing to the ELA cost sharing provisions, Southern Union requested a reimbursement of $757,487.72 from Westar (fifty percent (50%) of the monies paid up by Southern Union for costs not recovered from insurance, PRPs, or through customer rates).[16] Ramifications of the ELA are discussed later in this brief.

Staff witness Harrison testified the Staff had not audited any invoices for costs MGE has claimed it incurred during the period between March 31, 2008 and June 30, 2008.[17] Mr. Harrison further stated "…I don't even think the company started incurring costs until their projected numbers that they got between March 31st and June 30th of this year, over the last 14 years or so."[18]

MGE witness Noack testified any monies received from Westar would offset deferred costs booked if this AAO were granted and that if MGE is not successful in collecting its reimbursements from Westar, then MGE would seek those costs in the next rate case.[19] The amount MGE might seek from its ratepayers in a later rate case is quite large if MGE is unsuccessful in resolving the amount of reimbursable costs due from Westar. MGE counsel avers "As of June 30th of this year, the amount [of un-reimbursed remediation expenses] will

[15] Tr. Vol. 2, p 43 lns 13-14; p 44 lns 12-19; p 46 lns 21-22 and Ex 11 "Schedule 3".
[16] Ex 4, Morgan Surreb, Sched DKM-1, p 2.
[17] Tr. Vol 2, p 104 ln 21 – p 105 ln 3.
[18] Tr. Vol 2, p 105 lns 16-19.
[19] Tr. Vol 2 p 58 ln 13 to p 59 ln 6.

exceed 3.8 million [dollars] by the end of the calendar year as the remediation of the St. Joseph site progresses."[20]

Because the amount of environmental costs MGE may recover from Westar is unsettled, MGE's customers could be exposed to paying costs ultimately recoverable from Westar under the cost-sharing provisions of the ELA. By not granting this AAO, the Commission places a powerful incentive on MGE management to maximize its environmental cost reimbursements from Westar before turning to its customers for reimbursement.

Should the Commission grant this AAO, MGE management faces no downside consequences for any failure to aggressively pursue reimbursable costs owed by Westar under the ELA. Any reimbursable costs MGE does not pursue or collect from Westar could be deferred by MGE to its next rate case for collection in its cost of service. Moreover, granting of an AAO at this time provides Westar an opportunity to challenge payment of its liability to MGE, passing an unacceptable and unnecessary risk to Missouri ratepayers.

(See "Environmental Liability Agreement with Westar" discussed below).

**STANDARDS OF DEFERRAL**

As explained in Staff's verified Memorandum, the Commission expressed its general position and standards for deferral of costs incurred outside a rate case test year in its Report and Order in combined case Nos. EO-91-358 and EO-91-360, *In the matter of the application of Missouri Public Service*, 1 Mo.P.S.C.3d, 200-204 (1991). This is often referred to as the "Sibley" case.[21]

In that case, as in this case, the standard for allowing utility companies to defer costs incurred outside of a rate case test year as a regulatory asset must follow these criteria:

[20] Tr. Vol 2 p 14 lns 12-20.
[21] Ex 9, Staff's Declassified Memorandum, Appendix A at pp 7-8 [citing *In the matter of the application of Missouri Public Service*, 1 Mo.P.S.C.3d, 200-204 (1991)]

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

2. The costs associated with the material event are material.[22]

Application of these criteria is further guided by the Federal Energy Regulatory Commission (FERC) Uniform System of Accounts (USOA). The FERC USOA for natural gas utilities defines the term "extraordinary items" in its General Instruction No. 7 and 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*. (*emphasis added*)

The Commission has adopted the FERC USOA in its rule 4CSR 240-40.040.

**FMGP CLEAN-UP COSTS ARE NOT EXTRAORDINARY, UNUSUAL AND UNIQUE, AND NON-RECURRING EXPENSES THAT QUALIFY FOR AN AAO**

The evidence adduced in this case shows MGE's costs for investigation, assessment, remediation, monitoring, and related litigation of its FMGP sites are ongoing and recurring activities and do not meet the standard for deferral under an AAO. Facts supporting Staff's position from the evidence of record include the following:

[22] Id.

(a) MGE witness Crystal Callaway, an Environmental Compliance Specialist hired by the Company March 6, 2006, described her involvement with and review of MGE environmental activities since MGE purchased the company from Western Resources in 1994 as follows:

> "*The review of files revealed typical activities associated with natural gas utility company environmental matters, such as* regulated underground storage tank ("UST") removals, spill prevention, control, and countermeasure ("SPCC") plans, *former manufactured gas plant ("FMGP") investigations*, removal of equipment containing regulated substances, asbestos abatement/surveys, lead paint abatement/surveys, stormwater permits, hazardous waste notifications and reporting, Tier II reports, and the like."[23] (*emphasis added*)

Ms. Callaway's testimony shows that the Company's FMGP plant investigations and associated compliance activities are typical activities undertaken by a natural gas utility.

(b) Ms. Callaway, hired in 2006, is not the first environmental compliance specialist MGE has employed. She replaced an employee that performed Environmental, Health, and Safety duties for the Company.[24] At hearing Ms. Callaway testified she has on-site responsibilities for Stations A and B in Kansas City and the St. Joseph site, though work has yet to start at the Independence and Joplin sites.[25] Ms. Callaway further testified New England Gas Company, a Southern Union affiliate company, employs an EHS (Environmental Health and Safety) person and that she consults with the project manager that oversees some of the MGP plant work.[26] Southern Union Vice President – Litigation Dennis Morgan testified he performed work related to FMGP matters since he became chief legal officer for Southern Union in January 1991. Besides working on FMGP matters for MGE, Mr. Morgan also did FMGP related work

[23] Ex 5, Callaway Dir, p 1 lns 7-8; p 2 ln 16 to p 3 ln 2.
[24] Tr Vol 4, p 147 lns 11-16.
[25] Tr. Vol 4, p 155 lns 6-16.
[26] Tr Vol 4, p 154 ln 15 to p 155 ln 5.

for the New England Gas Company, Pennsylvania PGE and for Southern Union Gas Company which operated in Texas, Oklahoma, New Mexico and Arizona.[27]

Testimony of Ms. Callaway and Mr. Morgan clearly shows FMGP work has been and currently remains a regular part of their job duties for the Company.

(c ) Of the five MGP sites undergoing clean-up activities, MGE estimates most of the sites ended their manufactured gas activities around the early 1900's to 1930. The hazardous substances requiring clean-up are coal tar and benzene-like chemicals: naphthalene, heavy metals, and petroleum aromatic hydrocarbons. Such wide range of types of chemical contaminants are considered standard for MGP sites [28]

In its Report and Order in Case No GR-2006-0422, the Commission addressed this situation as follows:

> In the future, MGE may incur an unknown and unknowable amount of financial liability for the cleanup of environmental hazards left over from the operation of manufactured gas facilities 100 to 125 years ago. Manufactured gas facilities were used before the advent of interstate natural gas pipelines in the 1940s. Before there were interstate pipelines, gas could not be transported over long distances so gas companies manufactured gas by heating coal or oil and collecting the gas that was driven off in the process. The primary byproduct that comes from this process is tar, which contains hazardous carcinogens. This is what primarily drives investigation and remediation of the sites.[29]

FMGP sites are as much legacy operations of MGE as the Model T is to Ford. To make and distribute natural gas to customers before the advent of the interstate pipeline required gas utilities to operate MGP sites to serve its customers. Cleaning-up and managing FMGP sites exemplify a core set of activities created by the historic gas production operations of MGE's predecessor companies. This is true of many of today's gas utilities such as New England Gas

[27] Tr Vol 2 p 70 ln 16 to p 71 ln 7.
[28] Tr Vol 4 p 140 lns 6-22 and p 165 ln 18.
[29] Ex 4 Morgan Surreb, Sched DKM-1 pp 116-117 (Report and Order, Case No. GR-2006-0422, pp 18-19).

Company, a Southern Union affiliate. When asked do many LDCs (local gas distribution companies) like MGE incur these same kind of [remediation] costs, MGE witness Mr. Noack replied "I think many LDCs do have the problem of remediation costs, yes."[30] Mr. Noack also noted in his surrebuttal testimony that he was aware of 30 different public utility commission that have issued orders regarding FMGP costs.[31]

As can be seen, environmental compliance costs are not extraordinary, unique, or unusual in the gas utility industry. Environmental costs are an ongoing expense that requires management, planning, and budgeting.

(d) Staff witness Harrison, working jointly with MGE witness Noack, created a schedule of "FMGP Expenditures & Recoveries by Year", referred to as Schedule 3.[32] This schedule was created from MGE workpapers and invoices and shows the history and amount of MGE's FMGP expenditures during the period 1994 through March 31, 2008. The schedule also shows non-MGP expenditures, recoveries, and the $3 million initial Southern Union liability.

Schedule 3 points out two considerations. First, it shows a long 14 plus year history of recurring FMGP costs paid by MGE. Second, MGE plans and budgets for its FMGP costs. The Company planned a $3 million budget for recurring compliance costs it expects to pay at the St. Joseph site during July through December 2008.[33]

In addition, the Accounting Principles Board in its APB Bulleting No. 30 states "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

[30] Tr. Vol 2 p 46 lns 5-8.
[31] Ex 3, Noack Surreb, p 15 ln 34 to p 16 ln 2.
[32] Ex 7 Declassified Harrison Reb, Sched 3; also separate Exhibits 10 and 11, Work Paper Set (HC). Note that Sched 3 with and without handwritten notes is not HC. The handwritten comments were made by Mr. Noack and are a part of his workpaper set (Ex 11).
[33] Ex 11, Sched 3, MGE workpaper set with Mike Noack's handwritten notes. Tr Vol 2, p 46 lns 2-4; p 47 lns 5-23.

effect."[34] MGE's FMGP environmental compliance costs have occurred with great regularity over the past 14 plus years as shown on Schedule 3. FMGP costs are not extraordinary from a financial reporting perspective. They are common costs of addressing the legacy operations of natural gas utilities.

(e) MGE has five owned FMGP sites for cleanup and has been named in 19 or 20 other sites as a potentially responsible party.[35] MGE has not closed any sites. MGE has incurred costs at its Kansas City Station A site since 1999 and has received a No Further Action letter from MDNR for the soil only at Station A South. At Station B MGE has incurred costs since 2006 and at St. Joseph since 2007. No actions have been taken at Joplin and Independence sites.[36]

(f) Learning that MGE's FMGP expenditures do not meet the traditional definition of "extraordinary" as it applies to the Commission's stated AAO criteria, the Company's witnesses tried to justify this deferral request with several new arguments posing reasons why MGE's FMGP expenditures should be considered extraordinary. First, Company witness Noack stated in his surrebuttal testimony that this deferral should be granted because MGE's incurred FMGP costs have been highly variable from year to year.[37] However, he was unable to cite to any case on the witness stand where the Commission adopted annual variability in expense as a criterion for allowing AAO deferrals.[38] Also, Mr. Noack stated MGE's FMGP costs should be considered unique and non-recurring on an individual site basis; i.e., that once expenditures were completed at a particular site they would never have to be repeated.[39]

[34] Ex 9, Declassified Staff Memorandum, Appendix A p 9.
[35] Tr Vol 2 p 32 lns 5-13.
[36] Tr Vol 4 p 159 lns 4-17; p 162 ln 3 to p 163 ln 17.
[37] Ex 3, Noack Surreb p 3 lns 3-15.
[38] Tr Vol 2 p 32 ln 22 to p 33 ln 2.
[39] Ex 3, Noack Surreb p 4 lns 7-15.

However, the Staff disagrees with MGE's new arguments because they are completely irrelevant. MGE's FMGP costs clearly have been and will continue to be recurring when examined on a total company basis, inclusive of all MGP sites. For example, MGE witness Calloway conceded at hearing that FMGP site clean-up activities at all of its sites involve costs related to investigation, assessment, remediation and monitoring activities.[40]

MGE will continue to incur compliance costs at its sites until such time as it receives a No Further Action letter for the soil and groundwater at each of its sites.[41] MGE does not know the projected costs associated with these sites. There are too many variables.[42] MGE witness Callaway testified there will be different costs associated with each site, until MGE receives a No Further Action letter on its sites.[43]

The record evidence strongly suggests environmental compliance costs are recurring, and will be recurring well into the foreseeable future. After all, the Company has incurred FMGP compliance costs each year of the past 14 years since Southern Union purchased the MGE properties in 1994. No sites have been closed yet, and MGE's exposure has yet to be defined for its Joplin and Independence sites. Also undefined is MGE's cost exposure as a potentially responsible party for the other 19 or 20 sites mentioned by Mr. Noack.

**MGE's FMGP CLEAN-UP COSTS ARE NOT MATERIAL, KNOWN AND MEASURABLE, AND DO NOT ARISE FROM AN EXTRAORDINARY EVENT**

With respect to the issue of materiality and its relevance in this case, the Commission has said in *Sibley*:

> The company, under the USOA, is required to seek Commission approval if the costs to be deferred are less than five percent of the company's income computed before the extraordinary event. This five percent standard is thus relevant to materiality and whether the event is extraordinary but is not case-dispositive.

[40] Tr Vol 4 p 166 ln 2 to p 167 ln 5.
[41] Tr Vol 4 p 161 lns 5 to p 162 ln 2.
[42] Tr Vol 4 p 160 lns 17 -25.
[43] Tr Vol 4 p 156 lns 14-22.

> The Commission agrees with Staff that whether the event has occurred or is certain to occur in the near future is a relevant factor. Utilities should not seek deferral of speculative events since it is hard to determine whether an event is extraordinary or material unless there is a high probability of its occurring within the near future.[44]

MGE's current and past levels of un-reimbursed incurred FMGP costs do not meet the level of five percent (5%) of net operating income used by the FERC to qualify as "material" under the USOA. As discussed above, Staff witness Harrison and MGE witness Noack agreed that MGE had a "credit" of $609,000 as of March 31, 2008. This "credit" includes an offset of MGE's initial $3 million liability amount and its third party reimbursements against MGE's actual incurred expenses over a 14 year period from January 1994 to end of March 2008. There are no un-reimbursed costs that would distort MGE's current and past year's net income levels.

This picture reportedly changed as of end of June 2008. In its July 9th demand letter to Westar, Southern Union advised it had incurred $1,514,975.43 above its initial $3,000,000 liability under the ELA. Citing the ELA cost sharing provisions, Southern Union sought a reimbursement of $757,487.72 from Westar. Staff witness Harrison has not conducted an audit or review of MGE's invoices supporting MGE's expenses claimed by it after March 31, 2008.

At hearing, MGE told the Commission it would have some $3.8 million of un-reimbursed remediation expenses by end of the calendar year 2008 as it progresses the cleanup of the St. Joseph site. Not clear for reasons discussed below, is whether or when MGE might be reimbursed by Westar for its claimed remediation costs under the fifty percent (50%) cost sharing provisions of the ELA.

As the Commission decided in *Sibley*, utilities should not seek deferral of speculative events. Consideration of speculative events is a relevant factor in the Commission's decision to grant an AAO. In view of the clouded status of the ELA cost sharing provisions with Westar,

[44] *In the matter of the application of Missouri Public Service* (Sibley), 1 Mo.P.S.C.3d, 206 (1991).

MGE's projected level of future FMGP costs should not be considered in a valid materiality analysis. These costs have yet to be incurred, and may not be incurred at all or in the amount that MGE has estimated in this proceeding. Projected and speculative cost estimates cannot meet any valid test for materiality of expenses.

Furthermore, no extraordinary event has occurred. MGE's actions over the past 14 years have shown the cleanup of FMGP sites is a long continuing process of dealing with compliance issues born of its legacy operations.

**ENVIRONMENTAL LIABILITY AGREEMENT WITH WESTAR**

On January 31, 1994, Southern Union entered into an environmental liability agreement (ELA) with Western Resources, Inc. (Westar) when it purchased MGE.[45]

The import of the ELA is that it transfers *all* environmental liability to Southern Union. To be sure, federal courts have consistently upheld such contractual transfers of liability and indemnification under the Comprehensive Environmental Response, Compensation, & Liability Act (CERCLA).[46]

Under Article 1 of the ELA, Southern Union has assumed liability for all environmental claims related to MGE properties and assets. The ELA calls for Southern Union to be indemnified for its environmental costs as spelled out in the ELA's 5 tiers of cost recovery. The last or fifth tier includes a cost-sharing provision between Southern Union and Westar. (See Footnote 12).

The 5 tier approach contemplates Southern Union first seeking reimbursement from insurance carriers, second from other potentially responsible parties (PRPs), third through rates

[45] Ex 1, Noack Dir p 6 ln 22 – p 7 ln 2 and Sched MRN-1 "Environmental Liability Agreement" (ELA) dated January 31, 1994. ELA is also Attach 1 of Ex 9, Declassified Staff Memorandum.

[46] Coy/Superior Team v. BNFL, Inc., 174 Fed.Appx 901, 908 (6th Cir.2006) [citing *Olin Corp. v. Yeargin Inc*., 146 F.3d 398, 407 (6th Cir.1998); *Niecko v. Emro Marketing Co.*, 973 F.2d 1296, 1300-01 (6th Cir.1992)]. See also Interstate Power Co. v. Kansas City Power & Light Co., 909 F.Supp. 1241, 1264 (N.D.Iowa Sep 01, 1993) and White Consol. Industries, Inc. v. Westinghouse Elec. Corp. 179 F.3d 403, 409 (6th Circ. 1999).

charged to MGE customers, and fourth, Southern Union is responsible for the first $3 million of the initial remaining liability. After the first $3 million, under the fifth tier Westar shares one-half of the next $15 million of any remaining environmental costs. These cost sharing provisions run 15 years and terminate at the expiration of the ELA on January 31, 2009.[47]

According to testimony of Mr. Dennis Morgan, the Southern Union Senior Vice President – Litigation, only costs incurred through the end of January 2009 are recoverable from Westar.[48] Thereafter, any new incurred environmental costs will be recovered in their entirety from the ratepayer.[49]

Fourteen and one half years after signing the ELA, on July 9, 2008, Southern Union sent its *first* demand letter to Westar seeking reimbursement of $757,487.22 or fifty percent (50%) of the $1,514,975.43 paid up through June 30, 2008 for environmental costs claimed to have been paid by MGE. [50] Coincidently, that same day, Southern Union filed its surrebuttal testimony in this case.

The July 9th letter to Westar describes specific actions Southern Union has taken under each tier of recovery outlined in the ELA. With regard to rate recovery, the letter states "Southern Union has twice applied for and been denied rate recovery from the MPSC. (See Attachments A and B, MoPSC Orders in Case Nos. GR-2004-0209 and GR-2006-0422)." [51]

At hearing opening MGE counsel told the Commission the problem of cleaning up the MGP sites has been around a long time: "The existence of potential liability associated with this remediation has been known for many years….The ELA created a tiered process to seek recovery of environmental costs, to include FMGP remediation costs."[52]

[47] Ex 9, Staff Memorandum p 4 and Attach 1; Tr Vol 2 p 48 ln 21-p 50 ln 9; p 54 lns14-20; p 56 lns 7-12.
[48] Tr. Vol 4, p 78 lns 1-5.
[49] Id at 82, lns 2-5.
[50] Ex 4, Morgan Surreb, Sched DKM-1, pp 1-2 (HC).
[51] Id.
[52] Tr. Vol. 4 p 13 lns 14-21.

During in-camera questioning from Commissioner Murray, Mr. Morgan testified that under the ELA, Southern Union is required to seek rate recovery, to seek recovery from insurers, and to seek recovery from PRPs.[53] When asked if he thought receiving an AAO might cloud Westar's liability, Mr. Morgan answered "I don't think so, because it's not rate recovery".[54] When asked if he thought the potential or likely rate recovery of an AAO might delay reimbursement from Westar, Mr. Morgan said he could not speak for Westar and he had no idea where they might go. [55]

Westar's August 6th reply to Southern Union casts a different light on the cost recovery issue. Indeed, Westar's response amplified the uncertainty of an AAO clouding Westar's liability:

> In your letter, you also indicated that MGE has "twice applied for and been denied rate recovery from the MPSC." However, we understand that MGE currently has an application for an accounting authority pending before the Missouri Public Service Commission in Case No. GU-2007-0480. *The outcome of that proceeding will clearly have an impact on your claim.*[56] (*emphasis added*)

The possibility of Westar denying or delaying reimbursement to Southern Union should the Commission grant this AAO could lead to ultimate collection of these costs from MGE's ratepayers.

As brought to light at hearing, these adverse consequences pass to the ratepayer. MGE witness Mike Noack testified that MGE must pursue rate recovery of MGP costs before seeking those costs from Westar and that the costs it seeks to defer under the AAO are also costs it is seeking reimbursement from Westar.[57]

[53] Tr. Vol. 3 In Camera p 86 ln 25 – p 87 ln2.
[54] Id at lns 11-15.
[55] Id at pp 87-88.
[56] Ex 14 Data Request 23 (HC) Westar Energy letter from Martin Bregman to Dennis Morgan dated August 6, 2008. Note cert. mail receipt shows August 11, 2008 delivery, the first day of hearing.
[57] Tr. Vol. 2, p 34 lns 9-12 and 22-25.

Given the troubling uncertainty of whether Westar pays its share of MGE's claimed clean up costs, there becomes a strong chance ratepayers may end up paying all the costs MGE seeks to defer in an AAO. That possibility grows as the January 31, 2009 claim submission date nears.

When asked whether MGE believes it probable the Commission would allow for recovery of all of MGE's deferred MGP costs in future rate case proceedings, Mr. Noack replied "If those costs were deemed prudent, yes."[58]

**IF THE COMMISSION SHOULD DECIDE TO GRANT MGE AN AAO FOR ITS FMGP COSTS, THE COMMISSION SHOULD ORDER CONDITIONS**

The Staff strongly recommends the Commission reject MGE's AAO request for the reasons stated herein. However, if the Commission does decide to grant this application, the Staff is recommending that any issuance of any AAO to MGE for FMGP costs contain certain conditions.

The Staff and MGE agree on most of these conditions, but there is one condition the Staff insists the Commission order to protect MGE's customers that MGE does not support. At the center of this disagreement is the ELA cost sharing provision between Southern Union and Westar. This provision expires with the ELA on January 31, 2009.

Under Article II.C.(v) of the ELA, the fifth tier of recovery, both companies share up to a maximum of $15 million dollars of un-reimbursed expenditures upon the exhaustion of relief contemplated in the first four tiers.[59] The Staff recommends MGE should not be permitted to defer fifty percent (50%) of costs that are properly assignable to and payable by Westar under the cost sharing terms of this agreement.

[58] Tr Vol 3, p 33, lns 19-23.
[59] Ex 3, Noack Surreb, Sched MRN-1 p 6 (ELA).

As discussed earlier, the Commission's exclusion of $7.5 million dollars from the AAO works a powerful incentive on MGE management to maximize its remediation efforts and to exhaust its FMGP cost reimbursements from Westar. Without this condition, MGE would be permitted to defer costs that are recoverable from Westar - costs that would likely be added to the cost of service in the next rate case. Without this condition, MGE has no incentive to aggressively pursue its FMGP site remediation efforts.

The Commission itself noted in its Orders in Case Nos. GR-2004-0209 and GR-2006-0422 that granting MGE upfront recovery of FMGP costs in rates would blunt its incentive to seek maximum reimbursement of these costs from potential third parties. The same negative incentives would be fostered if the Commission were to grant MGE's AAO application in this proceeding without, at a minimum, exempting costs potentially recoverable from Westar from the deferral.

The public interest requires the Commission to protect MGE customers from the possibility of paying un-necessary costs deferred under an AAO – costs that should be paid by Westar under the ELA. The public interest is also served by MGE speeding up its FMGP site cleanup and removal of hazardous contaminants. With that, for any cleanup costs MGE submits to Westar by January 31, 2009, Westar will reimburse MGE on a 50-50 basis. If $15 million dollars or less can complete all remediation activities at all FMGP sites, then MGE's customers will pay only half that – a bargain by any standards.

Therefore, if the Commission for any reason decides to issue the requested AAO to MGE, the Staff recommends the Commission include the following language in its Ordered section of the AAO[60]:

> 1. That MGE is authorized to defer up to 50% of its MGP expenditures that it incurs eligible for potential sharing with Westar under the ELA, and 100%

[60] Ex 9, Declassified Staff Memorandum, Appendix A, pp12-13.

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

2. That the deferral authority be limited to MGE's incurred costs associated with former MGP sites.

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

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

5. That the AAO continue through the end of the Commission ordered test year as updated or true up period in MGE's next rate case provided MGE files its rate case within 24 months of the effective date of an order granting the AAO. In the even MGE fails to file their general rate case within 24 months of the effective date of the Order, MGE would write off the entire amount of previously booked deferrals to income.

With the exception of recommended ordered paragraph no. 1 limiting deferral amounts to fifty percent (50%) of its FMGP expenditures, MGE is in general agreement with the conditions expressed in paragraph no's 2 through 5.[61]

**CONCLUSION**

The Commission should not grant MGE an AAO for deferral of its FMGP environmental compliance costs. Such costs fail to meet the standards adopted by the Commission because FMGP costs are not extraordinary, unusual and unique, and non-recurring. FMGP clean-up costs are an everyday part of the business activities of natural gas utilities

[61] Tr. Vol 2 p 16 ln 6 – p 17 ln 15; p 30 lns 23-25.

because they address the legacy operations before gas utilities were connected by interstate gas pipelines for their gas supply.

FMGP costs fail to meet the USOA definition of "material" because they do not flow from an extraordinary event. Nor are these costs known, they are projected estimates based on speculative events. Perhaps the greatest speculation involves whether or when Westar reimburses Southern Union for its incurred FMGP costs under the ELA.

Doubt clouds the liability of Westar under the ELA cost sharing provision. At question now is how Westar might interpret the language of the ELA requiring the exhaustion of the first four tiers of recovery.

If the Commission decides to grant this AAO, then MGE can defer its FMGP costs for likely rate recovery – the very same FMGP costs eligible for sharing with Westar.

Not granting the AAO is the only way the Commission can remove any doubt about Westar interpreting the AAO as a necessary step toward rate recovery that in Westar's view may leave the rate recovery tier unexhausted. Should Westar prevail with this view, the cost sharing provision would not be reached.

If the Commission decides to grant MGE an AAO, then it must limit the amount of cost deferral to fifty percent (50%) of FMGP incurred costs. Doing so puts a powerful incentive on MGE management to pick up the pace of FMGP site cleanup efforts and to maximize the value of cost sharing with Westar before the ELA expires January 31, 2009.

**WHEREFORE**, the Staff submits its Brief as directed by the Commission.

Respectfully submitted,

***/s/ Robert S. Berlin***

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## Certificate of Service

I hereby certify that copies of the foregoing have been mailed, hand-delivered, transmitted by facsimile or electronic mail to all counsel of record this 10th day of October 2008.

***/s/ Robert S. Berlin***