Exhibit No.:	______________
Issue:	Insurance Recoveries, etc.
Witness:	Dennis K. Morgan
Type of Exhibit:	Surrebuttal Testimony
Sponsoring Party:	Missouri Gas Energy
Case No.:	GU-2007-0480
Date Testimony Prepared:	July 9, 2008

MISSOURI PUBLIC SERVICE COMMISSION

MISSOURI GAS ENERGY

CASE NO. GU-2007-0480

SURREBUTTAL TESTIMONY

OF

DENNIS K. MORGAN

Jefferson City, Missouri

July 2008

NON-PROPRIETARY

SURREBUTTAL TESTIMONY OF DENNIS K. MORGAN
ON BEHALF OF
MISSOURI GAS ENERGY
GU-2007-0480

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SURREBUTTAL TESTIMONY OF DENNIS K. MORGAN
ON BEHALF OF
MISSOURI GAS ENERGY
GU-2007-0480

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Dennis K. Morgan, and my business address is 5444 Westheimer, Houston, Texas 77056.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am employed by Southern Union Company as Senior Vice President - Litigation.

Q. WHAT ARE YOUR RESPONSIBILITIES AS SENIOR VICE PRESIDENT - LITIGATION?

A. I am responsible for the oversight and direction of litigation or potential litigation in which Southern Union Company and its divisions, subsidiaries and affiliates may become involved.

Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND AND PROFESSIONAL EXPERIENCE.

A. I hold a Bachelor of Journalism and Juris Doctor degrees from the University of Missouri at Columbia and a Master of Laws degree from Washington University in St. Louis. Since 1981, I have served in various legal and managerial roles at Southern Union, including vice president of its exploration and production subsidiary, president of its international subsidiary and general counsel and secretary of the corporation. I have served in my current role since 2004. As chief legal officer of the company from 1991 to 2004, and in my current capacity thereafter, I am familiar with the environmental liability agreement ("ELA") negotiated with Western Resources, Inc., in connection with the acquisition of MGE, as well as the company's insurance recovery program.

Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?

A. I will respond to portions of the rebuttal testimony of Office of the Public Counsel ("OPC") witness Ted Robertson.

Q. ON PAGE 15 OF HIS REBUTTAL TESTIMONY, OPC WITNESS ROBERTSON MENTIONS AN ENVIRONMENTAL LIABILITY AGREEMENT ("ELA") ENTERED INTO BETWEEN SOUTHERN UNION AND WESTERN RESOURCES, INC. ("WRI") (N/K/A "WESTAR"), AS A PART OF THE TRANSACTION PURSUANT TO WHICH SOUTHERN UNION ACQUIRED THE MGE PROPERTIES FROM WRI. ARE YOU FAMILIAR WITH THAT AGREEMENT?

A. Yes.

Q. PLEASE EXPLAIN HOW THE ELA OPERATES.

A. As a general matter, the ELA sets forth a tiered approach to the allocation of cost responsibility as between Southern Union and Westar for environmental matters covered thereunder, as follows:

- The first line of recovery is insurance.

- The second line of recovery is potentially responsible parties.
- The third line of recovery is regulated rates.
- The fourth line of recovery – which applies to costs in excess of the first three lines of recovery – is Southern Union's sole liability amount of $3 million.
- The fifth line of recovery is liability shared between Westar and Southern Union on a 50/50 basis for the cost of matters covered under the ELA which exceed the sum of amounts produced by way of the first four lines of recovery. The total amount to be shared is capped at $15 million and costs incurred after January 31, 2009 are not eligible for sharing.

Q. **ARE THE FORMER MANUFACTURED GAS PLANT ("FMGP") COSTS MGE SEEKS TO DEFER THROUGH THIS APPLICATION COVERED BY THE ELA?**

A. Yes.

Q. **ON PAGE 15 OF HIS REBUTTAL TESTIMONY, OPC WITNESS ROBERTSON INDICATES (AT LINES 7-10) THAT THE BULK OF MGE'S FMGP COSTS INCURRED TO DATE HAVE BEEN RECOVERED FROM OTHER ENTITIES OR BORNE BY SHAREHOLDERS AS OPPOSED TO BEING FUNDED THROUGH REGULATED RATES. DO YOU AGREE?**

A. Yes. Southern Union has for many years been actively engaged in an insurance recovery project on behalf of all affected Southern Union business units, including MGE. Through June 30, 2008, this insurance recovery project has yielded $8,344,733 in recoveries on behalf of the MGE properties. Adding this to the $3 million accrued liability placed on the Company's books upon the closing of Southern Union's acquisition of the MGE properties produces a sum of $11,344,733. Because MGE's FMGP expenditures have only recently, as of June 30, 2008, exceeded this sum, as a practical matter there have been no unrecovered costs to be included in the rate setting process in previous rate cases. In saying this, however, I should also point out that in its two most recent rate cases (Case Nos. GR-2004-0209 and GR-2006-0422), MGE has requested recovery of FMGP costs through regulated rates by way of a mechanism called an Environmental Response Fund. The Commission rejected MGE's request in both of those cases.

Q. PLEASE DESCRIBE THE INSURANCE RECOVERY PROJECT YOU JUST MENTIONED, PARTICULARLY AS IT RELATES TO MGE.

A. The project has been ongoing for many years – since approximately 1988 which is a number of years before MGE was acquired by Southern Union. The first step involves insurance archeology; that is obtaining, investigating and analyzing historical insurance policies that may apply to any of the business units in the Southern Union family of companies. Because the events giving rise to the claims generally occurred many decades ago and are characterized as pollution, the majority of the applicable insurance coverage is pre-1984. Therefore, even determining whether insurance coverage exists may be difficult. The second step is to identify if the insurer still exists and to evaluate its condition and status. The third step is to evaluate the potential environmental conditions that may exist. This involves identifying the possible universe of such environmental conditions and collecting past expenditures on such sites and estimating possible liability exposures regarding those sites. The fourth step is to merge the insurance policy information and the exposure information to be in a position to make a cogent demand on the insurer in order to settle out any potential claims under the polices. The fifth and final step is to attempt to settle what will be treated as a disputed claim under these policies. This process may take the form of direct negotiations with insurer(s) or in many cases it may take the form of submittals through an insolvency process somewhat akin to bankruptcy where all submittals under all policies of the underwriter are evaluated by those responsible for the insolvency process and recoveries are allocated based on factors such as magnitude of the claim, magnitude of past costs versus future potential liability, supporting documentation, limits of the policy, point of attachment of the policy, etc. At the end of the process the insurer may or may not pay any amounts and where payments are made they may be contingent on factors such as the amount of unresolved claims under the policies of the insurer. The entire process is complicated, time consuming and expensive.

Q. WILL SOUTHERN UNION OBTAIN ADDITIONAL INSURANCE RECOVERIES ON BEHALF OF MGE?

A. I do not know. Any further recovery is uncertain.

Q. HAS SOUTHERN UNION PURSUED COST RECOVERY AGAINST ANY POTENTIALLY RESPONSIBLE PARTIES ("PRPs")?

A. Not directly to date. We have focused our efforts primarily on insurance recovery which was an ongoing program when MGE was acquired. Seeking recovery against PRPs often involves protracted litigation particularly regarding sites that are very old and the chain of ownership or control is complex. Nevertheless, in the course of our negotiations with the Port Authority of Kansas City, we made the Port Authority aware of Honeywell, Inc.'s potential liability and Honeywell ultimately made a settlement with the Port Authority. Absent that settlement payment by Honeywell, it is likely that the Port Authority would have demanded a higher settlement payment from Southern Union in those negotiations.

Q. WILL SOUTHERN UNION OBTAIN COST RECOVERY FROM ANY PRPs?

A. I do not know. Assuming we are able to develop the necessary historical information on ownership and operation, any recovery would likely be dependent on the ability of Southern Union to prevail in litigation against such PRPs. Litigation is always uncertain.

Q. HAS SOUTHERN UNION SOUGHT TO RECOVER FMGP COSTS THROUGH REGULATED COST OF SERVICE?

A. Yes, but the Commission has denied cost recovery in MGE's two most recent general rate cases (Case Nos. GR-2004-0209 and GR-2006-0422).

Q. HAS SOUTHERN UNION MADE A CLAIM AGAINST WESTAR UNDER THE ELA?

A. Yes. Please see Schedule DKM-1. Similar to the situation regarding rate recovery of MGE's FMGP costs, because the sum of insurance recoveries obtained by Southern Union on MGE's behalf plus the $3 million accrued liability placed on the Company's books upon Southern Union's acquisition of MGE exceeded MGE's FMGP expenditures until only recently (i.e., June 30, 2008), Southern Union did not have a claim to make under the ELA.

Q. DOES SOUTHERN UNION EXPECT TO MAKE ADDITIONAL CLAIMS AGAINST WESTAR UNDER THE ELA?

A. Yes. FMGP costs that continue to be incurred at MGE's St. Joseph site will be included in claims to be made in the future. In addition, if other costs covered by the ELA are incurred prior to January 31, 2009, they will be included in claims to be made against Westar also.

Q. DO YOU KNOW WHETHER WESTAR WILL PAY THE CLAIMS SOUTHERN UNION MAKES UNDER THE ELA?

A. I do not know.

Q. ON PAGE 33 OF HIS REBUTTAL TESTMONY (LINES 1-8), OPC WITNESS ROBERTSON STATES HIS BELIEF THAT THE PURCHASE PRICE NEGOTIATED BY SOUTHERN UNION FOR ITS ACQUISITION OF THE MGE PROPERTIES WAS LIKELY ADJUSTED DOWNWARD ON ACCOUNT OF THE POTENTIAL MGP LIABILITY ASSOCIATED WITH THE MGE PROPERTIES AND, THEREFORE, THAT EXCLUSION OF MGE'S FMGP COSTS FROM

CUSTOMER RATES (AND DENIAL OF THE AAO REQUESTED HEREIN) WOULD BE FAIR TO (i.e., WOULD NOT PENALIZE) SOUTHERN UNION'S SHAREHOLDERS. DO YOU AGREE?

A. No. There is no evidence supporting Mr. Robertson's contention that the purchase price was reduced on account of potential FMGP liability. First, the full extent of that potential liability – in terms of dollars – is not even known today, almost 15 years after the closing of the transaction. It would have been impossible to quantify any reduction in the purchase price on the basis of non-existent information. Second, as indicated in Mr. Noack's surrebuttal testimony, FMGP costs are routinely included in the regulated cost of service of local distribution companies throughout the country. Consistent with this, Southern Union's assumption when undertaking its acquisition of the MGE properties was that FMGP costs would be recoverable through regulated rates, which is readily apparent by examining the ELA itself. Southern Union has diligently pursued FMGP cost recovery from other sources before seeking to recover these costs through customer rates. Southern Union's successful pursuit of these cost recovery efforts has benefited MGE customers and does not serve as any reasonable basis to deny the Company the ability to defer and recover excess costs (i.e., those above and beyond recoveries) through customer rates.

Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?

A. Yes, at this time.

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

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

AFFIDAVIT OF DENNIS K. MORGAN

STATE OF Texas)
) ss.
COUNTY OF Harris)

Dennis K. Morgan, of lawful age, on his oath states: that he has participated in the preparation of the foregoing Surrebuttal Testimony in question and answer form, to be presented in the above case; that the answers in the foregoing Surrebuttal Testimony were given by him; that he has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of his knowledge and belief.

DENNIS K. MORGAN

Subscribed and sworn to before me this 9th day of July 2008.

Brenda Clayton
Notary Public

My Commission Expires: ____________________

BRENDA CLAYTON
NOTARY PUBLIC, STATE OF TEXAS
MY COMMISSION EXPIRES
OCT. 22, 2008

MISSOURI PUBLIC SERVICE COMMISSION

MISSOURI GAS ENERGY

CASE NO. GU-2007-0480

SURREBUTTAL TESTIMONY OF DENNIS K. MORGAN

Pages 1-2 of 161 are Highly Confidential.

ATTACHMENT A

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of Missouri Gas Energy's Tariffs to	)	
Implement a General Rate Increase for	)	**Case No. GR-2004-0209**
Natural Gas Service	)	Tariff No. YG-2004-0624

REPORT AND ORDER

Issue Date: September 21, 2004

Effective Date: October 2, 2004

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of Missouri Gas Energy's Tariffs to Implement a General Rate Increase for Natural Gas Service	)))	**Case No. GR-2004-0209** Tariff No. YG-2004-0624

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For the Staff of the Missouri Public Service Commission

REGULATORY LAW JUDGE: **Morris L. Woodruff**

REPORT AND ORDER

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Summary

In this report and order, the Commission finds that Missouri Gas Energy, a division of Southern Union Company, is entitled to a rate increase sufficient to generate a revenue increase of approximately $22.5 million.

FINDINGS OF FACT

The Missouri Public Service Commission, having considered all of the competent and substantial evidence upon the whole record, makes the following findings of fact. The

Commission in making this decision has considered the positions and arguments of all of the parties. Failure to specifically address a piece of evidence, position, or argument of any party does not indicate that the Commission has failed to consider relevant evidence, but indicates rather that the omitted material was not dispositive of this decision.

Procedural History

On November 4, 2003, Missouri Gas Energy, a division of Southern Union Company (MGE), filed tariff sheets designed to implement a general rate increase for natural gas service in the amount of $44,875,635. The tariff revisions carried an effective date of December 4.

On November 7, the Commission suspended MGE's tariff until October 2, 2004, the maximum amount of time allowed by the controlling statute.[1] In the same order, the Commission directed that notice of MGE's tariff filing be provided to interested parties and the public. The Commission also established November 26 as the deadline for submission of applications to intervene.

Timely applications to intervene were filed by the City of Kansas City, Missouri; the Midwest Gas Users' Association (Midwest Gas);[2] the University of Missouri-Kansas City (UMKC), Central Missouri State University (CMSU), and Jackson County, Missouri. Those applications to intervene were granted on December 4. Subsequently, the Federal

[1] Section 393.150, RSMo 2000.

[2] The Midwest Gas Users' Association is an unincorporated non-profit association consisting of and representing business concerns and corporations that are substantial users of natural gas.

Executive Agencies[3] were allowed to intervene on February 10, 2004, and the City of Joplin, Missouri, was allowed to intervene on May 3.

On December 9, the Commission established the test year for this case as the 12-month period ending June 30, 2003, updated for known and measurable changes through December 31, 2003. A further true-up period through April 30, 2004, for the purpose of updating certain cost components, was established by Commission order on June 21, 2004. On December 18, 2003, the Commission established a procedural schedule leading to a hearing beginning on June 21, 2004.

The Commission conducted four local public hearings at which the Commission heard comments from MGE's customers and the public regarding MGE's request for a rate increase. Public hearings were held in Joplin on April 27, Blue Springs and Kansas City on April 28, and St. Joseph on April 29.

The parties prefiled direct, rebuttal, and surrebuttal testimony. The evidentiary hearing began on June 21, and continued through July 2. Further true-up direct testimony was prefiled on July 19, and a true-up hearing was conducted on July 23.

The Partial Stipulation and Agreement

On June 29, during the course of the evidentiary hearing, MGE and Staff filed a Nonunanimous Partial Stipulation and Agreement that concerned the issues of Alternative Minimum Tax, Depreciation, Accounting for Net Cost of Removal, Accounting for Pension Expenses, Revenues, Bad Debts, and May 1, 2004 Union Wage Increase issues. This partial stipulation and agreement reflected the agreement of Staff and MGE regarding

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[3] The Federal Executive Agencies include the United States Department of Defense, the United States Department of Energy, and other Federal Executive Agencies, which have offices, facilities or installations in the service territory of MGE and which purchase utility service from MGE.

several issues that would otherwise have been the subject of testimony at the hearing. No party opposed the partial stipulation and agreement. As permitted by its regulations, the Commission treated the unopposed partial stipulation and agreement as a unanimous partial stipulation and agreement. On July 8, the Commission issued an order approving that partial stipulation and agreement as a resolution of the issues addressed in that agreement.

Overview

MGE is a division of Southern Union Company. As a division, MGE has no separate corporate existence apart from Southern Union. MGE's divisional headquarters is located in Kansas City, Missouri, and it provides natural gas service to customers in Kansas City, Joplin, St. Joseph, and other smaller cities in the western half of Missouri. MGE is a local distribution company, sometimes referred to by the acronym LDC. That means that MGE purchases natural gas from a supplier, pays to transport the gas to Missouri over one or more interstate pipelines, and then distributes the natural gas to its customers in this state.

Southern Union is headquartered in Wilkes-Barre, Pennsylvania, and in addition to MGE, has other divisions that operate as LDCs in Pennsylvania and in New England. In addition to its LDC divisions, Southern Union owns Panhandle Eastern Pipeline Company, which is an interstate pipeline company. Unlike its LDC operating divisions, Panhandle Eastern is a subsidiary of Southern Union, rather than a division. That means that Panhandle Eastern has a separate corporate existence, and issues and holds debt in its own name.

As previously indicated, as an LDC, MGE must purchase natural gas from supply sources, transport the gas over an interstate pipeline, and then distribute that gas to its customers. This Commission does not have any authority to regulate the price that MGE must pay to purchase and transport gas over the interstate pipeline. The purchase price of natural gas is set by the market and transportation rates are regulated by the Federal Energy Regulatory Commission (FERC). As a result, this rate case has nothing to do with those aspects of the cost of natural gas.

The price that MGE must pay to purchase and transport natural gas is passed through, dollar for dollar, to its customers through the PGA/ACA process. Therefore, if MGE is to recover its cost of distributing natural gas to its customers, and earn a profit, it must have another source of income. It is those costs, and that source of income, that are at issue in this rate case.

MGE began the rate case process when it filed its tariff on November 4, 2003. In doing so, MGE asserted that it was entitled to increase its rates enough to generate an additional $44,875,635 in general revenues per year. MGE set out its rationale for increasing its rates in the direct testimony that it filed along with its tariff on November 4. In addition to its filed testimony, MGE provided work papers and other detailed information and records to the Staff of the Commission, Public Counsel, and to the intervening parties. Those parties then had the opportunity to review MGE's testimony and records to determine whether the requested rate increase was justified.

Obviously, there are a multitude of matters about which the parties could disagree. Fortunately, there was no disagreement about many matters and, as a result, those potential issues were never brought before the Commission. Where the parties disagreed, they prefiled written testimony for the purpose of raising those issues to the attention of the Commission. All parties were given an opportunity to prefile three rounds of testimony –

direct, rebuttal, and surrebuttal. The process of filing testimony and responding to the testimony filed by other parties revealed areas of agreement that resolved some issues and areas of disagreement that revealed new issues. On June 4, the parties filed a Joint Statement of Issues that listed the issues that they asked the Commission to resolve.

As previously indicated, a number of the identified issues were resolved by the approved partial stipulation and agreement and will not be further addressed in this report and order. The remaining issues will be addressed in turn. The issue description for each issue is taken from the Joint Statement of Issues filed by the parties. Factual matters will be addressed in the Findings of Fact section. If an issue also contains a legal aspect, that portion of the issue will be addressed in the Conclusions of Law section.

The Issues

The rates that MGE will be allowed to charge its customers are based on a determination of the company's revenue requirement. MGE's revenue requirement is calculated by adding the company's operating expenses, its depreciation on plant in rate base, taxes, and its rate of return multiplied by its rate base. The revenue requirement can be expressed as the following formula:[4]

Revenue Requirement = E + D + T + R(V-AD+A)
Where: E = Operating expense requirement
D = Depreciation on plant in rate base
T = Taxes including income tax related to return
R = Return requirement
(V-AD+A) = Rate base
For the rate base calculation:
V = Gross Plant
AD = Accumulated depreciation
A = Other rate base items

[4] Dunn Direct, Ex. 1, Page 11, Lines 5-26.

All parties accept the basic formula. Disagreements arise over the amounts that should be included in the formula.

Rate of Return Issues

The first group of issues concerns the rate of return that MGE will be authorized to earn on its rate base; in other words, the return requirement in the revenue requirement formula just mentioned. Rate base includes things like gas mains in the ground, gas meters, and the trucks driven by MGE's repair crews. In order to determine a rate of return, the Commission must determine MGE's cost of obtaining the capital that it needs. The first step toward doing that requires a determination of the appropriate mix of capital sources that MGE will use to obtain its needed capital. That is called a capital structure and that is the first issue.

1. Capital Structure

Issue Description: *What is the appropriate Capital Structure (i.e., the relative proportions of long-term debt, short-term debt, preferred equity and common equity) to use in calculating MGE's cost of capital?*

Determining an appropriate capital structure for MGE is complicated by the fact that MGE is a division of Southern Union and does not issue its own debt or equity. Therefore, MGE does not have its own capital structure.

As a substitute for its non-existent capital structure, MGE proposes to use the consolidated capital structure of Southern Union Company, as of April 30, 2004. However, MGE proposes to modify the actual consolidated capital structure to remove the impact of

Southern Union's subsidiary, Panhandle Eastern Pipeline Company. MGE's proposed structure is as follows:[5]

Common Equity.	41.10%
Preferred Equity	11.49%
Long-Term Debt	47.41%

Staff and Public Counsel also recommend that the Commission use the actual consolidated capital structure of Southern Union, as of the true-up date, April 30, 2004. But they would not adjust that structure to remove the equity and debt of Panhandle Eastern Pipeline. The specific recommendations of Staff and Public Counsel differ slightly because Public Counsel includes short-term debt in the calculated structure. Staff and MGE do not include short-term debt in their capital structures because Southern Union had no short-term debt as of April 30. Public Counsel includes a 13-month average of short-term debt because Southern Union has used short-term debt in the past and in Public Counsel's view is likely to continue to do so in the future. These are the capital structures recommended by Staff and Public Counsel:

	Public Counsel[6]	**Staff**[7]
Common Stock:	28.37%	29.99%
Preferred Stock	6.06%	6.40%
Long-Term Debt	59.77%	63.61%
Short-Term Debt	5.80%	0.00%

[5] Noack True-up, Ex. 49, Schedule F.

[6] Allen True-up , Ex. 233, Page 2, Lines 2-6.

[7] Murray True-up, Ex. 860, Schedule 1.

It is important to note that the capital structures recommended by Public Counsel and Staff contain a much smaller proportion of common stock than does the structure recommended by MGE. It costs a company more to issue equity than it does to incur debt. Therefore, a capital structure that uses a lot of debt with relatively low levels of equity is less expensive for the company. That means that, all else being equal, a capital structure that includes a low percentage of equity and a large percentage of debt will be less costly, resulting in a lower rate of return, and consequently a lower revenue requirement and lower rates to customers.

However, all else is not equal. Including a high percentage of debt in a capital structure has an effect on the cost of equity. The shareholders in a company – the holders of equity – are subordinate to holders of debt. Generally, the company must pay the interest on debt, such as bonds issued by the company, before it can pay dividends to its shareholders, or before it can invest profits in other ways that benefit shareholders. If a company's income goes down, the risk is borne by the shareholders. Furthermore, if something really goes wrong and the company has to be liquidated, the holders of debt get paid first. The shareholders get only whatever is left over. Therefore, a company with a capital structure that includes a high percentage of debt is more risky for shareholders. The shareholders will consequently demand a higher rate of return to compensate them for the increased risk caused by the high level of debt.

Southern Union's unadjusted consolidated capital structure contains a good deal more debt and less equity than the capital structure of the average LDC. MGE's witness John Dunn indicated that his group of 15 comparable LDCs had an average of 46.6%

equity in their capital structures.[8] Staff's witness David Murray's group of 8 comparable LDCs had an average capital structure containing 49.68%.[9] And Public Counsel witness Travis Allen reported that his group of 8 comparable companies had an average capital structure containing 49.75% equity.[10] That means that, all other things being equal, a shareholder's investment in Southern Union is more risky than an investment in an average LDC.

MGE contends that the use of the consolidated capital structure adjusted to remove the effects of the Panhandle Eastern Pipeline subsidiary is appropriate because that structure most closely approximates the capital structure of Southern Union's natural gas distribution operations, including its MGE division. It does this by removing the equity and debt of the Panhandle Eastern subsidiary from the consolidated capital structure in a manner that it contends is consistent with the requirements of Generally Accepted Accounting Principles (GAAP).

Although Southern Union describes its proposed capital structure as an adjusted actual consolidated capital structure, what it is proposing may more accurately be described as a hypothetical capital structure in that its proposed capital structure clearly does not exist in the real world. Rather, it is the unadjusted consolidated capital structure under which Southern Union actually operates in the marketplace. Southern Union is able to conduct business, finance its operations, and raise capital with an investment grade rating based on that capital structure. When a business analyst such as Moody's or

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[8] Dunn Direct, Ex. 1, Schedule JCD-2.

[9] Murray Direct, Ex. 825, Schedule 22.

[10] Ex. 32.

Standard & Poor's examines Southern Union to assess its credit worthiness, it looks to that unadjusted consolidated capital structure to make its determination.[11]

Furthermore, Southern Union's unadjusted consolidated capital structure, with its heavy reliance on debt, results directly from Southern Union's management decision to become highly leveraged to finance the purchase of Panhandle Eastern, as well as earlier acquisitions. Southern Union decided to take on that additional debt because it saw an opportunity to earn greater returns to the benefit of its shareholders. That decision is clearly within Southern Union's management prerogative and the Commission does not wish to criticize or punish Southern Union for that decision. However, Southern Union must operate with the results of its investment decisions and one result of those investment decisions is a capital structure that includes a large amount of debt and relatively low amounts of equity.

Southern Union argues that in a 1993 rate case, involving St. Joseph Light & Power Company, the Commission found that the use of a hypothetical capital structure was appropriate when the utility's actual capital structure fell outside of a "zone of reasonableness."[12] While that was the finding of the Commission in that case, an examination of the entire report and order reveals that St. Joseph Light & Power's actual capital structure was nearly a mirror image of Southern Union's consolidated capital structure. While Southern Union carries a large percentage of debt, St. Joseph Light & Power had an inordinate amount of equity in its capital structure.[13] That meant that

[11] Transcript Page 191, Lines 19-22, and Page 203, Lines 23-25.

[12] In Re: St. Joseph Light & Power, 2 Mo. P.S.C. 3d 248, 253 (1993)

[13] In Re: St Joseph Light & Power, 2 Mo. P.S.C. 3d 248, 250 (1993). SJL&P's actual capital structure contained approximately 58% equity and 40% debt.

St. Joseph Light & Power's capital structure, because it included an excessive amount of high cost equity, was unreasonably expensive for ratepayers. The Commission, therefore, adopted a hypothetical capital structure to protect ratepayers from a management decision, not to protect management from the consequences of its own decisions.

Having determined that the actual consolidated capital structure of Southern Union is the appropriate capital structure to use, the Commission now must decide whether the structure proposed by Staff, or that proposed by Public Counsel is more appropriate. The difference between the two structures results from Public Counsel's decision to include short-term debt in the capital structure. The evidence indicates that Southern Union has used substantial amounts of short-term debt in the past. However, most of that debt was used to finance temporary working capital needs and has been repaid or refinanced as long-term debt. As of the true-up date, April 30, 2004, Southern Union had no short-term debt.[14] Since the Commission has determined that it should use the actual capital structure of Southern Union, and that actual capital structure has no short-term debt as of the true-up date, the Commission finds that short-term debt should not be included in the capital structure. Therefore, the capital structure that shall be used for the purpose of calculating rate of return in this case is as follows:

Common Stock:	29.99%
Preferred Stock	6.40%
Long-Term Debt	63.61%

Once an appropriate capital structure is established, the cost of the various types of capital – common equity, preferred equity, long-term debt, and short-term debt – are

[14] Dunn Rebuttal, Ex. 2, Page 27, Lines 5-17.

multiplied by the percentage of their prevalence in the chosen capital structure to arrive at the weighted cost of capital. But before that can be done, the cost of each of the types of capital must be determined. That task is encompassed by the next three issues.

2. Embedded Cost of Long-Term Debt

Issue Description: *What is the appropriate cost of long-term debt in calculating MGE's cost of capital?*

The cost of long-term debt is determined simply by reviewing the interest rates specified in the debt issued by Southern Union. The only issue between the parties concerns which debt should be included in the calculations. MGE and Public Counsel agree that the long-term debt to be counted is the debt of Southern Union excluding the long-term debt associated with Southern Union's Panhandle Eastern subsidiary. Based on that assumption, MGE set the cost of long-term debt, as of April 30, 2004, at 7.4342%.[15] Public Counsel used a cost of long-term debt of 7.397%.[16] The slight difference was attributed to rounding differences in the calculations. Staff, however, includes the debt issued by Panhandle Eastern when calculating Southern Union's cost of long-term debt. As a result, Staff recommends use of a cost of long-term debt of 6.151%.[17]

Panhandle Eastern's debt is the debt of a subsidiary company and is not the debt of Southern Union. That debt was raised by Panhandle Eastern for its own purposes and is rated separately by the rating agencies.[18] Furthermore, that debt is non-recourse to Southern Union. That means that the debt restricts the assets that the debt holders can

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[15] Noack, True-Up Direct, Ex. 49, Schedule F1.

[16] Allen, True-Up Direct, Ex. 233, Schedule TA-3.

[17] Murray True-Up Direct, Ex. 860, Schedule 2.

[18] Dunn Rebuttal, Ex. 2, Page 25, Lines 11-15.

use to satisfy the debt. In other words, if Panhandle Eastern were to default on its debt, the debt holders would not be able to seize the assets of Southern Union to collect the debt.[19] In addition, a stipulation and agreement entered into by Southern Union, Staff, Public Counsel, and other parties in Case No. GM-2003-0238 – the case in which this Commission approved Southern Union's acquisition of Panhandle Eastern – provides that MGE is to be insulated from the impact of the acquisition of Panhandle Eastern.[20] For all these reasons, the Commission finds that the cost of long-term debt of Panhandle Eastern is properly excluded from the calculation of Southern Union's cost of long-term debt.

Since the differences between the cost of long-term debt as calculated by MGE and Public Counsel is simply based on rounding differences, the Commission will split the difference between the two percentages and use 7.4155% as the cost of long-term debt.

3. Return on Equity

Issue Description: *What is the appropriate return on equity in calculating MGE's cost of capital?*

Determining an appropriate return on equity is without a doubt the most difficult part of determining a rate of return. The cost of long-term debt and the cost of preferred stock are relatively easy to determine because their rate of return is specified within the instruments that create them. In contrast, determining a return on equity requires speculation about the desires and requirements of investors when they choose to invest their money in Southern Union rather than in some other investment opportunity. As a result, the Commission cannot simply find a rate of return on equity that is unassailably

[19] Allen Rebuttal, Ex. 201, Page 23, Lines 9-19.

[20] Dunn Rebuttal, Ex. 2, Page 23, Lines 18-26.

scientifically, mathematically, or legally correct. Such a "correct" rate does not exist. Instead, the Commission must use its judgment to establish a rate of return on equity that will be attractive enough to investors to allow the utility to fairly compete for the investors' dollar in the capital market, without permitting an excessive rate of return on equity that would drive up rates for MGE's ratepayers. In order to obtain guidance about that rate of return on equity is appropriate, the Commission must turn to the expert advice offered by financial analysts.

Three financial analysts offered recommendations regarding an appropriate return on equity in this case. MGE's witness John Dunn utilized a discounted cash flow (DCF) model to arrive at an initial return on equity estimate of 10.9% to 11.9%. Dunn then argued that the return on equity should be further increased to compensate for risks that are unique to MGE. Specifically, Dunn argued that MGE faces more risk because it is smaller than the average company in his proxy group; because its depreciation rates are substantially lower than those authorized for comparable companies; and because it faces greater regulatory risk because it operates in Missouri. Because of these extra risks, Dunn recommended a return on equity of approximately 12%.[21] Staff's witness David Murray primarily relying on a DCF model, arrived at a recommended a return on equity in the range of 8.52% to 9.52%, with a midpoint of 9.02%.[22] Public Counsel's witness Travis Allen also relying primarily on a DCF model, recommended that MGE be allowed a return on equity of between 9.01% and 9.34%.[23]

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[21] Dunn Direct, Ex. 1, Page 60, Lines 19-20.

[22] Murray Direct, Ex. 825, Page 33, Lines 3-4.

[23] Allen Direct, Ex. 200, Page 16, Lines 10-11.

Obviously, despite the fact that all three experts are relying on essentially similar DCF models, there is a very wide range in recommended return on equity between MGE's witness and those of Staff and Public Counsel. However, there is one more number that the Commission must consider in establishing an appropriate return on equity. In a survey of regulatory decisions from around the country, as reported by Regulatory Research Associates, the average allowed return in the gas utility industry for 2002 and 2003 was 11%. For the first quarter of 2004, the average return on equity reported was 11.1%.[24] That is the market in which Southern Union will be seeking to raise capital.

Not surprisingly, the low rates of return on equity espoused by the witnesses for Staff and Public Counsel led MGE to aggressively challenge the credibility of Murray and Allen. MGE engaged the services of Dr. Roger Morin to challenge the recommendation of Murray. Dr. Morin is a Professor of Finance for Regulated Industry at the Center for the Study of Regulated Industry at Georgia State University. He has a Ph.D. in Finance and Econometrics at the Wharton School of Finance, University of Pennsylvania. Dr. Morin wrote the textbook, Regulatory Finance,[25] upon which the other witnesses rely in their own testimony. Dr. Morin's rebuttal testimony cites 15 specific criticisms of the methods Murray used to arrive at his recommendation and concludes that "Mr. Murray employs inappropriate and stale model inputs throughout his analysis, which causes him to recommend returns that are well below investors' required returns."[26] Dr. Morin did not, however, offer his own recommendation regarding an appropriate return on equity.

[24] Morin Rebuttal, Ex. 5, Page 10, Lines 6-11.

[25] Roger A. Morin, Regulatory Finance (1994).

[26] Morin Rebuttal, Ex. 5, Page 5, Lines 1-4.

MGE did not engage Dr. Morin to challenge the recommendation of Public Counsel's witness Travis Allen. Instead, MGE attacked Allen's credibility based on his lack of experience regarding regulated utilities. Allen has a master of science degree in Business Economic and Finance with a specialization in Finance from Southern Illinois University – Edwardsville. However, his current position with Public Counsel is his first professional position after he earned his master's degree. He did not have any professional experience dealing with regulated utility finance before he began working for Public Counsel, and he filed his direct testimony in this case only two weeks after he started working for Public Counsel.[27] In response to MGE's criticism of Allen, Public Counsel engaged the services of John Tuck, a former Public Counsel employee and currently Senior Investment Officer for the Public School and Non-Teacher School Employee Retirement Systems of Missouri,[28] to offer surrebuttal testimony to bolster the recommendation offered by Allen.

Whatever other credibility questions may be raised against the positions offered by Staff and Public Counsel, the fact is their recommendations are nearly 200 basis points lower than the national average return on equity. The Commission does not believe that it would be appropriate for its return on equity finding to unthinkingly mirror the national average. Obviously, if all commissions took that approach returns on equity would never change, despite changing economic facts, leading to unjust results. However, the national average is a good indicator of the capital market in which Southern Union will have to compete for the equity needed to finance MGE's operations. The Commission has an obligation under the law and well as a matter of practical necessity, to allow Southern

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[27] Transcript, Page 332, Lines 1-10.

[28] Tuck Surrebuttal, Ex. 203, Page 1, Lines 7-8.

Union an opportunity to earn a return that will allow it to compete in the capital market. No one, including ratepayers, benefits if MGE is starved for capital.

As indicated, the national average for return on equity is approximately 11%. Dunn's return on equity recommendation on behalf of MGE was 12%. The Commission will take that to mean that MGE believes a variation of 100 basis point above the national average would be appropriate. A variation of 100 basis points below the national average should also be appropriate. That means that the lowest reasonable return on equity would be 10%. The Commission will adjust that amount upward by 50 basis points to recognize that Southern Union's equity is more risky than that of the average gas company due to its debt heavy capital structure. The 50 basis point adjustment is based on the current spread between the average A bond rating for the comparable companies used in Murray's DCF analysis and Southern Union's BBB bond rating. That adjustment is described by MGE's witness, Dr. Morin, in his rebuttal testimony as a correction to the 32 basis point adjustment made by Murray.[29] After making that adjustment, the Commission arrives at a return on equity of 10.5%.

A return on equity of 10.5% is supported by the evidence presented in this case. First, Dunn's DCF analysis, if adjusted appropriately, will yield a number in the range of 10.5%. Dunn testified that his initial DCF analysis showed that a return in the range of 10.9% to 11.9% would be appropriate for his comparable companies.[30] He then increased his recommended return on equity to 12% to take into account what he asserted were additional risks associated with MGE beyond the risk associated with his comparable

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[29] Morin Rebuttal, Ex. 5, Page 8-9, Lines 18-23, 1-2.

[30] Dunn Direct, Ex. 1, Page 51, Lines 8-11.

companies. The additional risks cited by Dunn are that MGE is smaller than the comparable companies, it experiences greater regulatory risk because it operates in Missouri, and its earnings are more volatile than those of his comparable group of companies.

None of those additional risks would justify Dunn's increase in his recommended return on equity. None of these risk factors are unique to MGE and they do not justify a deviation from the rate of return that would be established by an examination of the comparable companies. The comparable companies might have other factors that would increase their risk that do not apply to MGE. That is why comparable companies are chosen as a proxy for making that sort of detailed comparison of risk between companies. Furthermore, Dunn's contention that MGE should receive a higher return on equity because it is regulated by the Missouri Commission is undercut by Dr. Morin's testimony that the Missouri Commission is perceived by the investment community as an "average, fair, reasonable, supportive" commission.[31]

If Dunn's upward adjustment is not made, his testimony indicates that a return on equity in the range of 10.9% to 11.9% would be fair and reasonable. 10.9% is at the bottom of that range, but it is still fair and reasonable. Dunn's recommended return on equity should be further adjusted by removing flotation costs, which he includes in his DCF study.

Flotation costs are related to the direct and indirect costs associated with the issuance of new equity. The direct costs are the costs associated with issuing and

[31] Transcript, Page 1707, Lines 2-5.

marketing the stock. The indirect costs represent the downward pressure on the stock price as a result of the increased supply of stock from the new issue. Dunn makes an upward adjustment in his calculations to include such flotation costs.

Flotation costs should not be recovered from ratepayers in this case because the issuance of equity planned, and announced by MGE, for which flotation costs would be incurred, results directly from MGE's need to increase its equity as a result of the acquisition of Panhandle Eastern Pipeline. Thus the inclusion of flotation costs would violate the stipulation and agreement by which the acquisition of Panhandle was approved. That stipulation and agreement provides:

> Southern Union will not recommend an increase or claim Staff should make an adjustment to increase the cost of capital for MGE as a result of the Transaction. Any increases in cost of capital Southern Union seeks for MGE will be supported by documented proof: (1) that the increases are a result of factors not associated with the Transactions; (2) that the increases are not a result of changes in business, market, economic or other conditions for MGE caused by the Transaction; or (3) that the increases are not a result of changes in the risk profile of MGE caused by the Transaction.[32]

MGE's own witness testified that the sale of equity for which MGE is seeking to include flotation costs is required to maintain Southern Union's bond rating.[33] If Southern Union had not taken on approximately $1.2 billion in additional debt in the acquisition of Panhandle Eastern, a stock offering would not likely have been necessary to preserve the company's bond rating.[34] Therefore, the flotation cost would be an increased cost of capital relating to the Transaction that could not be passed on to ratepayers by the terms of the stipulation and agreement. Dr. Morin, MGE's witness, agreed that it would not be

[32] Tuck Surrebuttal, Ex. 203, Page 45, Lines 9-15.

[33] Dunn Rebuttal, Ex. 2, Page 41, Lines 3-5.

[34] Tuck Surrebuttal, Ex. 203, Page 45, Lines 16-17.

appropriate for MGE to recover flotation costs for Southern Union's acquisition related equity.[35]

MGE proposed to increase Murray's return on equity by 30 basis points to add flotation costs.[36] Since flotation costs are not appropriate in this case, Dunn's return on equity could be reduced by 30 basis points to remove flotation costs. Removing 30 basis points from the low end of Dunn's recommendation leaves a return on equity of 10.6%. That is consistent with the 10.5% return on equity found to be appropriate by the Commission.

A return on equity of 10.5% is also supported by part of the analysis of Public Counsel's witness Travis Allen. Allen performed a Capital Asset Pricing Model (CAPM) analysis using 30-year treasury bonds as the risk-free rate – the risk-free rate endorsed by Dr. Morin[37] – that resulted in a return on equity of 10.27%.[38] That is in the vicinity of the 10.5%. Similarly, if the corrections to Murray's DCF analysis proposed by Dr. Morin are made, the result is a return on equity of between 10.4% and 11.4%.[39]

The Commission finds that 10.5% is a fair and reasonable return on equity for MGE that will allow Southern Union an opportunity to compete in the capital market for the funds needed to keep MGE healthy.

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[35] Transcript, Page 1688-1689, Lines 25, 1-8.

[36] Morin Rebuttal, Ex. 5, Page 11, Lines 12-14.

[37] Transcript, Page 1721, Lines 17-25.

[38] Allen Direct, Ex. 200, Schedule TA-9.

[39] Morin Rebuttal, Ex. 5, Page 41, Lines 20-23.

4. Cost of Preferred Stock

Issue Description: *What is the appropriate cost of MGE's preferred stock in calculating MGE's cost of capital?*

There was no disagreement about this issue. Staff, Public Counsel, and MGE agree that the appropriate cost of preferred stock as of April 30, 2004, is 7.758%. Therefore, the Commission finds that the cost of preferred stock is 7.758%.

5. Rate of Return Adder

Issue Description: *Should MGE be granted an additional 25 basis points of rate of return on account of its level of management efficiency?*

MGE asks the Commission to add 25 basis points to MGE's authorized rate of return in recognition of its high management efficiency. Thus if the Commission were to determine that the appropriate rate of return was 8%, MGE asks that the Commission authorize a rate of return of 8.25%.

MGE claims that such an adder is appropriate because MGE is currently operating very efficiently and should be rewarded for its efforts. In particular, MGE contends that it is providing good customer service and that its operating and maintenance expenses are low when compared to other Missouri local distribution companies. MGE points out that the Commission made such an upward adjustment for management efficiency in at least two rate cases in the early 1980s[40] and that in MGE's last two litigated rate cases, the Commission made a downward adjustment to MGE's allowed return because of customer

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[40] In Re: Empire District Electric, 26 Mo. P.S.C. (N.S.) 58 (1983) and In Re: Kansas City Power & Light Company, 26 Mo. P.S.C. (N.S.) 104 (1983).

service problems.[41] MGE asks that the Commission recognize MGE's improved efficiency by bumping up its rate of return in this case.

MGE is correct that for a period in the early 1980s, the Commission had a policy of explicitly adjusting rates of return for the perceived efficiency or inefficiency of the utility. That policy actually began in a 1982 rate case for Missouri Public Service Company.[42] In that case the Commission was quite concerned about the company's failure to deal with a problem of unaccounted-for-water being lost from its water system. As a result, the Commission reduced the rate of return on the company's water rate base by a full percentage point.[43] A year later, in the cases cited by MGE, the Commission explicitly rewarded the affected utilities for management efficiency. Empire District Electric and Kansas City Power & Light Company were rewarded with a .4% increase to their return on equity.[44]

By 1986, however, the Commission had rejected that approach. In a Kansas City Power & Light rate case,[45] the Commission held as follows:

> In the Company's last rate case ... the Commission awarded the Company a 40 basis point upward adjustment to its return on common equity for its efforts in improving management efficiency. ... The Commission has reevaluated its prior order and determined it is not necessary nor appropriate to upwardly adjust the return on equity which has been found to be reasonable 'to encourage the provision of energy on the most efficient and

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[41] In Re: Missouri Gas Energy, 5 Mo.P.S.C. 3d 437 (1997) and In Re: Missouri Gas Energy, 7 Mo.P.S.C. 3d 394 (1998).

[42] In Re: Missouri Public Service Company, 25 Mo.P.S.C (N.S.) 136 (1982).

[43] In Re: Missouri Public Service Company, 25 Mo.P.S.C. (N.S.) 136, 177-180 (1982).

[44] In Re: Empire District Electric, 26 Mo. P.S.C. (N.S.) 58, 70 (1983), In Re: Kansas City Power & Light Company, 26 Mo. P.S.C. (N.S.) 104, 150 (1983).

[45] In Re: Kansas City Power & Light Company, 28 Mo.P.S.C. (N.S.) 228 (1986).

> economical basis possible.' Adequate encouragement is given through the recovery of all prudently incurred costs.[46]

The Commission again addressed the question of adjusting return based on management efficiency in a 1989 case, where the Commission explained that it was rejecting Staff's suggestion to set a company's rate of return at the low end of Staff's recommended range for alleged management inefficiency:

> The Commission has determined that it is not appropriate to adjust the rate of return SWB will be authorized to earn for management decisions. Now the Commission has determined that where it has made adjustments to ROE in other cases, these types of adjustments can rarely be supported by sufficient evidence to warrant such a decision. The difficulty of deciding how much value a certain management decision has in terms of ROE makes the determination almost impossible. The evidence in this case provides no real guide to the Commission on how to value the various allegations of inefficient management. The more appropriate method for making adjustments to a public utility's revenue requirement is where specific dollar adjustments can be addressed, not by adjusting the ROE.[47]

Clearly, the Commission has moved away from the idea of adjusting a company's rate of return for perceived management efficiency or inefficiency.

MGE correctly points out that in MGE's last two litigated rate cases the Commission cited MGE's failure to provide quality customer service as the basis for allowing the company a lower rate of return than it might have otherwise received. In the 1997 case, the Commission set the authorized rate of return on equity at 11.3%, which was the low end of Staff's recommendation, because of a great increase in the number of customer complaints after Southern Union bought the MGE system in 1994. In comparison, MGE's expert witness in that case recommended a return on equity in the range of 11.5% to

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[46] In Re: Kansas City Power & Light Company, 28 Mo.P.S.C. (N.S.) 228, 247 (1986).

[47] Staff v. Southwestern Bell Telephone Company, 29 Mo.P.S.C. (N.S.) 607, 654 (1989).

12.5%. Public Counsel's expert recommended a return on equity of 10.75%.[48] Similarly, in the 1998 case, the Commission set the authorized rate of return on equity at 10.93%, which was the midpoint of the range recommended by Staff. In doing, so the Commission again cited MGE's continuing customer service problems as one reason, among several others, for accepting Staff's recommended return on equity. MGE's expert had recommended a return on equity of 12%, with Public Counsel recommending 10.7%.[49]

In those cases, the Commission appropriately took into consideration the quality of service provided by MGE in determining a just and reasonable rate of return for the company. In both cases the allowed rate of return was within the range supported by the testimony of financial experts. The Commission did not determine a just and reasonable rate of return and then reduce that rate to punish MGE. In sum, the Commission did not, by citing the poor customer service record of MGE, return to the practice of using adjustments to the rate of return to reward or punish utilities for efficient or inefficient management practice.

As the Commission found in 1986, and as was demonstrated in this case, a rate of return adder is inappropriate in concept and unworkable in practice. Conceptually, the Commission must determine a just and reasonable rate of return for the utility that it regulates. To then tack an additional percentage to the rate as a reward for efficiency means that the company would be receiving a rate of return that is higher than the just and reasonable rate. In essence, the Commission would be making a gift to the company from the ratepayer's pocket. Obviously, that is not acceptable.

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[48] In Re: Missouri Gas Energy, 5 Mo.P.S.C. 3d 437, 467-468 (1997).

[49] In Re: Missouri Gas Energy, 7 Mo.P.S.C 3d. 394, 401-404 (1998).

As a practical matter, an adder is nearly impossible to support by any objective evidence. As was demonstrated in this case, there is really no way to determine with any degree of certainty that one company is more efficient than another. MGE attempted to do so by comparing its annual operating and maintenance expense to that of other Missouri gas companies.[50] However, as Staff pointed out, operating and maintenance expenses are subject to many variables and are not a good basis for determining management efficiency.[51] Although none of the evidence presented actually demonstrates that MGE is any more or less efficient than other gas companies, there was a lot of evidence filed on that question and its presentation took up a good deal of hearing time. The Commission does not wish to encourage a flood of indeterminate and ultimately pointless testimony on the question of management efficiency in future rate cases.

The Commission finds that a rate of return adder is not appropriate and will not be ordered in this case.

Operating Expense Issues

A second group of issues concerns the expenses that MGE incurred during the test year and will likely incur in the future. MGE asks to recover these expenses from its customers through the rates that will be established in this case.

6. Capacity Release/Off System Sales

Issue Description: *What, if any, is the appropriate level of capacity release/off-system sales revenues to be used in calculating MGE's cost of service? As an alternative to including capacity release/off-system sales revenues in the calculation of MGE's revenue*

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[50] Noack Direct, Ex. 8, Page 24, Lines 14-18, and Schedule G-1.

[51] Oligschlaeger Rebuttal, Ex. 829, Pages 3-4, Lines 22-23, 1-5.

requirement, should the PGA-based revenue sharing mechanism proposed by MGE be adopted?[52]

As an LDC, MGE must purchase enough pipeline capacity from an interstate pipeline company to meet its customers' anticipated demand for natural gas. Pipeline capacity is essentially the space on the pipeline required to move the amount of gas that MGE will need to supply its customers. MGE recovers the cost of purchasing that pipeline capacity from its customers through the PGA (Purchased Gas Adjustment) mechanism. Pipeline capacity is generally purchased using long-term contracts based on peak capacity needs. Sometimes not all of the pipeline capacity is needed and MGE can sell the unused capacity to a third-party that might need to transport gas on that pipeline at that time for its own purposes.[53] MGE is able to obtain some revenue each year from these sales.

MGE's current rates are based on the assumption that MGE will earn $1.2 million per year in capacity release revenue.[54] That amount was included as an offset in MGE's revenue requirement for purposes of calculating its rates. In other words, MGE's rates were set based on an assumption that it would earn $1.2 million per year from capacity release sales. If the company earned more than $1.2 million, it was able to keep the extra income. But, if it earned less than $1.2 million, MGE would have a revenue shortfall. As a result, the company has an incentive to maximize its capacity release sales, to the benefit

[52] Although the issue refers to both capacity release and off-system sales, the dispute between the parties concerns only capacity release revenues.

[53] Hayes Rebuttal, Ex. 17, Page 7, Lines 8-12.

[54] Busch Direct, Ex. 211, Page 6, Lines 1-10.

of both the company and its ratepayers. Because it has an incentive to maximize capacity release sales, MGE aggressively markets its available capacity to potential buyers.[55]

Based on a past three-year average of MGE's capacity release earnings, Staff recommends that the Commission include $1,340,400 per year for capacity release revenue in MGE's revenue requirement for this case.[56] Public Counsel also analyzed the last three years of earnings and recommends that the Commission include $1,500,000 per year for capacity release revenue.[57]

MGE argues that the past is not a good guide to predict future capacity release revenue because a new pipeline is about to go into operation, which may drastically reduce the revenue MGE is able to achieve from capacity release sales. Much of MGE's current capacity release revenue is derived from sales on the Kinder Morgan Pony Express Pipeline.[58] The Cheyenne Plains Pipeline is scheduled to begin operations in January 2005, in competition with Kinder Morgan. Since Cheyenne Plains is larger than Kinder Morgan, and since its rates are expected to be lower, MGE is concerned that Cheyenne Plains may reduce or eliminate the market for release of MGE's capacity on Kinder Morgan.[59] If that happens, MGE would not be able to earn the anticipated revenues that have been included in its rates and, as a result, would suffer a revenue shortfall.

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[55] Transcript Pages 1474-1475, Lines 8-25, 1-8.

[56] Allee Direct, Ex. 800, Page 5, Lines 5-17.

[57] Busch Direct, Ex. 211, Page 9, Line 14. Public Counsel refers to this number as highly confidential but during the hearing – transcript page 1570, lines 18-20 – MGE indicated that total dollars of sales per month or year are not confidential.

[58] Transcript Page 1543, Lines 10-17.

[59] Hayes Rebuttal, Ex. 17, Page 9, Lines 4-18.

To avoid such a revenue shortfall, MGE proposes that capacity release revenue be included in the PGA mechanism. That way MGE would avoid any risk of revenue shortfall. In order to retain an incentive to maximize capacity release revenue, MGE asks that the Commission establish a sharing grid to allow MGE to retain a portion of each dollar earned through the sale of capacity release.

MGE requests that the Commission include the following language in its order to allow MGE to implement a capacity-release-sharing-grid in its PGA:

> MGE shall be authorized to implement, through its PGA mechanism, a revenue sharing grid pursuant to which revenues generated by capacity release and off-system sales (net of revenues from off-system sales made for "system protection" purposes) shall be shared between MGE and its customers as follows:
>
> First \$300,000 – 15% to MGE and 85% to customers
> Second \$300,000 – 20% to MGE and 80% to customers
> Third \$300,000 – 25% to MGE and 75% to customers
> Above \$900,000 – 30% to MGE and 70% to customers.
>
> Any excess capacity disallowance resulting from an actual cost adjustment ("ACA") proceeding shall be offset by capacity release revenues before application of the above sharing grid and before any shareholder funding may be required.[60]

Staff and Public Counsel argue that the capacity release revenue should remain in base rates. They contend that MGE has failed to present sufficient evidence to justify a conclusion that MGE will be unable to match its past capacity release revenue in coming years. They discount as mere speculation the suggestion that the new Cheyenne Plains pipeline will decrease MGE's revenues.

[60] Noack Corrected Rebuttal, Ex. 10, Page 28-29, Lines 16-22, 1-13.

The Commission agrees with MGE that the capacity release revenue should be considered as part of the PGA rather than as an offset to revenue requirement. Staff's witness Anne Allee conceded at the hearing that the Cheyenne Plains pipeline will be going into service in competition with Kinder Morgan.[61] When the new pipeline goes into service, the demand for release of MGE's capacity on the Kinder Morgan pipeline is likely to decrease, along with the price that MGE can demand for the release of that capacity. It is a basic economic principle that when supply increases, prices in the market are likely to decline. The upcoming changes in the market make MGE's historical level of capacity release revenue an unreliable indicator of the amount of revenue that MGE can reasonably be expected to earn in the future.

Since the past is not a reliable indicator of future revenue, any amount of capacity release revenue that the Commission could ascribe to MGE's revenue requirement would be based on unsupported speculation. The inclusion of any speculative amount in revenue requirement would be unfair to MGE if it was set too high and MGE was unable to earn the designated amount. Similarly, if the amount is set too low and MGE's revenues do not decrease as much as feared, MGE's customers would be unfairly deprived of revenue while MGE collected a windfall.

Placing the capacity release revenue into the PGA is a logical and convenient solution to this problem. Those revenues have been handled through MGE's PGA process in the past; only in the last three years have they been placed in the company's revenue requirement.[62] Capacity release revenues are directly related to pipeline transportation

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[61] Transcript, Pages 1554-1556.

[62] Transcript, Page1548, Lines 8-21.

costs, which are a normal component of the PGA process.[63] Furthermore, other LDCs in Missouri already handle their capacity release revenue through their PGA processes.[64]

If the Commission disagrees with their proposals to include capacity release revenue as an offset to MGE's revenue requirement, Staff and Public Counsel are willing to accept the movement of the capacity release revenue into the PGA. However, they oppose the inclusion of any sharing grid in the PGA. Staff and Public Counsel contend that a sharing grid in the PGA would allow MGE to benefit from every dollar of capacity release while shouldering no risk. Since the ratepayers have already paid for the capacity that is being sold, Staff and Public Counsel believe that it would be unfair to allow MGE to benefit from those sales.[65]

Although MGE's ratepayers have undeniably paid for the capacity that is being released, sales of capacity do not just happen. Those sales occur because MGE's employees aggressively market the available pipeline capacity. Under the current system, MGE has a strong incentive to maximize sales of available capacity. If it does not, it faces either a revenue shortfall, or it foregoes income that it can keep. If capacity release income is placed in the PGA mechanism without any sort of sharing mechanism, then MGE is essentially told to do that work for free. As a result, it loses much of its incentive to maximize those sales.

It is easy to say that ratepayers pay the salary of MGE's employees and that ratepayers should expect aggressive marketing of that capacity even if the company cannot

[63] Transcript, Page 1549, Lines 18-24.

[64] Transcript, Page 1559, Lines 9-13.

[65] Allee Surrebuttal, Ex. 802, Page 4, Lines 18-19.

benefit from those sales. However, it is unrealistic to believe that MGE will put as much effort into marketing available capacity if it can achieve no benefit from doing so. Yes, the Commission has a stick that it can wield over MGE to encourage it to aggressively market its available capacity: it can adjust MGE's PGA recovery if it finds that the company has not sufficiently marketed its available capacity. However, that would entail the difficult task of proving how much revenue MGE could have obtained if it had tried harder to market available capacity. The Commission does not wish to undertake that daunting task when a simple incentive mechanism is sufficient to ensure that MGE markets available pipeline capacity as aggressively as possible, to the benefit of both ratepayers and the company's shareholders.

MGE's proposed capacity release tariff language also provides that:

> Any excess capacity disallowance resulting from an actual cost adjustment ('ACA') proceeding shall be offset by capacity release revenues before application of the above sharing grid and before any shareholder funding may be required.[66]

Staff contends that this language is a backdoor attempt by MGE to avoid the effect of a PGA adjustment proposed by Staff in another case, in which Staff alleges that MGE has purchased excess capacity beyond what it would need to meet even peak day demands.[67]

The Commission agrees with Staff. The provision that would mandate the offset of a capacity disallowance against capacity release revenue is inappropriate. The capacity disallowance that this provision would affect is unrelated to capacity release revenue. If such a disallowance were required by the Commission, it would be because MGE had

[66] Noack Corrected Rebuttal, Ex. 10, Page 29, Lines 9-11.

[67] Allee Surrebuttal, Ex. 802, Page 7, Lines 8-15.

failed to properly plan for its peak day gas needs and had purchased more capacity than it would ever reasonably expect to need. In that circumstance, MGE's shareholders should be expected to pay for the cost of that imprudence without passing that cost off to the ratepayers through an offset of revenues obtained from revenue release sales.

The Commission will approve MGE's proposal to implement a revenue sharing grid through the PGA. It will, however, reject that portion of MGE's proposal that would offset any excess capacity disallowance against capacity release revenues.

7. Environmental Response Fund

Issue Description: *Should the environmental response fund proposed by MGE be adopted and what, if any, level of environmental costs should be used in calculating MGE's cost of service?*

MGE will, in the future, incur an unknown, and unknowable, amount of financial liability for the cleanup of environmental hazards left over from the operation of manufactured gas facilities 50 to 100 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. A toxic tar was left over from this process and was frequently dumped on-site at the manufactured gas plant.[68]

Manufactured gas plants were located in various cities in MGE's service territory and the leftover toxic tar is now causing environmental problems requiring that it be

[68] Noack Surrebuttal, Ex. 11, Schedule MRN-3.

cleaned up. Federal law, specifically the Comprehensive Environmental Compensation and Liability Act (CERCLA), also known as Superfund, imposes strict, joint and several liability on present or former owners or operators of facilities where hazardous wastes were released into the environment.[69] MGE owns six sites in Missouri for which it may be required to pay cleanup costs under CERCLA. There are fourteen additional sites that MGE does not now own but for which it may face liability.[70]

Since it purchased the gas system that is now operated by MGE in 1994, Southern Union has expended approximately $9.3 million in cleanup costs related to manufactured gas plants in Missouri.[71] However, Southern Union has been able to obtain reimbursement for these costs from other sources, including from insurance policies that were purchased many years ago by The Gas Service Company, a previous operator of the natural gas distribution system now operated by MGE.

In addition, when Southern Union purchased the system now operated by MGE, it entered into an Environmental Liability Agreement with the previous owner, Western Resources, Inc. by which the buyer and seller agreed to share liability for environmental cleanup costs for which reimbursement could not be obtained from insurance, or other third parties.[72] That agreement provides that Southern Union would be solely responsible for the first $3 million in unreimbursed costs and that the companies would equally share liability for additional unreimbursed costs up to $15 million until 2009.

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[69] Bolin Direct, Ex. 204, Pages 9-10, Lines 19-22, 1-12.

[70] The list of sites for which MGE may be responsible is highly confidential but may be found at Bolin Direct, Ex. 204HC, Schedule KKB-2.

[71] Noack Surrebuttal, Ex. 11, Page 9, Lines 9-11.

[72] A copy of the Environmental Agreement may be found at Bolin Rebuttal, Ex. 205, Schedule KKB-16.

Using insurance proceeds and the $3 million it set aside when it purchased MGE's system, Southern Union has thus far avoided paying out any unreimbursed costs for manufactured gas plant cleanup costs in Missouri.[73] As a result, MGE is not seeking to recover any such costs in this case. However, the $3 million set aside when Southern Union purchased the MGE system is nearly exhausted and, as a result, Southern Union expects to face unreimbursed costs in the future.

MGE proposes to create an environmental response fund to deal with these future expenses. The environmental response fund is essentially a tracking mechanism designed to avoid a mismatch between expenses and revenues. MGE proposes to include $750,000 per year in its revenue requirement for collection from ratepayers. That $750,000 would be paid into the environmental response fund and then paid out to cover cleanup expenses as they occur. Staff and Public Counsel would then have an opportunity to audit the fund to determine whether the expenses paid by MGE were prudently incurred.[74]

MGE also proposes that any insurance proceeds or contributions from Western Resources that it may obtain be shared 50/50 between the company and ratepayers. In other words, if MGE were to obtain $100,000 in reimbursement from an insurance company for an environmental cleanup cost, the environmental response fund would be credited with $50,000 and MGE would retain the other $50,000.[75]

Staff and Public Counsel oppose the creation of an Environmental Response Fund. The Commission agrees. The cleanup costs for which MGE seeks to establish the Fund

[73] The details of the costs and reimbursements may be found in Ex. 855HC.

[74] Noack Surrebuttal, Ex. 11, Pages 6-7, Lines 21-22, 1.

[75] Harrison Rebuttal, Ex. 814, Page 6, Lines 13-20.

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 these cleanup efforts. 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.[76] 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.

Public Counsel also argues that, aside from the rejecting the prospective Environmental Response Fund, the Commission should find that MGE will not be allowed

[76] Transcript, Page 1865, Lines 6-17.

to recover environmental cleanup costs related to manufactured gas plants under any circumstances. Public Counsel contends that these cleanup costs relate to facilities that are no longer used and useful to MGE's ratepayers and on that basis should not be paid for by ratepayers. Since MGE is not seeking to recover any such costs in this proceeding and the Commission is rejecting the creation of the Environmental Response Fund on other grounds, the Commission need not further address that question and will not do so.

8. Lobbying/Legislative costs

Issue Description: *What is the proper ratemaking treatment of lobbying/legislative activities in calculating MGE's cost of service?*

Staff and Public Counsel contend that MGE should not be allowed to recover in rates its cost of lobbying the Legislature. MGE does not contest that general proposition and it does not seek to include the cost of hiring outside, contract lobbyists in its cost of service. Neither does it seek to recover the dues it pays to the Missouri Energy Development Association (MEDA), a lobbying organization.[77] The dispute concerns Staff's and Public Counsel's recommendation to also exclude 100% of the salary of Paul Snider, the company's legislative liaison, and 10% of the salaries of company president, Jim Oglesby, and legal counsel, Rob Hack, on the theory that they also engage in lobbying activities on behalf of MGE.

The parties agree that this Commission has defined lobbying as any attempt to influence the decisions of regulators or legislators.[78] Staff and Public Counsel also contend that FERC's Uniform System of Accounts requires that all lobbying costs – both internal

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[77] Noack Corrected Rebuttal, Ex. 10, Page 13, Lines 16-18.

[78] In Re: Kansas City Power & Light Company, 24 Mo P.S.C. (N.S.) 386, 400 (1981).

and external -- be recorded "below the line" for ratemaking purposes.[79] That means that lobbying costs would not be included in MGE's revenue requirement for ratemaking purposes and that those costs would be borne by shareholders rather than ratepayers. MGE does not dispute that lobbying costs are to be paid by shareholders. It does, however, dispute Staff's and Public Counsel's conclusions about how much of the contested salaries should be excluded from revenue requirement. MGE did not provide any detailed information about the amount of time Snider spends lobbying but contends that he has job duties that are not related to lobbying and that therefore a 100% exclusion of his salary is not appropriate. It also contends that the proposed exclusion of 10% of the salaries of Oglesby and Hack is not supported by the evidence.

The problem is that there is no way to really know how much of the time of Snider, Oglesby, and Hack is spent lobbying. MGE does not keep detailed time records that separately account for the lobbying activities of its employees.[80] Staff and Public Counsel admit that their estimations of the time the three employees spend on lobbying is just an educated guess based on available time records and calendars. However, specific information that would allow a more precise determination of the amount of time these employees spend lobbying does not exist because MGE has failed to properly account for lobbying activities by its employees.

Since MGE has not properly accounted for the lobbying activities of its employees, the Commission must make adjustments based on the limited information that is available. The evidence presented to the Commission indicates that Snider, Oglesby, and Hack

[79] Hyneman Surrebuttal, Ex. 817, Page 3, Lines 23-27.

[80] Transcript, Pages 1172-1173, Lines 15-25, 1-6.

spend some amount of time engaged in lobbying. The Commission's inability to determine the exact amount of time that they spend in lobbying must be laid solely to MGE's failure to properly account for their time. Staff's proposal to exclude 10% of the salaries of Oglesby and Hack is reasonable and is accepted. However, the evidence established that Snider has substantial job duties relating to public affairs and press relations, aside from his lobbying activities.[81] As a result, excluding 100% of his salary would be unfair. The Commission finds that 50% of Snider's salary should be excluded as related to lobbying activities.

9. Incentive Compensation

Issue Description: *What, if any, is the appropriate level of MGE's incentive compensation expense to be used in calculating MGE's cost of service? What, if any, is the appropriate level of Southern Union's allocated incentive compensation expense to be used in calculating MGE's cost of service?*

Southern Union's compensation plan for its non-union employees includes an amount of incentive compensation to be paid to those employees if Southern Union and MGE meet certain goals. The incentive compensation is offered in addition to an employee's base salary. Specifically, the incentive plan contains financial goals relating to the earnings of Southern Union as a whole, and MGE as a division. Together, the financial goals make up 90% of the total incentive compensation plan.[82] The plan also offers an incentive relating to customer service. That portion of the plan rewards employees if a specified average speed of answer is achieved at MGE's call center. The customer service

[81] Transcript, Pages 1963-1967.

[82] Transcript, Page 1611, Lines 1-5.

incentive makes up 5% of the total incentive compensation plan.[83] Finally, the plan offers an incentive relating to safety that rewards employees if the average time for response to gas leaks is below a specified threshold. The safety incentive also makes up 5% of the total incentive compensation plan.[84]

Staff and Public Counsel argue that the Commission should exclude from MGE's cost of service the incentive compensation that the company pays at the divisional and corporate level for achieving the company's financial goals. As indicated, the financial portion makes up 90% of the total incentive compensation plan. Public Counsel, but not Staff, would also exclude the cost of the customer service goal.

Staff and Public Counsel contend that incentive compensation based on meeting the financial goals of the company benefits shareholders and not ratepayers. On that basis, they would require the shareholders to pay the costs of the incentive compensation plan by excluding those costs from the company's revenue requirement for ratemaking purposes. Public Counsel opposes inclusion in rates of the customer service portion of the incentive compensation plan because it believes that the average speed of answer at which employees receive extra compensation is set slower than the industry average and therefore is not a fair basis for awarding additional compensation to MGE's employees.[85]

MGE replies that its compensation plan is simply a portion of the means that it has chosen to pay its employees. It contends that nothing in the incentive compensation plan would harm ratepayers. On the contrary, MGE contends that its incentive compensation

[83] Transcript, Pages 1608-1609, Lines 24-25, 1.

[84] Transcript, Page 1608, Lines 21-23. The entire plan may be found as an HC attachment to Bolin Rebuttal, Ex. 205HC, Schedule KKB-15.

[85] Bolin Direct, Ex. 204HC, Page 15, Lines 8-10.

plan encourages the efficient operation of the company to the benefit of both shareholders and ratepayers. MGE argues that it needs its incentive compensation plan to be able to compete with other companies for top employees. Furthermore, it contends that its decision to either pay its employees a straight salary or to offer incentives is simply a matter for its business judgment and should not be of concern to the Commission.

The Commission agrees with Staff and Public Counsel that the financial incentive portions of the incentive compensation plan should not be recovered in rates. Those financial incentives seek to reward the company's employees for making their best efforts to improve the company's bottom line. Improvements to the company's bottom line chiefly benefit the company's shareholders, not its ratepayers. Indeed, some actions that might benefit a company's bottom line, such as a large rate increase, or the elimination of customer service personnel, might have an adverse effect on ratepayers.

If the company wants to have an incentive compensation plan that rewards its employees for achieving financial goals that chiefly benefit shareholders, it is welcome to do so. However, the shareholders that benefit from that plan should pay the costs of that plan. The portion of the incentive compensation plan relating to the company's financial goals will be excluded from the company's cost of service revenue requirement.

Public Counsel's argument for excluding the cost of the customer service portion of the incentive compensation plan is not well founded. Public Counsel's position is based on a 1998 call center evaluation study that was commissioned by MGE, and conducted by Theodore Barry and Associates.[86] That study indicates that the industry average speed of

[86] The entire study is attached to Bolin Rebuttal, Ex. 205 as Schedule KKB-4.

answer was 60 seconds.[87] The speed of answer for which the incentive compensation plan would reward employees is slower than 60 seconds and Public Counsel contends that MGE's employees should not be rewarded for achieving a goal that is slower than industry average.

The problem with Public Counsel's argument is that it relies entirely on a finding of industry average contained in a study completed in 1998, using data from 1996 and 1997. There is no evidence in this record that would demonstrate that the industry average in 1998 is still the industry average in 2004. A lot has changed in the natural gas industry in the last six or seven years, and it is certainly reasonable to believe that the industry average speed of answer may also have changed in that time. Admittedly, the 1998 study is the latest study available regarding MGE's call center, but that does not make it any more reliable in 2004. There is simply not enough evidence in the record to conclude that MGE's customer service incentive standard would reward below average speed of answer times in 2004. On that basis, the cost of the portion of the company's incentive compensation relating to customer service will be included in the company's cost of service revenue requirement.

10. Corporate Expenses: New York Office

Issue Description: *What, if any, is the appropriate level of cost associated with Southern Union's New York office to be used in calculating MGE's cost of service?*

Southern Union's corporate offices are located in Wilkes-Barre, Pennsylvania, and MGE's divisional offices are located in Kansas City, Missouri. However, Southern Union also maintains executive offices in New York City for the use of its Chairman, George

[87] Bolin Rebuttal, Ex. 205, Schedule KKB-4, Page 6 of 23.

Lindemann, and Vice-Chairman, John Brennan. The New York office is also used by other company executives when conducting business in New York. The office space is sublet from Activated Communications, Inc., an entity owned by Lindemann and his family, and by Brennan.[88] The cost to Southern Union of subleasing the New York office in 2003 was $690,000.[89] Staff, supported by Public Counsel, argues that allowing Lindemann and Brennan to maintain an office in New York is not a benefit to MGE's ratepayers and that the costs associated with Southern Union's New York office should therefore be excluded from MGE's cost of service for ratemaking purposes.

MGE replies that the New York office are more than just the offices of Lindemann and Brennan: they are also used by Southern Union to meet with Wall Street investors and with other members of the New York financial community. Having a New York office helps Southern Union in its efforts to attract capital, and thus benefits ratepayers as well as shareholders. [90]

While the evidence indicates that Southern Union's executives frequently use the New York office to meet with the New York financial community, it is apparent that those meetings could be conducted at other locations. Certainly, not all utilities see the need to maintain offices in New York just to have a convenient place to meet Wall Street bankers. It is also troubling that Southern Union sublets the New York office space from a non-regulated company owned by Lindemann, and his family, and Brennan. Certainly, the

[88] Hyneman Surrebuttal, Ex. 817, Page 31, Lines 7-13.

[89] Hyneman Surrebuttal, Ex. 817, Page 31, Lines 14-18.

[90] McLaughlin Rebuttal, Ex. 18, Pages 8-9, Lines 18-22, 1-10.

possibility exists that Southern Union's sublease could be used to unfairly thrust part of the cost of Activated Communications' office onto the backs of MGE's ratepayers.

The evidence indicates that Southern Union maintains an office in New York City primarily for the convenience of its chairman and vice-chairman. Maintaining that office is not a prudent expenditure necessary to provide service to MGE's ratepayers in Missouri. On that basis, the cost of maintaining a New York office will be excluded from MGE's cost of service for ratemaking purposes.

11. Corporate Expenses: Lindemann/Brennan Salaries

Issue Description: *What is the appropriate amount of salaries for Southern Union's Chief Executive Officer/Chairman of the Board and Vice Chairman of the Board to be used in calculating MGE's cost of service?*

This issue is closely related to the previous issue regarding Southern Union's New York City office. As the Commission found for that issue, George Lindemann is the Chairman of the Board for Southern Union and John Brennan is Vice-Chairman. Lindemann also holds the title of Chief Executive Officer for Southern Union. Lindemann and Brennan, along with Tom Karam, who is President and Chief Operating Officer of Southern Union, serve on the Executive Committee of the Southern Union's Board of Directors. The Executive Committee of the Board has the authority to exercise many of the powers of the Board of Directors between meetings of the full board.[91]

Staff, supported by Public Counsel, would limit the recovery in rates of the salaries that Southern Union pays to Lindemann and Brennan. For purpose of inclusion of the corporate joint and common costs ascribed to MGE, Staff would limit each man's salary to

[91] McLaughlin Rebuttal, Ex. 18, Page 6, Lines 1-15.

$100,000, which is more than three times the salary allowed to other board members.[92] Staff would also eliminate the costs of Lindemann's and Brennan's administrative support staff in the New York office.

Staff would impose this limit because it believes that Lindemann and Brennan are active board members, but are not actually involved enough in the day-to-day operations of the company to justify a larger salary. Staff supports this position by pointing out that Lindemann and Brennan maintain offices in New York, rather than at the corporate headquarters in Wilkes-Barre, Pennsylvania. Furthermore, Staff argues that Lindemann's and Brennan's calendars reveal that they spend most of their time at their homes in Florida rather than at Southern Union's offices.

MGE replies that Lindemann and Brennan lead Southern Union's executive management team. Lindemann is also chief executive officer of the company. Because of their contributions as managers who help promote fiscal discipline throughout Southern Union, which benefits both customers and shareholders, MGE contends that their salaries should be allowed in cost of service. MGE argues that Lindemann and Brennan are quite capable of leading the company from their homes in Florida.

The evidence supports Staff's adjustment. Lindemann's and Brennan's calendars reveal that they spend very little time at Southern Union's corporate offices. Although they can keep in touch by telephone, e-mail, and many other modern conveniences, their distance from the corporate office indicates that they are not heavily involved in the day-to-day operations of the corporation. Both men are also involved in owning and operating other business interests. Clearly, they do provide service to Southern Union as involved

[92] Hyneman Direct, Ex. 816, Page 30, Lines 18-24.

board members, and Staff's adjustment properly recognizes that level of service. However, neither man is so involved in the day-to day operations of Southern Union as to justify an annual salary larger than the $100,000 allowed by Staff. The costs of Lindemann's and Brennan's administrative support staff in the New York office will also be eliminated.

Revenue Allocation Issues

Once the Commission has determined the amount of revenue that MGE will be authorized to earn, it must determine the means by which that revenue will be collected from customers. Furthermore, it must determine the share of that revenue that MGE will collect from each customer class. That is the next set of issues.

12. Class Revenue Responsibility

Issue Description: *What is the appropriate level of revenue responsibility for each customer class to be used in calculating revenue?*

Class Cost of Service Issues:

This issue concerns the proper allocation of revenue responsibility among MGE's four revenue-producing classes: Residential, Small General Services, Large General Services, and Large Volume Services. In other words, what percentage of MGE's total revenue requirement should each class be required to pay?

An allocation of revenue among the various classes begins with a class cost of service study. Such studies seek to assign cost responsibility based on cost causation principles by classifying all cost elements as customer-related, demand-related, or commodity-related. The guiding principle is that the class that causes the cost should be required to pay rates that will allow the utility to recover that cost. For a local distribution company like MGE, the vast majority of cost of service elements will be either *customer* or demand related.

There are two full class cost of service studies in the record: those of MGE and Public Counsel. In addition, the Federal Agencies' witness Gary Price evaluated the other studies and corrected a mathematical error in MGE's study. MGE's witness acknowledged his error in his surrebuttal testimony, and during the hearing, and agreed that Price's rebuttal testimony shows the corrected numbers for MGE's study.[93] The intervenor group comprised of Midwest Gas, UMKC, CMSU and Jackson County supports the use of the MGE study, as corrected, as the best available class cost of service study.[94] However, that group contends that MGE's study still overstates the costs attributed to the large volume service customers – largely because the large volume service customers are transportation service only customers – it just does so less than the other studies.[95]

The percentage of revenue derived from each class under the various studies is shown in the following chart:[96]

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[93] Cummings Surrebuttal, Ex. 26, Pages 30-31, Lines 20-22, 1-2. Transcript, Page 2048, Lines 17-23.

[94] Initial brief at page 13.

[95] Johnston Rebuttal, Ex. 600, Pages 8-10.

[96] This chart is based on that appearing as Table 4, Price Rebuttal, Ex. 500, Page 13.

Description	Residential	Small General Service	Large General Service	Large Volume Service	Total
Current Rate Revenue Percentage	69.80%	20.56%	1.99%	7.65%	100.00%
MGE COS (corrected)	75.37%	17.09%	1.00%	6.54%	100.00%
Public Counsel COS	62.95%	21.79%	1.43%	13.83%	100.00%
Federal Agencies	75.09%	17.87%	0.80%	6.24%	100.00%

The differences between the cost studies largely derives from a disagreement on how to allocate the cost of mains, which are MGE's largest investment, representing about 39% of its total plant in service.[97] MGE uses a zero-intercept method to classify 34.7% of the investment in mains as being customer-related and 65.3% as demand-related. Public Counsel uses a relative system utilization methodology – know by the acronym RSUM – to classify investment in mains as entirely demand related.

The zero-intercept method used by MGE recognizes that when a main is built to reach a customer, a certain portion of the cost of the main will be incurred no matter how much gas the customer uses. Thus the cost of a zero inch main would be the customer-related portion of the cost of the main. The extra cost derived from installing larger mains, mains that are large enough to meet peak demand, would be the demand-related portion of the cost of the main.[98]

[97] Cummings Rebuttal, Ex. 25, Page 23, Lines 20-21.

[98] Cummings Direct, Ex. 23, Pages 25-26, Lines 8-23, 1-7.

Public Counsel's witness James Busch testified that he allocated the cost of mains using a modified RSUM. Public Counsel's method seeks to identify the portion of capacity that corresponds to each month's demand and then allocate the costs that correspond to that capacity to the customers that use gas in that month.[99] Public Counsel's method allocates mains costs based only on demand and does not allocate any cost of mains to customer-related costs.[100] Public Counsel contends that its method recognizes that mains are in the ground to provide service throughout the year and not just at peak demand.[101] Peak demand on MGE's system is driven by residential customers[102] so minimizing the effect of peak demand tends to reduce the residential class' share of costs.

This is not the first case in which Public Counsel has used the modified RSUM method to allocate costs. In its consideration on remand of a prior MGE rate, the Commission rejected Public Counsel's RSUM method as over-allocating costs to the large volume service class.[103] The Commission will again reject Public Counsel's RSUM method as inappropriate.

Public Counsel's method, by treating all mains costs as demand related, ignores the fact that unless mains are constructed, at a cost, customers would not have access to the gas distribution system.[104] Furthermore, any gas distribution system must be built to accommodate peak demand, and peak demand on MGE's system is driven by residential

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[99] Busch Direct, Ex. 212, Page 5, Lines 19-22.

[100] Busch Rebuttal, Ex. 213, Pages 2-4.

[101] Busch Surrebuttal, Ex. 214, Page 3, Lines 9-15.

[102] Ex. 610.

[103] In Re: Missouri Gas Energy, 10 Mo.P.S.C. 3d 1, 27 (2001).

[104] *Cummings Rebuttal*, Ex. 25, Page 25, Lines 3-8.

heating. Public Counsel's cost allocation method fails to recognize that fact and under allocates the cost of those mains to the residential and small general service customers that cause the systems peak requirement.[105] MGE's zero-intercept method recognizes the different nature of these costs and is a preferable method. As a result, the Commission finds that the class cost of service study presented by MGE, as modified by the Federal Agencies' witness provides the best estimate of the actual revenue that might appropriately be derived from each class

Revenue Requirement to be Assigned to Each Class:

The class cost of service studies are just the starting point in the Commission's determination of the amount of revenue that should be recovered from each class. As MGE's witness explained:

> The simple fact is that any cost of service study necessarily entails simplifications and judgments. As a result, no study should be considered anything more than a guide to the regulatory authority as it decides how a revenue increase should be distributed among customer classes.[106]

Class cost of service studies serve as a guide to the ultimate goal of just and reasonable rates, but the Commission does not need to slavishly adhere to any particular study.

Not surprisingly, the parties have varying recommendations about how to divide up the revenue recovery assignments. Public Counsel recommends that the percentage of the revenue requirement to be recovered from the residential and large general service classifications be held constant, while the bulk of the increased revenue is recovered from

[105] Price Rebuttal, Ex. 500, Page 10, Lines 5-9.

[106] Cummings Surrebuttal, Ex. 26, Page 33, Lines 4-7. The Federal Agencies' witness, Gary Price, expresses the same opinion at Price Rebuttal, Ex. 500, Pages 4-5, Lines 20-22, 1-2.

the Large Volume Class.[107] MGE recommends that the Commission determine rate increases based on MGE's class cost of service, or if it doesn't wish to do that, by simply allocating the revenue increase to customer classes based on current revenue percentages.[108] Midwest Gas, UMKC, CMSU, and Jackson County recommend that the percentage paid by the large volume class should be no larger than the level recommended in the MGE cost of service study, as corrected by the Federal Agencies witness Price.[109] Staff simply suggests that any rate increase be apportioned to the classes equally.[110] Finally, the Federal Agencies recommend that the large general services class receive an increase that is only 75% of the increase allocated to the other classes.

The Federal Agencies' witness, Gary Price, includes the following table in his testimony:[111]

Description	Residential	Small General Services	Large General Services	Large Volume Service	Total
Current Rate Revenue	69.80%	20.56%	1.99%	7.65%	100.00%
Federal Agencies COS	75.09%	17.87%	0.80%	6.24%	100.00%
Difference as a Percentage	7.57%	-13.09%	-59.94%	-18.32%	

Price's table suggests that currently the revenue that MGE collects from the residential class is under-recovering the costs assigned to the residential class by 7.57%. The

[107] Meisenheimer Direct, Ex. 208, Page 4, Table 1.

[108] Cummings Rebuttal, Ex. 25, Page 28, Lines 6-8.

[109] Initial Brief of Midwest Gas, UMKC, CMSU, and Jackson County at page 14.

[110] Beck Direct, Ex. 803, Page 5, Lines 7-17.

[111] Price Rebuttal, Ex. 500, Page 14, Table 5.

revenue collected from other classes is over-recovering the costs assigned to those classes. However, all of the classes, except Large General Service, are currently within 20% of their appropriate revenue recovery assignment. Large General Services is the exception because as a class it is currently over-recovering its assigned expenses by almost 60%.

Price suggests that the Large General Service class' substantial over-recovery be ameliorated by assigning the Large General Service class only 75% of the system revenue increase. The remaining customer classes would receive the system average increase and would share proportionally any remaining revenue increase not assigned to the Large General Service class. For example, if MGE were granted a 5% increase in revenue, Large General Services would see an increase of 3.75% while the other classes would see an increase of 5.05%.[112]

The Commission will adopt Price's suggestion. That suggestion has the virtue of minimizing the only glaring inequity in the current class revenue assignments, while protecting the residential class, from the shock of the substantial rate increase that would be required to bring all classes into complete agreement with MGE's corrected class cost of service study.

13. Fixed Monthly Rate Elements

Issue Description: *What is the appropriate level and structure for fixed monthly rate elements including the residential customer charge?*

MGE recovers its distribution revenues from a combination of fixed and volumetric rate elements. Fixed rates are predetermined and do not vary with the amount of natural

[112] Price Rebuttal, Ex. 500, Pages 14-15, Lines 6-16, 1-3.

gas consumed in a month. Volumetric rates are added to the cost of the natural gas that is consumed in a given month. When a customer consumes less gas, either because of warm weather or efforts to conserve, he or she will pay less in volumetric rates. Obviously, when a customer pays less in volumetric rates, MGE receives less revenue, which it needs to cover its costs.

Currently, MGE recovers approximately 55% of its residential distribution revenues from fixed elements and the remaining 45% from volumetric rate elements. MGE would like to shift some of its revenue recovery from volumetric rates to fixed monthly elements to address a problem of earnings shortfalls resulting from decreased customer usage due to warmer than normal weather. As part of its effort to shift its revenue recovery, MGE wants to increase the fixed monthly rate for the residential and small general service customer classes. It would increase the customer charge for residential from $10.05 to $13.55 and for small general services from $13.55 to $18.30.

Public Counsel flatly opposes any increase in the customer charge and would require MGE to recover any rate increase through volumetric rates.[113] Staff would allow MGE to increase the customer charge but only proportionally to current levels.[114]

High fixed monthly customer charges tend to defeat customer efforts to reduce their bill by conserving natural gas. As a result, the Commission finds that the public interest is best served by setting customer charges as low as reasonably possible. MGE's proposal to increase the residential customer charge from $10.05 to $13.55 would result in an increase of nearly 35% and is not reasonable. However, simply leaving the customer

[113] Busch Rebuttal, Ex. 213, Page 4, Line 11.

[114] Beck Surrebuttal, Ex. 805, Pages 9-20.

charges unchanged while allowing MGE to otherwise increase its rates would necessarily require that the vast majority of the rate increase be collected through volumetric rates.[115] That result would not be fair to MGE because MGE is already having difficulty in recovering its costs under the current rate structure. An increased reliance on volumetric rate elements will only increase MGE's weather risk and reduce its chance to actually recover its costs, which for the most part do not vary with the weather or the amount of gas sold.[116] The Commission finds that current ratio between fixed and volumetric rate elements, whereby MGE recovers approximately 55% of its residential distribution revenues from fixed elements, is appropriate. In order to be fair to the company and to its ratepayers, the Commission will order that the customer charge for the residential and small general service classes may be increased to an amount sufficient to maintain the current ratio between volumetric rate elements and fixed charges elements.

14. Volumetric Rate Elements

Issue Description: *What is the appropriate level and structure of volumetric rate elements?*

Volumetric rate elements are the flip side of the fixed monthly rate elements discussed in the previous issue. Volumetric rate elements allow MGE to recover its costs by adding a small amount to each volume measure of gas that it sells. Under its current rates, that amount is $0.11423 per Ccf.[117] MGE proposes that the Commission adopt a

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[115] A portion of the revenue increase would be collected through increased connection, reconnection, and transfer fees, which the Commission is authorizing elsewhere in this report and order.

[116] Transcript, Page 2231, Lines 12-24.

[117] Busch Rebuttal, Ex. 213, Page 6, Line 6.

weather-mitigation rate design for the residential and small general service rate classes to avoid volatility in the company's revenue stream. The rate design that MGE has proposed is based on the rate design that the Commission approved for Laclede Gas as part of a stipulation and agreement in Case Number GR-2002-0356.[118]

MGE's proposed weather mitigation rate design is fairly complicated; but, essentially, MGE's customers would pay more for the first block of gas they use during the winter months so that a greater percentage of delivery costs would be recovered in the first rate block. MGE also proposes to adjust the PGA to offset the bill impacts on small and moderate size users.[119] The result of the proposed rate design would allow MGE to recover a greater percentage of its costs even when warm weather results in the sale and consumption of fewer units of natural gas.

Staff opposes MGE's weather mitigation rate design proposal, but Public Counsel voices the most vehement opposition. Public Counsel correctly points out that the proposed rate design would reduce MGE's risk associated with warmer than normal weather by effectively creating a second, fixed, customer charge.[120] As a result, customers would not receive as much of a benefit from warmer than normal weather. Furthermore, customers would have less ability to lower their bills by conserving energy. As the Commission found in its discussion of fixed rate elements, such a result is contrary to good public policy.

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[118] Laclede's rate design was approved as part of a stipulation and agreement but the parties bitterly disagreed about the implementation of the rate design, necessitating an emergency hearing and rejection and revision of the implementing tariffs. See Beck Rebuttal, Ex. 804, Pages 15-18.

[119] Cummings Direct, Ex. 23, Pages 28-29.

[120] Busch Rebuttal, Ex. 213, Page 8, Lines 7-12.

Public Counsel also raises several legal arguments against MGE's proposed weather mitigation rate design. Those arguments are addressed in the Conclusions of Law section of this report and order. Based on its conclusions of law and the facts that it has found, the Commission concludes that MGE's proposed weather mitigation rate design must be rejected.

15. Miscellaneous Service Charges

Issue Description: *Should the Commission change the current tariffed charges for customer connects, standard customer reconnects, and transfer fees?*

MGE currently charges customers additional fees for providing certain services. In this case, MGE proposes to increase its connection fee from $20 to $45, its reconnection fee from $35 to $45, and its transfer fee from $5.00 to $6.50. Staff supports the requested fee increases but Public Counsel opposes them.

Public Counsel argues that the increases are unreasonably large and would be a burden on low-income customers. The connection fee in particular would increase by 125% and the reconnection fee would increase by 28.6%.[121] Public Counsel is concerned that such large increases could be a barrier to the initiation or restoration of service.[122] Public Counsel also attacked the validity of the cost study that MGE performed to evaluate the cost of performing the connections for which it is seeking increased fees. Public Counsel contends that the study should have looked at the incremental cost of providing

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[121] Meisenheimer Rebuttal, Ex. 209, Page 18, Lines 8-11.

[122] Meisenheimer Rebuttal, Ex. 209. Pages 18-19, Lines 20-23, 1-7.

the connection and reconnection services, and instead included joint and common costs that should not properly be ascribed to those activities.[123]

It is important to set the fees that MGE will charge for these services at a rate that will recover the actual cost of providing that service. These are services that are requested by a particular customer and general principles of cost causation suggest that the person responsible for a cost should be required to bear that cost. If the fee does not cover the actual cost of providing the service, other customers will be subsidizing the cost causer through higher than necessary base rates.[124] In other words, MGE incurs these costs. If they are not recovered through the increased fees, they will be recovered through base rates.

Public Counsel also suggests that the cost studies used by MGE to support its determination of the actual cost of providing these services overstate the actual costs because they do not measure the incremental cost of providing the service by excluding any allocation of joint or common costs associated with shared facilities or expenses needed to provide the company's other services.[125] There is no support for Public Counsel's suggestion that such fees should be calculated on an incremental cost basis. MGE is not attempting to price an optional service that it is offering for sale. Rather it is attempting to allocate the cost of providing a service to its customers. It is only fair that the customer using the service pay the costs associated with that service because those costs

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[123] Meisenheimer Rebuttal, Ex. 209, Pages 20-22.

[124] Imhoff Direct, Ex. 818, Page 7, Lines 1-3. *See also* Cummings Rebuttal, Ex. 25, Page 20, Lines16-19.

[125] Meisenheimer Rebuttal, Ex. 209, Pages 20-21, Lines 11-23, 1-6.

cannot be avoided. If the customer using the service does not pay those costs, they will be paid by other ratepayers.[126]

Finally, Public Counsel challenges the inclusion of specific costs in MGE's study. In particular, Public Counsel disagrees with MGE's inclusion of field personnel nonproductive time in the cost study.[127] That would include such things as vacation, sick leave, holiday pay, training, and standby time.[128] MGE contends that those costs are a part of the cost of providing the service and are properly included in the cost study. Staff's witness Tom Imhoff agrees with Public Counsel's position on this question but concludes that MGE's inclusion of nonproductive time in the cost study did not materially affect the rate calculation.[129] In other words, the inclusion of nonproductive time in the calculations did not have a large enough effect to make any difference in the rate that MGE proposes to charge.

The Commission finds that the proposed fees for connection, reconnection, and transfer are consistent with MGE's actual cost of providing those services. Public Counsel's suggestions to the contrary are not supported by the evidence. While the connection fee is more than doubling, a substantial increase is needed because the connection fee was deliberately set at half its actual cost in the last rate case to avoid shocking consumers.[130] The Commission is mindful of the need to avoid shocking ratepayers and certainly does not wish to create a barrier that would prevent them from

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[126] Cummings Rebuttal, Ex. 26, Page 28, Lines 12-15.

[127] Meisenheimer Rebuttal, Ex. 209, Page 22, Lines 6-10.

[128] Cummings Rebuttal, Ex. 26, Page 29, Lines 2-3.

[129] Imhoff Direct, Ex. 818, Pages 7-8, Lines 21-22, 1-2

[130] Cummings Surrebuttal, Ex. 26, Page 27, Lines 12-20.

obtaining gas service. However, ratepayers will not incur these fees frequently so the increased fees should not be a shock to their budgets.[131]

Low-Income Issues

16. Weatherization

Issue Description: *What is the appropriate level of funding for the low-income weatherization program and how should such funding be allocated among the geographic regions of MGE's service territory?*

MGE's ratepayers have provided funding for a low-income weatherization program since 1994. The weatherization program provides financial assistance to MGE's low-income customers to make improvements to their homes to improve energy efficiency. The average cost to weatherize a home in Missouri is $2,600 and weatherizing a home can provide annual natural gas savings of as much as 23% and annual electric savings of about 12%.[132] Aside from reducing the energy bill of the customer whose home is weatherized, the program also benefits all of MGE's customers by reducing MGE's expenses required to collect debts, by reducing the amount of late payments, and by reducing the amount of uncollectable bills.[133]

Since the program began in 1994 over 800 homes have been weatherized. The current program requires little administrative support from MGE as, at least in Kansas City, the program is administered by the City of Kansas City.[134] The weatherization program is

[131] Transcript Page 2022, Lines 9-25.

[132] Ross Direct, Ex. 836, Page 15, Lines 16-23.

[133] Ross Direct, Ex. 836, Page 16, Lines 17-21.

[134] Jackson Direct, Ex. 300, Page 2.

quite popular and currently has a waiting list of more than 500 applicants in Kansas City.[135] The cost of the weatherization program is currently built into rates and recovered from MGE's customers through those rates.[136]

MGE acknowledges that the weatherization program has been effective and does not require significant administrative involvement by MGE's employees. As a result, MGE proposes to increase low-income weatherization funding by $160,000 to be allocated according to the existing proportions.[137] Of the $340,000 in current funding, $250,000 is administered by the City of Kansas City and $90,000 is administered throughout the balance of MGE's service territory. If existing proportions were maintained, MGE's proposal would result in a $118,000 funding increase for the weatherization program in Kansas City.

The City of Kansas City contends that the weatherization program has been very successful and cost effective, and asks for a funding increase of $250,000 for the Kansas City service area. If current proportions are maintained, a total weatherization increase of approximately $340,000 would be required to give the City of Kansas City an additional $250,000 in weatherization funding.

During the course of the hearing, Staff, Public Counsel, and the City of Joplin filed a non-unanimous stipulation and agreement dealing with the three low-income issues. With regard to weatherization, that stipulation and agreement provides that weatherization funding should be increased by 15% across the board, totaling $51,000 per year. The

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[135] Jackson Direct, Ex. 300, Page 3.

[136] Transcript, Page 2408.

[137] Noack Corrected Rebuttal, Ex. 10, Page 31, Lines 6-17.

stipulation and agreement would also direct an additional $50,000 per year to the City of Kansas City and $50,000 to MGE's non-Kansas City, and non-Joplin service areas. Weatherization for the Joplin service area would be set at $130,000 and would be included in the existing experimental low-income rate (ELIR) program, which is the subject of the next issue. Joplin currently receives $31,000 in weatherization funding.[138] The non-unanimous stipulation also provides that the weatherization funding, as well as funding for all other low-income programs, would be recovered through volumetric rates rather than through a specific surcharge or adder on the customer's bill.[139] The total annual funding requirement of the programs proposed in the non-unanimous stipulation and agreement would be $896,000.[140]

MGE opposes the non-unanimous stipulation and agreement. As a result, Commission rule 4 CSR 240-2.115(2)(D) provides that the stipulation can only be treated as a statement of the positions of the signatory parties to which no party is bound. As a result, the Commission cannot "approve" or "disapprove" the stipulation and agreement. Instead, the Commission must address each issue on its own merits.

The Commission finds that the existing low-income weatherization program has been successful and should be continued with additional funding. The Commission is not, however, willing to increase funding beyond the amount requested by the company. The Commission will order that annual funding for the low-income weatherization program be

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[138] Ross Rebuttal, Ex. 837, Page 16, Table.

[139] Transcript, Page 2409, Lines 2-5.

[140] Non-Unanimous Stipulation and Agreement, Attachment A.

increased by $160,000 to a total of $500,000. The additional funding is to be allocated consistent with the current funding plan.

17. Experimental Low Income Rate

Issue Description: *What, if any, modifications should be made to the existing Experimental Low Income Rate Program?*

The existing experimental low-income rate ("ELIR") was established in the Joplin service area as a result of the stipulation and agreement that resolved MGE's last rate case. The goal of the program is to make it possible for low-income ratepayers to pay their bills and thereby reduce MGE's bad debt expenses. Under the program, low-income ratepayers participating in the program receive a $40 monthly bill discount if their household income is 50% or less of the federal poverty level, provided that they make timely payment of their gas bill. Participating ratepayers whose household income is 51%-100% of the federal poverty level receive a $20 monthly bill discount. The program has been funded by an $0.08 adder to all MGE residential customer bills.[141] That adder, which expired in August 2003, collected enough funds to allow the program to continue at current levels until July 2006 without collecting any more funds from ratepayers.[142]

MGE is willing to continue the current ELIR through July 2006, or until funding runs out, but opposes proposals to expand the program. MGE contends that the changes and expansion proposed by Staff, Public Counsel, and Joplin are too costly, would impose

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[141] Meisenheimer Direct, Ex. 207, Page 6, Lines 11-16.

[142] Noack Corrected Rebuttal, Ex. 10, Page 32, Lines 3-5.

additional administrative requirements on MGE, and will likely complicate evaluation of ELIR results.[143]

The non-unanimous stipulation and agreement provides that the ELIR will continue with some modifications: participation in the weatherization program will be required for ELIR participants; the bill discount levels will be revised; and the Joplin Community Action Agency will be asked to replace MGE as administrator of the ELIR. The stipulation and agreement would not renew the $0.08 adder and would instead recover the cost of the program through volumetric rates.

The ELIR is an interesting attempt to make natural gas bills more affordable for low-income customers while ultimately saving money for MGE and its other ratepayers by reducing expenses that result from bad debts. However, it is only an experimental program and it has had problems. For example, nearly half of the participants that initially entered the program dropped out by January 2004.[144] The Commission is not willing to pour more ratepayers funds into this program, particularly without the agreement of MGE. The Commission will allow the program to continue in its current form through July 2006, or until funding runs outs, which ever occurs first.

18. Experimental Energy Efficiency Programs including PAYS

Issue Description: *Should the Pay As You Save (PAYS) program proposed by the Office of Public Counsel be adopted?*

The Pay As You Save (PAYS) program is an experimental program designed to help residential ratepayers finance weatherization projects for their homes. It would essentially

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[143] Noack Corrected Rebuttal, Ex. 10, Page 32, Lines 5-7.

[144] Ross Rebuttal, Ex. 837, Page 12, Lines 20-22.

loan money to the ratepayers to pay for new windows, insulation, a new furnace, etc. The ratepayer would pay back the loan by way of his or her monthly utility bill. The idea is that the savings from increased energy efficiency would lower the customer's monthly bills enough so that the loan could be repaid from the savings. The program would not necessarily be limited to low-income ratepayers and the seed money to make the loans could be provided by MGE or by some other lender.[145]

The non-unanimous stipulation and agreement provides for a feasibility study to determine whether a PAYS program could be implemented in the Kansas City area. Funding for the feasibility study and a potential PAYS system would be set at $100,000 per year for two years, collected through volumetric rates. MGE opposes the proposal to explore the development of a PAYS program as part of this rate case.

The Commission is interested in further consideration and development of the PAYS program. However, such consideration needs to take place in a broader setting than is afforded by MGE's rate case. The Commission agrees with MGE that this rate case is not the appropriate setting for the funding of such a study. As a result, the Commission will reject the proposal offered by Staff, Public Counsel, and the City of Joplin.

Requests by Staff to Require Action by MGE

Staff has asked the Commission to order MGE to take several specific actions regarding its operations. These requests are addressed in the following issues.

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[145] Meisenheimer Direct, Ex. 207, Page11, Lines 2-13 and Warren Rebuttal, Ex. 839, Page 3, Lines 7-20.

19. Merger and Acquisition Recordkeeping

Issue Description: *Should the Commission adopt Staff's proposal to order Southern Union to keep time reports related to merger and acquisition activities?*

Staff asks the Commission to order Southern Union to keep records of the time spent by Southern Union corporate personnel on merger and acquisition related activity. Staff is concerned that Southern Union is very involved in merger and acquisition activities, and would like to exclude such activities from Southern Union's revenue requirement in future rate cases but says that it cannot do so unless Southern Union's executives keep better time records to allow Staff to separate out the merger and acquisition activities.[146] Southern Union contends that the Commission has no authority to make such an order in a rate case. Instead, if the Commission wants to make such a requirement, it must do so through a rulemaking that would apply to all gas companies. This legal issue is addressed in the Conclusions of Law section of this report and order.

Based on its conclusions of law, the Commission finds that the order requested by Staff is not a rulemaking and that the Commission has the authority to issue such an order. However, the Commission finds that such an order is neither needed nor appropriate in this case. The Commission does not wish to attempt to manage either Southern Union or MGE by ordering the company to keep specific time records regarding merger and acquisition activities. If Staff, or any other party, wishes to obtain specific information from Southern Union or MGE, it may do so through the discovery techniques that are recognized and commonly used at this Commission. If, in a future rate case, Staff or another party wishes to propose an adjustment regarding merger and acquisition activities and the company has

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[146] Hyneman Direct, Ex. 816, Pages 34-35, Lines 15-23, 1-2.

not kept sufficient records, the company will bear the risk of an imprecise adjustment, as it did in this case with the ordered adjustment for lobbying activities.

20. Gas Purchasing/Reliability Plan Reporting

Issue Description: *Should the Commission order MGE to submit by October 1, 2004, a Natural Gas Supply Plan (updated annually)? Should the Commission order MGE to submit by October 1, 2004, a Natural Gas Supply Reliability Analysis (updated every two to three years)?*

Staff is concerned that MGE is not doing enough to plan for the reliability of its natural gas supply and asks the Commission to order MGE to periodically submit such a plan, including a specific supply reliability analysis, which Staff insists be submitted by October 1, 2004, even though the effective date of this report and order will be October 2, 2004.[147] Staff indicates that it is simply seeking the same information from MGE that is already voluntarily provided by other gas companies.[148] But Staff adds that it is particularly concerned about MGE because it recently replaced its entire gas supply department.

MGE replies that it is doing all that it needs to do to assure that its supplies of gas are reliable. It states that it is perfectly willing to answer data requests and to open its records to Staff as required. However, it contends that the Commission has no authority in a rate case to order MGE to submit such reports. It further argues that if the Commission wants to make such a requirement it should do so through a rulemaking that would apply to all gas companies.

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[147] *See*. Staff's Reply Brief at page 55.

[148] Transcript, Page 1649-1650.

Based on its conclusion of law regarding Issue 19, Merger and Acquisition Recordkeeping, the Commission finds that the order requested by Staff is not a rulemaking and that the Commission has the authority to issue such an order. However, the Commission finds that such an order is neither needed nor appropriate in this case. Staff has not presented any evidence that would indicate that MGE is not properly planning for its future gas needs. Staff has many discovery tools at its disposal to allow it to obtain any information from MGE that it believes it needs. If Staff believes that all gas companies should file such report, and Staff's witness indicated that other gas companies have supplied such reports voluntarily, then Staff should avail itself of the rulemaking procedures to promulgate a rule that will apply to all gas companies.

21. Legislative/Lobbying Time Reporting

Issue Description: *Should the Commission adopt Staff's proposal to order MGE to keep detailed time reporting on the amount of time employees spend on lobbying and lobbying related activities?*

Staff asks the Commission to order MGE to keep records of the time spent by its personnel on lobbying activity. Staff and Public Counsel have argued that lobbying activity should be excluded from MGE's revenue requirement in this and future rate cases but says that it cannot easily do so unless MGE's employees keep better time records to allow Staff to separate out the lobbying activities. Staff contends that MGE is already required to keep such records by Commission rule and wants an order requiring MGE to comply with those requirements.

MGE contends that the Commission has no authority to make such an order in a rate case. It further argues that if the Commission wants to make such a requirement it should do so through a rulemaking that would apply to all gas companies.

Based on its conclusion of law regarding Issue, 19 Merger and Acquisition Recordkeeping, the Commission finds that the order requested by Staff is not a rulemaking and that the Commission has the authority to issue such an order. However, the Commission finds that such an order is neither needed nor appropriate in this case. The Commission does not wish to attempt to manage either Southern Union or MGE by ordering the company to keep specific time records regarding lobbying activities. If Staff, or any other party, wishes to obtain specific information from Southern Union or MGE, it may do so through the discovery techniques that are recognized and commonly used at this Commission. Furthermore, if Staff believes that MGE is currently refusing to comply with Commission regulations, it may bring a complaint against MGE. Finally, if, in a future rate case, Staff, or another party, wishes to propose an adjustment regarding lobbying activities and the company has not kept sufficient records, the company will bear the risk of an imprecise adjustment, as it did in this case.

22. Response Time to Commission-referred Customer Complaints/ Inquiries

Issue Description: *Should the Commission order MGE to respond to Customer Complaints/Inquiries within three business days?*

Staff asks the Commission to order MGE to respond to Commission forwarded customer complaints/inquiries within three business days of receiving the complaint or inquiry. For interruption of service issues, the response time should be within twenty-four hours. Staff's witness indicated that there is not a particular problem at MGE but that it is trying to hold all utilities to this standard.[149] Other companies have already agreed to this standard and Staff specifically mentions Missouri-American Water Company as one company that has agreed to this requirement in a stipulation and agreement.[150]

MGE contends that the Commission has no authority to make such an order in a rate case. It further argues that if the Commission wants to make such a requirement it should do so through a rulemaking that would apply to all gas companies.

Based on its conclusion of law regarding Issue 19, Merger and Acquisition Recordkeeping, the Commission finds that the order requested by Staff is not a rulemaking and that the Commission has the authority to issue such an order. However, the Commission finds that such an order is neither needed nor appropriate in this case. Staff failed to show any reason why this order should be entered in this case. If this standard is appropriate for all utilities, then Staff should avail itself of the appropriate rulemaking procedure rather than attempt to impose the requirement on utilities one at a time.

23. GM-2003-0238 Cost and Allocation Study Issue

Issue Description: *Should the Commission order MGE to complete and file a study concerning the impacts of the Panhandle Eastern Pipeline Company acquisition on Southern Union's administrative and general expenses and cost allocation methodology?*

In the unanimous stipulation and agreement that resolved the merger case regarding Southern Union's acquisition of Panhandle Eastern, Southern Union agreed to perform a study within six months regarding the effect of the acquisition on corporate cost allocations following the acquisition. Southern Union provided Staff with some information, but Staff

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[149] Transcript, Pages 1294-1299.

[150] Bernsen Direct, Ex. 806, Page 9, Lines 10-16.

complains that Southern Union did not provide sufficient information regarding its merger and acquisition activities. Staff asks the Commission to order Southern Union to complete this study, file it in this case before the operation of law date for this order, and provide its completed study to the parties in the merger case.[151] Southern Union replies that it has fully complied with all the requirements of the stipulation and agreement and that no action by the Commission is required.

This issue simply does not belong in this case. If Staff believes that Southern Union has failed to comply with a requirement of the stipulation and agreement in the merger case – GM-2003-0238 – it may file a motion in that case bringing the alleged failure to the Commission's attention. If any relief is needed, it will be granted in that case.

True-Up Issues

The next two issues arose for the first time at the true-up hearing.

24. Rate Case Expenses

MGE is entitled to recover its reasonable and prudently incurred cost of presenting this rate case to the Commission. Such costs are routinely accepted as a cost of doing business for which the company will be allowed to recover its costs in rates and no party disputes MGE's right to recover its rate case expenses in this case. There is a dispute, however, over how much MGE should be allowed to recover.

MGE has claimed $1,383,333 in expenses relating to the presentation of this rate case. That figure does not include any amount for post-hearing work.[152] MGE submitted statements from its attorneys and expert witnesses to support that amount. MGE suggests

[151] Oligschlaeger Direct, Ex. 828, Pages 9-10, Lines 14-22, 1-18.

[152] Noack True-Up Direct, Ex. 49, Page 5, Lines 4-12.

that rate case expense be amortized over 3 years, resulting in an annual cost of $461,111, which would be included in MGE's cost of service for inclusion in the rates established for this case. MGE is also willing to accept a 4-year amortization at an annual cost of $345,833 if the rates that result from this case are sufficient to allow them to remain in effect for four years.[153]

Staff argues that that the rate case expenses submitted by MGE are not reasonable. In particular, Staff contends that the fees paid to MGE's New York law firm – Kasowitz, Benson, Torres & Friedman, LLP – are excessive, especially given what Staff asserts is that firm's inexperience in regulatory law. Staff also contends that MGE failed to present enough documentation to justify some of its submitted expenses. Staff's witness Charles Hyneman recommends that the Commission allow $650,000 for rate case expenses because that is the amount the Commission found to be reasonable and prudent in MGE's last litigated rate case, GR-98-140. As an alternative, he recommends that the Commission allow recovery of $750,000, which Staff claims is the highest amount of rate case expense ever allowed for a utility in a Missouri rate case.[154]

The Commission finds that Staff's proposal to limit MGE's rate case expenses to an amount found to be reasonable in a previous rate case is completely arbitrary and capricious. There was no evidence presented that would allow the Commission to conclude that this case was so comparable to any other case that the Commission would be justified in placing an arbitrary limit on recovery of rate case expense. Furthermore, the rate cases that Staff would use to limit MGE's recovery took place five or six years ago.

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[153] Noack True-up, Ex. 49, Page 5, Lines 4-12.

[154] Hyneman True-up, Ex. 861, Page 10, Lines 11-19.

When asked, Staff's witness could not even say whether attorney fees and consultant fees have increased since 1997.[155] Staff's proposal to limit recovery of rate case expense to the amounts recovered in earlier cases must be rejected.

Public Counsel also disputes MGE's request for rate case expenses, but Public Counsel would come at MGE's rate case expenses from the opposite direction. Public Counsel suggests that certain costs be removed from MGE's expenses as imprudently incurred. Specifically, Public Counsel would reduce the hourly fees charged by Kasowitz, Benson, Torres & Friedman, MGE's New York law firm, from $690 per hour to $200 per hour. That would allow only $171,950 of that firm's charges to be recovered in rates, a reduction from $614,000 requested by MGE. Public Counsel would also disallow $47,522 in fees charged by MGE's Texas counsel, Watson Bishop London and Brophy, because the work that firm did was allegedly duplicative of the work done by Kasowitz, Benson, Torres & Friedman and MGE's Missouri counsel, Brydon, Swearengen & England. Public Counsel would also exclude $36,303 paid to the law firm of MGE's witness John Quain. Quain, a former commissioner from Pennsylvania, offered public policy testimony that Public Counsel found to be insubstantial. Public Counsel would also reduce recovery of the fee that MGE paid to its witness, Dr. Morin, from $30,000 to $9,800. All of Public Counsel's adjustments would result in a total rate case expense of $787,766.[156]

Public Counsel contends that this amount is still too high. It would average its adjusted total of $787,766 with the amounts allowed MGE for rate case expense in its last two litigated rate cases to arrive at an average of $634,839, which it would amortize over

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[155] Transcript, Page 2616, Lines 4-6.

[156] Bolin True-up Direct, Ex. 234, Page 13, Lines 9-16.

three years for an annual cost of $211,613. As the Commission indicated when rejecting Staff's proposal, the arbitrary reliance on past rate cases to establish a limit on MGE's rate case expense recovery in this case is improper. Therefore, Public Counsel's proposal to further adjust its recommended rate case expense will be rejected.

However, the Commission will further examine Public Counsel's proposals to reduce specific rate case expenses for which MGE is seeking recovery. The first expense challenged by Public Counsel is the $614,000 in bills submitted by Kasowitz, Benson, Torres & Friedman. That firm billed MGE at a rate of $690 per hour and Public Counsel suggests that the hourly rate be reduced to $200, which is the hourly rate charged by MGE's local counsel. At $200 per hour, multiplied by 859.75 hours, the total bill from Kasowitz, Benson, Torres & Friedman would be $171,950.[157] That amount does not include travel and meal expenses because at the time Ms. Bolin submitted her testimony those expenses were not properly documented. Additional invoices were submitted at the hearing and at least Staff's witness was satisfied that nearly all of the submitted expenses were now supported by invoices.[158] The expenses submitted by Kasowitz, Benson, Torres & Friedman, including travel and meal expenses, total $16,250.75.[159]

The Commission is hesitant to disallow expenses incurred by MGE in prosecuting its rate case. The company is entitled to present its case as it sees fit and the Commission will not lightly intrude into the company's decisions about how best to present its case. However, the Commission has a responsibility to ensure that the expenses that the

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[157] Bolin True-Up Direct, Ex. 234, Page 8-9, Lines 11-22, 1-4.

[158] Transcript, Page 2638, Lines 8-21.

[159] Exhibit 51.

company submits to its ratepayers are reasonably and prudently incurred. Otherwise, the company could take a cost-is-no-object approach to its rate case presentation, secure in the knowledge that the ratepayers would be required to pay for any cost that the company might incur.

In this case, MGE, or perhaps Southern Union, chose to hire the Kasowitz, Benson, Torres & Friedman law firm out of New York. MGE explained that it chose that firm because it had previously represented Southern Union in other complex litigation and the company was very pleased with the results obtained in that case.[160] The other litigation for which the Kasowitz firm had represented Southern Union was, however, a merger and acquisition case and this case was the firm's first litigated regulatory rate case.[161]

Eric Herschmann and Michael Fay of the Kasowitz firm did a good job of representing their client at the hearing. But the firm charged up to $690 per hour for its work. That rate is far higher than the typical rates charged by lawyers appearing before this Commission. The company is certainly entitled to hire lawyers with whom it is comfortable, but it would not be fair to require ratepayers to pay such high rates. The Commission will reduce the rate to $200 per hour, which is the rate charged by MGE's local counsel. The $16,250.75 in expenses incurred by the Kasowitz firm will be allowed. The total allowed for representation by Kasowitz, Benson, Torres & Friedman is $188,200.75.

Public Counsel urges the Commission to disallow $47,522 in fees charged by the Austin Texas firm of Watson Bishop London and Brophy. Public Counsel contends that the work done by that firm did was duplicative of the work done by Kasowitz, Benson, Torres &

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[160] Transcript, Pages 2482-2483, Lines 24-25, 1-3.

[161] Transcript, Page 2499, Lines 7-17.

Friedman and MGE's Missouri counsel, Brydon, Swearengen & England.[162] MGE explained that Christine Dodds, an attorney with Watson Bishop, served as second chair for Eric Herschmann at the hearing. She assisted Herschmann in preparation of witnesses, issues, and cross-examination questions.[163] The Commission does not wish to disparage the work done by the Watson Bishop firm, but $47,522 is more than ratepayers should pay for the services performed by the firm. The fees charged by Watson Bishop will be disallowed in their entirety.

Public Counsel would also exclude $36,303 paid by MGE to Klett Rooney Lieber & Schorling, the law firm of MGE's witness John Quain. In fact, at the true-up hearing, an updated statement from Klett Rooney was admitted into evidence showing that the bill submitted by Klett Rooney totaled $20,115, not $36,303 as previously estimated.[164] Quain, a former commissioner from Pennsylvania, offered public policy testimony that Public Counsel found to be insubstantial. The Commission found Quain's testimony to be helpful and his fees will be allowed as a rate case expense.

Public Counsel would also reduce recovery of the fee that MGE paid to its witness Roger A. Morin from $30,000 to $9,800 because it believes that the fee paid to Dr. Morin is excessive if calculated as a per hour fee. Public Counsel estimated that Morin worked 35 hours and if his full fee were allowed that would amount to an hourly fee of $857. Public Counsel would allow only $280 per hour for Dr. Morin's time for a total of $9,800. The

[162] Bolin True-Up Direct, Ex. 234, Page 9, Lines 7-14.

[163] Transcript, Pages 2509-2510, Lines 24-25, 1-7.

[164] Transcript, Page 2490, Lines 14-21.

Commission does not agree with Public Counsel. Dr. Morin is a highly respected expert in his field. His $30,000 fee is not excessive and will be allowed as a rate case expense.

MGE's rate expense claim will be adjusted in the following manner. $1,383,333 - $425,799.25 (the amount of reduction in Kasowitz bill) - $47,522 (the Watson Bishop fee) - $16,188 (the difference between the estimated and final bills from Klett Rooney) = $893,823.75. Amortizing that amount over three years, results in an annual amount of $297,941.25, which the Commission finds to be appropriate for inclusion in MGE's annual cost of service.

25. Kansas Property Taxes

At its last legislative session, Kansas imposed a new property tax on gas held in inventory in Kansas. MGE began to incur liability for this tax for the tax year beginning January 1, 2004. It will actually have to begin paying the tax in December 2004, with the balance of the year's tax payment due in June 2005. MGE's tax liability is based on the level of natural gas held in storage in Kansas as of December 31, 2003. MGE indicated that it questions the legality of Kansas' new tax and indicates that it will pay the taxes under protest while it challenges the tax in the courts.[165] Nevertheless, MGE contends that this is a known cost that it will incur during the period covered by the rate that will be established in this case. It asks that it be allowed to recover $1,262,059 annually in rates for these new taxes.[166]

Because MGE did not learn about the creation of this new tax until after the hearing was completed, it did not raise this issue until it filed true-up direct testimony on July 19.

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[165] Transcript, Page 2523, Lines 17-25.

[166] Noack True-Up Direct, Ex. 49, Pages 5-6, Lines 24-26, 1-12.

The question was the subject of rebuttal testimony and cross-examination at the true-up hearing held on July 23.

Staff opposes allowing MGE to recover those taxes in this case but suggests that the Commission instead issue an accounting authority order (AAO) that would allow MGE to defer those increased costs until its next rate case.[167] MGE would accept the issuance of an AAO.[168] Public Counsel, Midwest Gas, UMKC, CMSU, and Jackson County oppose allowing MGE to recover those tax costs in this case and they also oppose the issuance of an AAO.

The Commission agrees that MGE cannot recover the new Kansas taxes in this case. These taxes were not paid during the test year established for this case and the taxes will not be paid at all, until December 2004. MGE also indicated that it would be paying the taxes under protest. That means that if its legal challenge is upheld MGE would receive a refund from the state of Kansas. However, MGE's witness testified that if MGE received a tax refund, it probably would not pass that refund back to ratepayers unless it was ordered to do so by this Commission.[169] As a result, MGE's potential tax liability is not currently known or measurable and on that basis it cannot be included in MGE's cost of service for this case.

Furthermore, property taxes were not included as a true-up issue.[170] The parties had no notice that this issue even existed until MGE filed its true-up direct testimony four

[167] Transcript, Pages 2607-2608, Lines 19-25, 1-25.

[168] Transcript, Page 2480, Lines 13-23.

[169] Transcript, Pages 2524-2525, Lines 1-25, 1-13.

[170] Transcript, Page 2558, Lines 17-24.

days before the hearing. As a result, this entirely new issue cannot be considered in this case.

This is a harsh result for MGE, as it will likely be paying taxes that are not included in its cost of service for calculation of rates in this case. An accounting authority order allowing MGE to defer those tax payments for possible recovery in its next rate case would be a means of avoiding that result. However, this case is not the appropriate forum for deciding whether to grant MGE such an AAO. The other parties have not been given a reasonable opportunity to present testimony and arguments to the Commission regarding this issue. If MGE wishes to request an AAO, it may file a separate application, to which the Commission will give due consideration.

CONCLUSIONS OF LAW

The Missouri Public Service Commission has reached the following conclusions of law.

MGE is a public utility, and a gas corporation, as those terms are defined in Section 386.020(42) and (18), RSMo 2000. As such, MGE is subject to the Commission's jurisdiction pursuant to Chapters 386 and 393, RSMo.

Section 393.140(11), RSMo 2000, gives the Commission the authority to regulate the rates that MGE may charge its customers for natural gas. When MGE filed a tariff designed to increase its rates, the Commission exercised its authority under Section 393.150, RSMo 2000, to suspend the effective date of that tariff for 120 days beyond the effective date of the tariff, plus an additional six months.

In determining the rates that MGE may charge its customers, the Commission is required to determine that the proposed rate is just and reasonable.[171] MGE has the burden of proving that its proposed increase is just and reasonable.[172]

Issues

The parties raised legal arguments regarding some, but not all of the identified issues. The legal arguments relating to those issues are discussed in this section.

1-5. Rate of Return Issues

In determining whether the rates proposed by MGE are just and reasonable, the Commission must balance the interests of the investor and the consumer.[173] The Commission's failure to establish just and reasonable rates would, in fact, violate the United States Constitution. In discussing the need for a regulatory body to institute just and reasonable rates, the United States Supreme Court has held as follows:

> Rates which are not sufficient to yield a reasonable return on the value of the property used at the time it is being used to render the services are unjust, unreasonable and confiscatory, and their enforcement deprives the public utility company of its property in violation of the Fourteenth Amendment.[174]

In the same case, the Supreme Court provided the following guidance on what is a just and reasonable rate:

> What annual rate will constitute just compensation depends upon many circumstances and must be determined by the exercise of a fair and enlightened judgment, having regard to all relevant facts. A public utility is entitled to such rates as will permit it to earn a return on the value of the

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[171] Section 393.150.2, RSMo 2000

[172] Section 393.150.2, RSMo 2000

[173] Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 603, (1943).

[174] Bluefield Water Works & Improvement Co. v. Public Service Commission of the State of West Virginia, 262 U.S. 679, 690 (1923).

> property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties. A rate of return may be reasonable at one time and become too high or too low by changes affecting opportunities for investment, the money market and business conditions generally.[175]

The Supreme Court has further indicated:

> '[R]egulation does not insure that the business shall produce net revenues.' But such considerations aside, the investor interest has a legitimate concern with the financial integrity of the company whose rates are being regulated. From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.[176]

In undertaking the balancing required by the Constitution, the Commission is not bound to apply any particular formula or combination of formulas. Instead, the Supreme Court has said:

> Agencies to whom this legislative power has been delegated are free, within the ambit of their statutory authority, to make the pragmatic adjustments which may be called for by particular circumstances.[177]

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[175] Bluefield Water Works & Improvement Co. v. Public Service Commission of the State of West Virginia, 262 U.S. 679, 692-93 (1923).

[176] Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591, 603 (1944) (citations omitted).

[177] Federal Power Commission v. Natural Gas Pipeline Co. 315 U.S. 575, 586 (1942).

14. Volumetric Rate Elements

Public Counsel points out that the weather mitigation rate design proposed by MGE would effectively result in the creation of rates that vary with the weather, contrary to Missouri law that requires rates to be fixed. Public Counsel also contends that allowing rates to vary with the weather would be forbidden as single issue ratemaking because it would allow the single issue of weather to determine whether MGE could charge a higher rate for gas without consideration of other factors that might indicate that the company was earning other income that could offset the need for a higher rate. Public Counsel cites State ex rel Utility Consumers Counsel of Missouri Inc. v. Public Service Commission,[178] a Missouri Supreme Court decision rejecting a fuel-adjustment clause for electric utilities, as support for its position. After reviewing that decision, the Commission concludes that Public Counsel has correctly interpreted the Utility Consumers decision.

The fuel adjustment clause at issue in the Utility Consumers case established a complicated formula that allowed an electric utility's rates to automatically adjust up or down depending upon the cost of fuel used to generate electricity. In rejecting that clause, the Missouri Supreme Court held as follows:

> By permitting an electric utility to utilize a fuel adjustment clause [FAC], the commission permits one factor to be considered to the exclusion of all others in determining whether or not a rate is to be increased. That is, although the FAC may not *itself* be a rate, by approval of an FAC in a utility's rate schedule, the commission in advance approves any increase (or decrease) in rates which will automatically result through application of the FAC if the price of fuel to the utility increases or decreases.

Although the Utility Consumers decision does not address a weather normalization clause by name, its reasoning would equally apply to the clause that is at issue in this case.

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[178] 585 S.W.2d 41 (Mo. banc 1979).

Under the weather normalization clause proposed by MGE, the rates paid by the company's customers would vary depending upon the amount of gas used, which depends in large measure upon the weather. Those rates would change without any further evaluation by the Commission of whether the new rates are just and reasonable. That is defined as single-issue ratemaking and is forbidden by the Utility Consumers decision.

In addition to condemning the fuel adjustment clause as single-issue ratemaking, the Utility Consumers decision also held that the fuel adjustment clause would:

> negate the effect of §393.140(11), by which all rates are printed and open for public inspection. The purpose of thus providing the customer with a method of ascertaining what rates are in effect and enabling him to take the appropriate steps to challenge those rates would be destroyed with a fuel adjustment clause. Upon reference to the filed rate schedule of the utility, the consumer would be confronted with a formula and a rate filed as a result thereof.

Again, the proposed weather normalization clause suffers from the same defect as the fuel adjustment clause and would violate the requirements of Section 393.140(11), RSMo (2000).

As an alternative to the weather normalization clause that it originally proposed, MGE suggests that the Commission implement what it terms a "traditional weather normalization clause" on an experimental basis.[179] MGE argues that if Commission adopts its "traditional weather normalization clause" on an experimental basis, it can avoid the restrictions of the Utility Consumers decision.

Whatever support there may be for the dubious proposition that the Commission has the authority to establish experimental rates that would otherwise violate state law,[180] there

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[179] Cummings Rebuttal, Ex. 25, Pages 34-38.

[180] The six cases cited by MGE at page 77 of its reply brief discuss the Commission's authority to establish interim rates. They do not support the proposition urged by MGE.

is nothing about MGE's proposal to institute a "traditional weather normalization clause" that is in any way experimental. The Commission will not call a weather normalization clause experimental just to try to find a way around a very clear ruling by the Supreme Court of this state.

19. Merger and Acquisition Recordkeeping

Staff asks the Commission to order MGE to keep time records concerning the amount of time corporate employees spend on merger and acquisition activities. MGE contends that the order that Staff is requesting has nothing to do with setting rates and is not properly before the Commission in a rate case. MGE further contends that Staff's proposal to require MGE to keep specific records is properly the subject for a rulemaking. MGE suggests that any order that the Commission might enter in this case would be "null, void, and unenforceable" as an improperly promulgated rule.

A cursory examination of Missouri's statute concerning administrative rulemaking reveals that MGE is incorrect. Section 536.010, RSMo 2000, defines "rule" as:

> each agency statement of general applicability that implements, interprets, or prescribes law or policy, or that describes the organization, procedure or practice requirements of any agency. The term includes the amendment or repeal of an existing rule, but does not include:
> (d) A determination, decision, or order in a contested case.

This is a contested case. Thus, by definition, an order that the Commission issues in this case cannot be a rule and need not be promulgated in compliance with the rulemaking requirements of Chapter 536, RSMo.

DECISION

After applying the facts as it has found them to its conclusions of law, the Commission has reached the following decisions regarding the issues identified by the parties.

1. Capital Structure

Issue Description: *What is the appropriate Capital Structure (i.e., the relative proportions of long-term debt, short-term debt, preferred equity and common equity) to use in calculating MGE's cost of capital?*

Common Stock:	29.99%
Preferred Stock	6.40%
Long-Term Debt	63.61%

2. Embedded Cost of Long-Term Debt

Issue Description: *What is the appropriate cost of long-term debt in calculating MGE's cost of capital?*

The embedded cost of long-term debt is 7.4155%.

3. Return on Equity

Issue Description: *What is the appropriate return on equity in calculating MGE's cost of capital?*

The appropriate return on equity is 10.5%.

4. Cost of Preferred Stock

Issue Description: *What is the appropriate cost of MGE's preferred stock in calculating MGE's cost of capital?*

The appropriate cost of preferred stock is 7.758%