BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Missouri Gas Energy's Tariff Sheets Designed to Increase Rates for Gas Service in the Company's Missouri Service Area.	))))	Case No. GR-2009-0355

REPLY BRIEF OF THE
OFFICE OF THE PUBLIC COUNSEL

OPC agrees with MGE's statement that the Commission is to balance the interests between MGE's consumers and SUC's shareholders. However, OPC disagrees with the suggestion that the Commission is to give each interest equal weight. Missouri Courts determined that the foremost purpose of the Commission is to serve and protect the public: "The primary purpose of public regulation of utilities is the ultimate good of the public. Protection afforded utilities is merely incidental to the attainment of that object." *State ex rel. Pitcairn v. P.S.C.,* 111 S.W.2d 982 (Mo. App. 1937).

MGE characterizes this balancing of interests as a balance between "public consumers" and "public investors." One distinguishing difference between these two interests is that public consumers are Missouri residents whereas public investors in SUC stock are most likely foreign investors. Every customer of MGE is either a Missouri resident or a Missouri business, and the interests this Commission has in protecting their interests is to be balanced against the interests of investors in Houston, Texas based Southern Union Company, a multi-billion dollar company with only a small subset of its operations in Missouri. (Ex.69, pp.19-20).

MGE cites to § 386.610 RSMo and the general statement of Commission authority that states "[t]he provisions of this chapter shall be liberally construed with a view to the public welfare, efficient facilities and substantial justice between patrons and public utilities." MGE highlights the Missouri public utility law goal of "substantial justice between patrons and public utilities" but ignores the first goal - public welfare. The term *public welfare* as used in § 386.610 RSMo has been defined by the Missouri Supreme Court:

> The term "public welfare" used in the quoted statute, stating the rule of construction of the public service commission act, is a comprehensive expression, and embraces the health, peace, morals and safety of the community; that which is a public necessity or for the convenience of the public.

State ex rel. City of St. Louis v. P.S.C., 56 S.W.2d 398 (Mo. 1932). Health, peace, morals and safety are at stake in this case, and the Commission must consider the public welfare separately from the balancing of interests between consumers and investors. In *State ex rel. City of St. Louis v. P.S.C.*, 73 S.W.2d 393 (Mo. 1934), the Missouri Supreme Court cited to a decision of the Supreme Court of the State of Maryland, which explained that one of the most important goals of a public service commission is to protect the public:

> To prevent injury to the public, in the clashing of private interest with public good in the operation of public utilities, is one of the most important functions of Public Service Commissions.

OPC asks that the Commission recognize this important function and prevent private interests from harming the public good.

MGE argues that it has not been able to earn its authorized return. (MGE Brief, p.3). MGE cites to the same generalized statements from the testimony of Mr. Rob Hack without any reference to data and without citing earnings figures. MGE's evidence does not reveal an analysis that shows MGE's earned return on common equity (ROE) during the test year. The only ROE data is for Southern Union Company as a whole, which earned an ROE of 13.21%.

Although MGE does not reveal its ROE data, MGE does provide a spreadsheet showing MGE's achieved rate of return vs. authorized rate of return in the Direct Testimony of Mr. Michael Noack. (Ex.30, Sch. G-4). Since MGE was last granted a rate increase in March 2007, MGE has performed very well and earned nearly all of its authorized 8.60% return. (*Id.*). In 2007, MGE achieved 94% of its authorized return by achieving an 8.07% rate of return. (*Id.*). In 2008, MGE achieved 92% of its authorized return by achieving a 7.92% rate of return. (*Id.*). This data shows that MGE is doing extremely well and hardly impacted by the economic recession.

A. RATE DESIGN

1. <u>Residential Rate Design</u>: *What rate design should the Commission adopt for the residential customer class?*

2. <u>Small General Service Rate Design</u>: What rate design should the Commission adopt for the small general service customer class?

a. Court of Appeals for the Southern District Opinion

MGE begins its argument on rate design by citing to the recent Southern District Court of Appeals decision affirming the Commission's 2007 Report and Order that initially adopted a SFV rate design for MGE's residential customers. (MGE Brief, p.6). MGE wrongly characterizes the Southern District's opinion as a finding that the SFV is just and reasonable. The Southern District's opinion looked at the following narrow questions on the lawfulness and reasonableness of the Commission's 2007 Order.

Lawfulness: OPC argued to the Southern District that the rate design portion of the 2007 Order did not contain sufficient findings of fact because the Commission did not identify the basis for its decision. The Court concluded that, while "[b]etter practice would dictate the explicit identification of the facts determined by the Commission," the Order was lawful because the Commission can infer fact findings by finding a party's arguments to be "persuasive." *State ex rel. Missouri Office of the Public Counsel v. P.S.C.*, 293 S.W.3d 63, 72 (Mo. App. S.D. 2009) ("*Southern District Opinion*."). Incidentally, the Court allowed the Commission to make a "finding" that low-volume consumers were subsidizing high-volume users without ever including an explicit finding of subsidization in its Order. OPC asks that the Commission address this important issue directly and make a determination of whether the facts support a conclusion that high-volume residential customers subsidize the service of low-volume residential customers under a traditional rate design. The evidence clearly shows the existence of substantial costs based on demand, which proves that allocating demand costs to a demand charge under a traditional rate design is the most appropriate rate design for the residential class.

Reasonableness: OPC argued to the Southern District that the Order was unreasonable because there was not competent and substantial evidence showing subsidization under the traditional rate design. (*Id.*). OPC argued that the evidence in the record showed costs based on demand, thus disproving the argument that the cost to serve each residential customer is identical. (*Id.*). The Commission's Order only briefly touches on this issue and states that *the Staff* argues "that customers in the Residential class are homogeneous with respect to the cost of serving them and that it is unfair to collect these costs through a volumetric rate." (Order p.10). The Order makes no mention of any evidence presented by MGE regarding subsidization – the Order only cited to the subsidization evidence of Staff.

Rather than address whether there was substantial and competent evidence from the Staff on this issue, the Court simply concluded that it did not need to address whether the Staff's evidence was competent and substantial "because, although OPC limits its challenge to just the evidence presented by Staff, the Commission in making its decision was not so limited." (*Southern District Opinion*, at 72). The Court concluded that "[i]rrespective of the validity of OPC's alleged deficiencies in the evidence presented by Staff, the testimony of Feingold and Thompson provided substantial and competent evidence of subsidization." (*Southern District Opinion,* at 73). Unfortunately, the Court failed to consider the same deficiencies in the testimony of Mr. Feingold and Dr. Thompson, and chose not to address those deficiencies simply because OPC did not challenge evidence that was not relied on by the Commission.

OPC would have argued that this additional "evidence" of subsidization also failed to consider demand costs. The Court should not have poured through the Commission's record seeking evidence that the Commission did not rely on. "Findings of fact must be sufficiently definite and certain under the circumstances of the particular case to enable the court of review to review the decision intelligently and ascertain if the facts afford a reasonable basis for the order without resorting to the evidence." *Friendship Village of South County v. P.S.C.,* 907 S.W.2d 339 (Mo. App. W.D. 1995). The Commission never concluded there was evidence of subsidization, and the Court should not have weighed the evidence and substituted its findings for those of the Commission. *Union Electric Co. v. P.S.C.,* 136 S.W.3d 146 (Mo. App. W.D. 2004).

The Court's opinion cannot be trumpeted as a finding that the SFV is just and reasonable because neither the Commission nor the Court gave any consideration for demand costs, and the Court only found that the Commission's Order was just and reasonable, not the rate design it adopted. (*Southern District Opinion,* at 73). Now the Commission is presented with an opportunity to fix these errors and consider *all* costs in determining whether subsidization occurs under the traditional rate design or the SFV rate design. To date, the only Commission decision that concluded there was subsidization under the traditional rate design was overturned by the Missouri Court of Appeals for the Western District because the evidence did not support that conclusion. *State ex rel. Public Counsel v. P.S.C.,* 289 S.W.3d 240 (Mo. App. W.D. 2009).

b. Court of Appeals for the Western District Opinion

A more thorough decision to consider regarding the SFV rate design is the decision by the Western District Court of Appeals reversing and remanding the Commission's Report and Order adopting a SFV rate design for Atmos Energy Corporation ("Atmos"). *Id.* The Western District considered the same cost study evidence relied on by the Commission in the Southern District case and concluded that such evidence did not constitute competent and substantial evidence upon which the Commission could base a finding that low-volume users are subsidized by high-volume users under the longstanding traditional rate design. *Id.*

The Western District concluded that the class cost of service "studies themselves do not support a finding that the cost of service is the same for all residential customers or that there is subsidization within the residential class." *Id.* The Court reversed the Commission's Report and Order and first addressed whether there was competent and substantial evidence to determine that the cost to serve all residential customers is the same regardless of usage:

> The Commission relied on Ms. Ross's testimony when it found that the cost of serving all residential customers is the same regardless of usage. Therefore, the question remains whether Ms. Ross's statements regarding cost of service constitute competent and substantial evidence. First, we note that when Ms. Ross testified that Atmos's cost of service is the same for each residential customer, she continually referred only to the costs associated with meters, regulators, and service lines, stating that, regardless of their usage, all residential customers have "the exact same equipment outside the house." The evidence shows that each of the costs mentioned by Ms. Ross was already included in the fixed charge recovered under the traditional rate design. As OPC argues, Ms. Ross's identification of these costs as fixed costs does not explain why costs previously recovered through a volumetric rate should now be shifted to a fixed charge. While Ms. Ross once mentioned that there are no differences in "other expenses," she failed to clarify to which expenses she was referring.
>
> Additionally, Ms. Ross's statement that all residential customers have the same equipment outside of their homes does not address equipment and costs that go far beyond what is present on a residential customer's premises. While Ms. Ross solidified the concept that the costs of meters, regulators, and service lines are fixed regardless of a residential customer's usage, she did not provide an explanation as to why the costs previously recovered through a volumetric rate should be charged through a fixed rate rather than a usage-based rate. In its application for rehearing before the Commission and in its brief, OPC provides several examples of costs which are recovered or measured volumetrically under the traditional rate structure. These include storage costs, distribution measuring costs, and distribution regulating costs. Where Ms. Ross testified that certain costs are the same for each customer regardless of usage but failed to take all costs into account, her testimony does not constitute competent and substantial evidence upon which the Commission could find that the cost to serve all residential customers is the same.

Id. The Court explained that simply identifying a cost as a fixed cost "does not explain why costs previously recovered through a volumetric rate should now be shifted to a fixed charge." *Id.* The Staff's evidence "failed to take all costs into account" and therefore, "does not constitute competent and substantial evidence." *Id.*

In addition to there being no support for a finding that all costs are the same, the Court also concluded that were was no support for a finding that low-volume consumers subsidize high-volume consumers under a traditional rate design. The Court referred to the Commission's finding that low-use consumers are being subsidized:

> Not only does this portion of the order show that the Commission cites in support of its finding only Ms. Ross's testimony, which we have found does not constitute competent and substantial evidence upon which to base such a finding, but it also demonstrates that the Commission failed to consider a multitude of costs that go beyond the meters and pipes installed on a residential customer's premises. Where an agency's findings are not based on competent and substantial evidence, the agency has acted unreasonably and arbitrarily. *Barry Serv. Agency Co.*, 891 S.W.2d at 892. As the Commission's findings regarding subsidization and the cost to serve residential customers were not based upon competent and substantial evidence, the Commission's adoption of the SFV rate design cannot be upheld based upon those findings.

Id. The Court recognized that the Commission "failed to consider a multitude of costs that go beyond the meters and pipes installed on a residential customer's premises." *Id.* These ignored costs are the demand costs that should be appropriately recovered from consumers through a volumetric rate.

c. Demand Cost Evidence

MGE argues that the Residential and Small General Service (SGS) classes are "reasonably homogeneous." (MGE Brief, p.6). The evidence showing the existence of demand costs and the variations in costs within these classes is in the evidence of Staff, MGE and OPC. MGE's own evidence shows that 20% of residential margin costs are based on demand, and that 34% of small general service margin costs are also based on demand. (Ex.72, p.9). Ms. Meisenheimer provided additional examples:

> For example, the methods used by the Company to determine design day demand, by the Staff to determine coincident peak day demand and by both to determine annual volumes are based on equations that predict average customer use based on Heating Degree Days. If average customer use

> increases due to some customers using more the level of costs allocated to the class will increase. This is consistent with the Staff cost of service study in which the Staff allocates an increasing amount of certain investments and expenses based on increasing class use. It is appropriate and reasonable that a portion of cost recovery be based on rates that vary with use.

(Ex.73, p.14). Ms. Meisenheimer explained in more detail why one significant cost that varies by demand, the cost of mains, is dependent on gas demand of the customers on the system served by that main:

> For example, the cost of mains depends in part on the level of demand reflected in planning for capacity requirements. Design day demand which is used for planning capacity requirements is developed based on historic demand during extremely cost weather that reflects variation in use across customers. Higher anticipated demand causes larger sized mains to be placed and a larger level of total mains investment. Because the level of fixed cost in mains investment depends in part on demand that varies among customers, the investment should not be recovered in a uniform fixed charge.

(Ex. 74, pp.8-9). Declaring these demand costs to be fixed and not dependent on peak demand ignores "the drivers underlying the level of cost". (*Id.* p.15). Distribution mains and their associated expenses are one of the largest single plant categories of margin costs. (Tr. 609).

The primary problem with the evidence of MGE and Staff is that it lumps all short run and long run marginal costs into the fixed cost category without analyzing how those costs were incurred. "Marginal cost is defined as the change in total cost associated with a change in the quantity of output per period of time." (*Id.* p.18). Over the long run, these marginal costs include both short run fixed costs as well as long run variable costs that recognize the changes to the inputs that were fixed in the short run. (*Id.*). Long run costs are a key factor in determining how to size plant and how much investment must be made in that plant. (Tr. 611).

d. SFV Does Not Recognize Cost Differences Within a Class

The Staff argues that recognizing demand costs is appropriate for allocating costs between customer classes, but that it is not appropriate for allocating costs within a customer class. (Staff Brief, p.32). The only reason cited by the Staff is that "rate classes are composed of customers similar in size and usage patterns." (*Id.*). To the contrary, the usage of residential customers fluctuates significantly. The evidence proves that annual residential usage varies from under 50 Ccf to over 5,000 Ccf. (Ex. 120). In other words, the smallest residential gas customers use only one percent (1%) of the gas of the largest residential gas customers. (*Id.*). This is a far cry from the similar size and usage pattern claimed by the Staff. A 99% greater contribution to the peak day demand that is used to size the distribution system should be recognized in rates, and MGE and Staff have provided no convincing arguments to support an order ignoring these huge differences in residential usage. Over the long run, consumers that use 99% more gas will cause a greater contribution to the cost of distribution mains attributable to the residential class.

MGE argues that the SFV best reflects actual cost causation because "the minimum installed size of distribution main will serve over 99 percent of the Company's residential customers…" (MGE Brief, p.7). MGE cites to Mr. Feingold's testimony regarding a hypothetical system of 2" mains. The obvious problem with Mr. Feingold's hypothetical system is that it has nothing to do with the reality of MGE's distribution system. *Id.* In reality, MGE's customers are served by an integrated network of mains, including mains between 3/4" and 1 ½". (Ex.74, p.15, 17). Furthermore, Mr. Feingold's hypothetical system built of 2" mains should be rejected because if applied to reality it would not satisfy the capacity demands of residential customers. (Ex.74, p.16). Mr. Feingold's analysis does not recognize that as mains approach the city gate, they must be much larger than 2" to satisfy aggregate capacity demand. *Id.* MGE's aggregate demand is determined by sizing mains to satisfy the peak day of usage. (Tr. 397-398). By failing to consider the aggregate distribution demands, and by assuming a non-existent system of all 2" distribution mains, MGE has simply manufactured imaginary evidence that is proof of nothing relative to MGE's actual distribution costs. Since the only evidence MGE can cite is hypothetical evidence that fails to recognize how distribution main costs are actually incurred, the evidence before the Commission lacks any support whatsoever to conclude that all costs incurred to serve each residential customer is identical.

Under the SFV rate design, according to MGE's witness Mr. Michael Noack, forty-three percent (43%) of MGE's customers will pay higher rates than under a traditional rate design. (Tr. 1164-1165). Accordingly, forty three percent (43%) of MGE's residential customers are low-volume and will pay higher rates under the SFV without justification. This is a substantial burden to place on such a large number of customers. MGE claims to have 440,000 residential customers. (Tr. 1115). Consequently, forty three percent (43%) of these customers represents <u>189,200 low-volume residential customers of MGE that will overpay the costs to serve them under the SFV rate design</u>.

e. SFV is Not Necessary to Reduce Bill Fluctuations

The second alleged advantage of the SFV is that it reduces spikes in winter bills and moderates bill fluctuations throughout the year. (MGE Brief, p.8). MGE fails to note that customers wishing to reduce their bill fluctuations already do so through MGE's budget billing plan that allows customers to balance their bill and pay the same amount month to month. (Tr. 484). MGE also fails to take into account that customers with high electric usage associated with home cooling during the summer months might prefer a rate design that properly assigns costs to the period in which they were incurred.

f. SFV Does Not Align the Interests of MGE and Consumers

MGE argues that under the SFV, the financial interests of MGE are aligned with the financial of its customers. (MGE Brief, p.10). In reality, the SFV merely makes MGE indifferent towards the impacts of its energy efficiency programs, whereas the interests of consumers are still to use less energy. MGE is indifferent under the SFV because it will recover non-gas costs regardless of whether MGE operates efficiently, whereas consumers must still continue to control their efficiency to achieve their goals of controlling energy costs. These interests are not aligned under the SFV. In addition, OPC's proposed cost recovery mechanism, the LMRRM, would achieve this same goal of making MGE indifferent towards the impact of energy efficiency programs because the LMRRM would allow MGE to recover lost revenues caused by the programs.

MGE also argues that under the traditional rate design, MGE "has an incentive to sell more gas to at least recover its cost." (MGE Brief, p.12). The problem with this argument is that MGE did not actually encourage gas usage under traditional rates. In fact, MGE has done absolutely nothing different since using a SFV rate design with regard to incentivizing customers to use more or less gas. MGE witness Mr. Noack testified that the only way MGE encouraged consumption before the SFV was simply *not* administering energy efficiency programs. (Tr.721-722). The argument that the SFV is necessary to stop MGE from incentivizing its customers to use more gas is false because without the SFV, MGE did nothing differently in terms of promoting gas usage. *Id.* Following MGE's logic, so long as there are sufficient energy efficiency programs in place, the incentive to encourage gas usage has been removed. *Id.* The SFV is not a prerequisite for effective energy efficiency programs, and therefore, the argument that the SFV removes an incentive to encourage usage lacks merit because energy efficiency programs can be ordered and administered under traditional rates just as well.

g. Support for Decoupling is Not Support for SFV

MGE wrongly claims that state and federal energy policy supports SFV. The evidence cited by MGE only shows support for revenue decoupling generally and not the narrow approach of assuming MGE's distribution system has zero costs that vary with demand. MGE quotes OPC's rate of return witness Mr. Lawton's testimony regarding the efforts by gas utilities across the country to implement a SFV rate design, and misinterprets Mr. Lawton's testimony as a statement that SFV is being accepted by other regulatory authorities. (MGE Brief, p.14). In fact, Mr. Lawton's quote only referenced the efforts by utility companies to adopt a SFV rate design. Mr. Lawton clarified that only two jurisdictions have actually adopted a SFV rate design, and that his "sweeping the nation" reference was in regards to mere *proposals* by utility companies to adopt a SFV rate design. (Tr.359-360).

For an understanding of what other state commissions are adopting across the country, OPC refers the Commission to the state commission cases discussed in OPC's Initial Brief where state commissions are overwhelming adopting rate designs that maintain the demand cost recognition inherent in a rate based in part on volumetric demand.

h. Subsidization Claims are Unsupported

On page 21 of MGE's Initial Brief MGE lists the deficiencies of the traditional rate design. MGE argues that reverting to the traditional rate design is deficient because the cost to serve residential and SGS customers does not vary based upon the volumes consumed. (MGE Brief p.21). Missing from MGE's argument is a reference to evidence supporting such claim. Likewise, MGE cites to no evidence to support its claim that "[a] volumetric rate design is not reflective of the true costs of serving those customers." (*Id.*). The only cite to the evidence made by MGE in its list of deficiencies with the traditional rate design is the claim that "[a] volumetric-based rate design will cause residential customers to overpay for services by a greater amount during colder than normal periods." MGE fails to provide evidence that under the traditional rate design high-volume users subsidize the services of low-volume users. MGE's only cite to the evidence is a citation to the obvious; that under a traditional rate design more costs are recovered during the winter. The Commission should not infer, as MGE does, that this will cause customers to "overpay" for services. The lawful rates resulting from this case will be normalized for weather variations to avoid over recovery and under recovery. Furthermore, higher winter use is a cost driver properly recognized by a traditional rate design that recovers more in the winter and less in summer. (Ex.74, p.12).

i. Customer Comments

MGE continued its objection to the Commission taking official notice of, or entering into evidence, the roughly 12,000 customer comments received by the Commission from MGE's customers regarding MGE's rate case. However, in addition to having an opportunity to address this evidence during the regularly scheduled evidentiary hearing, the Commission has provided MGE with an additional hearing for the very purpose of rebutting this evidence.

The Commission should note that all throughout the process of soliciting comments and receiving comments, MGE's customers were not made aware of the continued dispute over the SFV rate design. In fact, the notice that went out to customers did nothing more than highlight MGE's current rate and MGE's proposed rate. (Tr. 1132). The notice made no mention of OPC's proposed rate design. Had customers been given an explanation of the rate design proposal of OPC to revert back to the decades old traditional rate design, OPC would expect the number of customers raising this as an issue to increase substantially.

During the on-the-record, MGE attempted to assert that the response in opposition to the SFV rate design was minimal. This assertion is contradicted by the testimony of Staff witness Ms. Gay Fred, as discussed in OPC's Initial Brief. The accuracy of MGE's "study" is questionable. First, MGE was not performing an unbiased survey because those performing the analysis were already aware of the outcome MGE wanted.[1] Second, MGE's analysis included a search of only a few terms rather than a comprehensive list of terms that may be used to indicate displeasure with a rate design proposal. For example, MGE's analysis looked for the figure $24.62, which is MGE's current fixed customer charge. (Tr. 1136). MGE did not, however, look for comments on the fixed rate proposed by MGE of $29.83. (*Id.*). MGE's witness also testified that she could not recall any customer comments that supported the SFV rate design. (Tr. 1138).

j. Rate Design Conclusion

MGE's rate design position represents the interests of MGE's shareholders with little if any regard for the welfare of consumers. The Staff's positions with regard to rate design contradicts countless positions taken by the Staff in support of a traditional rate design, it contradicts prior testimony of Staff witness Mr. Michael Proctor that concluded a high fixed charge is harmful to consumers, and it contradicts the current conclusion by Staff witness Mr. Dan Beck that the traditional rate design is a just and reasonable methodology. (Ex.100). And by relying on the same evidence and arguments regarding the SFV rate design, the Staff's position also ignores the Opinion of the Western District concluding that the Staff's evidence on rate design was neither competent nor substantial.

OPC's positions recognize MGE's needs through the partial settlement and through proposals such as the Lost Margin Revenue Recovery Mechanism that would essentially make the utility indifferent towards administering energy efficiency and conservation programs. This was a proposal OPC proposed in the interest of compromise and to provide the Commission with an alternative that addresses the concerns raised by ordering an LDC to implement energy efficiency and conservation programs. Similarly, OPC recommends that the Commission collect more through the customer charge than the $12.36 direct costs attributed to fixed costs because OPC sought to respond to MGE's arguments that it needs insulation against variations in volumes. (Tr. 597-598). OPC has attempted to respond to MGE's criticisms of the traditional rate design. It is not surprising that MGE has not endorsed OPC's proposals because they fail to continue shifting risk to consumers to the same extent sought by MGE.

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[1] MGE's witness at first testified that she was not aware of MGE's opposition to the comment cards at the time she conducted her analysis, but on further cross-examination she recanted and

B. RATE OF RETURN, CAPITAL STRUCTURE, and COST OF CAPITAL

1. Capital Structure: *What capital structure should be used for determining MGE's rate of return?*

MGE attempts the same arguments that have been repeatedly rejected by the Commission time and again. MGE wants the Commission to believe there has been a change in circumstances that somehow warrants a change from the Commission's repeated findings and conclusions rejecting this very proposal. An order from the Massachusetts Department of Public Utilities (DPU) is consistent with the Commission's past orders and provides further support for an order that continues to reject MGE's attempt to increase rates by relying on a hypothetical capital structure.

New England Gas Company (NEGC), MGE's sister SUC company, requested a hypothetical capital structure from the Massachusetts DPU. The Massachusetts DPU rejected the request and ordered NEGC to use the capital structure of Southern Union Company. In a February 2009 order the Massachusetts DPU held:

> We acknowledge that this capitalization ratio is somewhat skewed in favor of debt. In imputing a capital structure with minor adjustments to SUG's actual capital structure, however, the Department has attempted to implement two objectives. First, to relieve ratepayers by approximating fiscal policies that management should have been previously implementing in order to take advantage of lower-cost financing, and, second, to provide management with an incentive to introduce greater leveraging in their companies' capital structures. Assabet Water Company, DPU 95-35, at 33 (1996); Ashfield Water Company, D.P.U. 1438/1595, at 5-6 (1984); D.P.U. 1360, at 26; Blackstone Gas Company, D.P.U. 19830/19980, at 26 (1979). In this case, however, SUG has taken advantage of the debt markets and leveraged its investment through long-term borrowings. While the Department has cautioned SUG about excessive reliance on the debt markets, we do not consider its actual capital structure to deviate substantially from sound and well-established utility practice to such a degree that warrants imputation of a hypothetical capital structure. Moreover, although SUG's debt ratio may not be consistent with optimum gas distribution utility practice, that fact alone does not warrant the imputation of a hypothetical capital structure. D.P.U. 91-

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admitted that she was aware of MGE's objections before starting her review. (Tr. 1135-1136).

> 106/138, at 97. To the extent that investors may no longer associate SUG as a gas distribution company, this distinction is more appropriately considered in the context of the appropriate return on equity associated with the Company, not through imputation of a hypothetical capital structure.
>
> Based on the foregoing analysis, the Department rejects the Company's proposed hypothetical capital structure. We direct the Company to use the actual capital structure of SUG as of December 31, 2007, with the adjustments described above. Consistent with these findings, we direct the Company to apply a cost of long-term debt of 6.46 percent and a cost of preferred stock of 7.76 percent. The resulting capital structure is provided in Schedule 5 of this Order.[2]

This Commission should also reject SUC's arguments that fail to warrant the imputation of a hypothetical capital structure. According to the Massachusetts DPU, even if investors no longer consider SUC to be a gas distribution company, this distinction should not be recognized through a hypothetical capital structure.

Mr. Lawton has extensive experience testifying on cost of capital issues before regulatory commissions across the country. (Ex. 69). Mr. Lawton testified that it is not typical to see hypothetical capital structures used where the subject company is a mere *division* of the corporate entity. (Tr. 319). Hypothetical capital structures are usually seen where the company is a separate legal entity like a subsidiary. (*Id.*). Such is not the case here, and using a hypothetical capital structure for MGE continues to be inappropriate and would be unnecessarily costly to consumers in that it would give MGE an opportunity to earn *more* than its authorized equity return. (Tr. 357-358).

2. <u>Rate Design Risk</u>: ***Would the Commission's adoption of MGE's proposed rate design that recovers all non-gas costs in a fixed customer charge for Residential and SGS customers reduce MGE's business risk? If the answer is "yes," should that reduced risk be recognized in the determination of either cost of capital or the revenue requirement?***

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[2] Petition of New England Gas Company to the Department of Public Utilities for Approval of Changes to its Schedule of Rates, Pursuant to G.L. c. 164, § 94 and 220 C.M.R. §§ 5.00 et seq., D.P.U. 08-35, Order, February 2, 2009, pp. 190-191.

MGE argues that Mr. Lawton's risk adjustment "completely ignores" the decoupling mechanisms and similar protections provided for the proxy companies. (MGE Brief, p.50). However, Mr. Lawton clearly recognized the different rate design mechanisms of the proxy companies by appropriately recognizing the difference between a rate design that *completely* eliminates weather risk from one that *partially* eliminates weather risk. MGE's witness "Mr. Hanley assumes that a SFV (decoupling) rate design is the economic equivalent of a weather normalization clause – which it is not." (Ex.70, p.5). Likewise, Mr. Hanley mislabels other mechanisms that are not decoupling as decoupling, and ignores the fixed customer charges in his analysis. (*Id.*). Mr. Lawton testified in regards to Mr. Hanley's analysis:

> A weather normalization clause is limited to only weather sensitive sales and is implemented only when weather deviates from normal for those weather sensitive volumes. On the other hand, SFV rate design or margin tracker mechanisms capture all sales, all revenues, and assure 100% of the recovery of the entire margin. While weather adjustment mechanisms have typically much smaller impacts. Thus, Mr. Hanley has overstated the amount of revenues that are truly subject to decoupling. Essentially, by treating all forms of decoupling as having an equal impact on revenue/margin recovery, Mr. Hanley overstates the level of decoupled revenue in the group and understates the risk shifting to customers in the case of MGE.

(Ex.70, p.5). A rate design that assures recovery of 100% of margin revenues through a fixed customer charge is clearly not the same as a rate design that recovers a portion of its margin revenues through a combined volumetric/fixed rate design. Unlike Mr. Hanley's flawed analysis that assumes all decoupling rate designs are the same, Mr. Lawton considered the true differences in rate designs and determined that the proxy company rate designs are understandably less risky than a SFV rate design. This necessitates a 50 basis point reduction to ROE or reduction to MGE's cost of service of $1,842,034 if the Commission were to order a SFV rate design for residential and SGS services.

MGE argues that there is little evidence of other jurisdictions accounting for the reduced risk of a SFV rate design through a reduced ROE or reduction to the authorized revenue requirement. However, the SFV is clearly not being accepted and adopted across the country and therefore the cases that address the risk associated with the SFV simply do not exist. This Commission is one of the first to address this issue in MGE's last rate case, where the Commission properly recognized that the SFV reduces risk and necessitates a significant corresponding reduction to the company's revenue requirement.

C. ENERGY EFFICIENCY

MGE argues that OPC's proposal to create a Lost Margin Revenue Recovery Mechanism (LMRRM) to incent MGE to continue offering energy efficiency programs is "a hastily offered afterthought." (MGE Brief p.32). Rather than provide any legitimate analysis and response to the LMRRM proposal, MGE is desperately trying to minimize the Commission's consideration of the LMRRM proposal because it does not achieve MGE's ultimate goal, which is to completely reduce the company's conservation risks and shift those risks to consumers by collecting the same from customers regardless of their usage. Nonetheless, the Commission *should* consider OPC's LMRRM proposal because it provides the same indifference towards the program's impact on revenue recovery. The only thing it does not have is the guaranteed recovery that ignores the opportunity to provide customers with a valuable price signal to provide additional encouragement for energy efficiency and conservation. MGE's arguments only highlight the truth behind MGE's incentives, and energy efficiency and conservation takes a significant back seat to guaranteed earnings. OPC is aware of no Commission policy, or other policy objective, that natural gas distribution companies should not be weather sensitive.

D. CONCLUSION

The State of Missouri's motto is "*Salus populi suprema lex esto*" which also appears on the Commission's emblem. It translates to "let the welfare of the people be the supreme law." § 10.060 RSMo. OPC asks that the Commission be mindful of this motto when fulfilling its duties and resolving the issues of this case. OPC believes the positions it has taken in this case, if followed in the Commission's order, would satisfy this public welfare purpose.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that copies of the foregoing have been mailed, emailed or hand-delivered to the following this 5th day of January 2010:

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