BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Missouri Gas Energy's Tariffs Increasing Rates for Gas Service Provided to Customers in the Company's Missouri Service Area.	))))	Case No. GR-2006-0422

BRIEF OF THE OFFICE OF THE PUBLIC COUNSEL

On May 1, 2006, Missouri Gas Energy ("MGE") filed proposed tariff sheets with the Commission designed to increase MGE's revenue for natural gas local distribution service by approximately $41.7 million annually. MGE's request seeks a substantial twenty-six percent (26%) increase in revenue over and above the revenues that the Commission authorized for MGE sixteen (16) months prior to the present rate case filing. This is a substantial increase for a company that effectively met its Commission authorized rate of return during the test year. In 2006, MGE was less than ¾ of one percent shy of their authorized 8.36% rate of return. This is not a company struggling to earn its authorized return. In fact, the President and CEO of MGE's parent, Southern Union Company ("SUC"), stated in SUC's 2005 Annual Report that MGE "performed exceptionally well and was the major contributor to the success of the company's distribution segment in 2005." (Tr. 289). This statement was made six weeks before MGE filed the present rate case. When asked by Chairman Davis what MGE's investors earned as an achieved return on equity during the test year, MGE's evasive response was that it does not calculate a return on equity. (Tr. 590). Such a calculation would seem important to a company trying to prove it is not able to achieve its authorized return, and not so important to a company meeting or exceeding its authorized return. The current rate design has given MGE more than an ample opportunity to earn its authorized return. Any substantial changes in revenue requirement

or in rate design could tip the balance in favor of MGE's shareholders to the detriment of the captive ratepayers the Commission is charged with protecting.

A. Cost of Capital

1. Return on Equity

If the Commission maintains the current rate design, Public Counsel supports the Staff's recommended rate of return and return on equity (ROE). If the Commission adopts a rate design proposal that eliminates weather variability and other business risk for MGE by allowing MGE to collect all non-gas costs through a fixed charge, a corresponding reduction should apply to the ROE. The United States Supreme Court, in *Bluefield Water Works and Improvement Company v. Public Service Commission of West Virginia*, 262 U.S. 679, 67 L.Ed. 1176, 43 S.Ct. 675 (1923), and in *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591, 88 L.Ed. 333, 64 S.Ct. 281 (1944), mandated that the rate of return for a utility must be comparable to the return on investments in other enterprises having a corresponding risk. The rate designs proposed by the Staff and MGE fail to properly apply the *Hope* and *Bluefield* analysis by not properly factoring risk into the calculation of ROE. Unless the elimination in business risk is accounted for through an offsetting reduction in the Company's rate of return, customers will unjustly pay through rates the higher return associated with a riskier investment in violation of the *Hope* and *Bluefield* standards. (Ex. 200, p. 6).

By ensuring recovery of a set level of revenue, the impact weather plays on MGE's earnings disappears. Under a decoupling rate design the non-gas revenue requirement, including ROE, intended to be collected will in fact be collected. (*Id.*). The result would be rates paid by customers that compensate stockholders for a risk they no longer have, therefore such rates would not be just and reasonable. (*Id.*). MGE and Staff make no allowances in their ROE

recommendations to recognize the reduction in risk which will occur if the Commission eliminates the risk of earnings variability for MGE. (*Id.* at p. 6).

A rate design that virtually eliminates all earnings risk for a utility has, to Public Counsel's knowledge, never been adopted by the Commission. Accordingly, Mr. Trippensee developed a sensible approach to factoring risk reduction into the ROE calculation and offers a reasonable ROE should the Commission give MGE a guaranteed return. The business risk reduction should be more than the cost of debt for MGE of 7.70% but less than the Staff's low end recommendation of 8.65% since Staff did not include a downward adjustment for risk. (Ex. 200, pp. 11-12). Since "financial risk recognizes that cash flows for stockholders are subordinate to the legal rights of debt holders," equity investors would be properly compensated with a return on equity in excess of the cost of debt of 7.70%. (Ex. 200, pp. 8-9).

MGE concedes that the ROE should be reduced to reflect the risk reduction. MGE witness Mr. Hanley adjusted ROE *upward* by 0.15% because MGE has no weather mitigation rate design. Mr. Hanley also testified that approval of such weather variability protections would *reduce* the "common equity cost rate risk by 0.25%." (Ex. 1, p. 73). Mr. Hanley offers absolutely no testimony to quantify the basis for his 0.15% upward adjustment or his 0.25% downward adjustment proposals. Mr. Hanley's 0.25% downward adjustment, if factored into the Staff's low end ROE recommendation, would produce a ROE of 8.4% - well within Mr. Trippensee's supported range of 7.7% to 8.65%.

Recognizing the impact of changes to shareholder risk is not a novel concept for Missouri utilities, especially MGE. In 1995, this Commission considered a weather normalization tariff for MGE in Case No. GT-95-429 and in rejecting it concluded:

> The Commission agrees with OPC and Staff that the institution of the WNC tariff could affect the company's rate of return by reducing its risk. If the rate of return

> were to change, the matching of revenues and expenses approved by the Commission in the company's last rate case would be abrogated and the effective rate structure changed without a reconsideration of all relevant factors.

In the Commission's decision approving a rate increase for MGE in 2004, the Court of Appeals upheld the Commission's decision to increase "Staff's recommended return on equity in recognition of the higher risk to shareholders from the large amount of debt" in the capital structure. *State ex rel. Missouri Gas Energy v. PSC,* 186 S.W.3d 376 (Mo. App. W.D. 2005). Rate of return analysis under *Hope* and *Bluefield* should not be a one-way analysis. Both increases and reductions in risk should be considered. Missouri Senate Bill 179 acknowledges the need to reduce a natural gas utility's ROE to account for the reduction in business risk associated with weather mitigation. In Section 386.266.7 RSMo (2005 Cum. Supp.), the Legislature authorized the Commission to approve weather normalization adjustments, and to "take into account any change in business risk…in setting the corporation's allowed return."

Recognizing the reduced ROE that logically flows from a reduction in risk has been recognized by courts and other regulatory agencies. When the Federal Energy Regulatory Commission (FERC) restructured the interstate natural gas pipeline industry in 1992, it adopted a straight fixed variable (SFV) rate design in order to promote competition. The FERC recognized the impact of a SFV rate design on risk in determining ROE and concluded that such recognition should be considered in rate proceedings.[1] In North Carolina, the North Carolina Utilities Commission (NCUC) considered a decoupling rate design proposal (CUT) for Piedmont Natural Gas Company and addressed the risk reduction by requiring a "substantial and effective conservation initiative" in return. The NCUC stated:

[1] FERC Order No. 636, 57 FR 13267, *Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation; and Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol,* April 16, 1992.

> Given the reduced shareholder risk, the Commission believes that customers should realize a distinct benefit as a part of any order approving the CUT. One benefit that would be particularly appropriate in the current environment is a conservation incentive to assist residential and commercial customers. … The Commission does not believe that it is sufficient to eliminate the Company's disincentive as to conservation. The Commission believes that in order for the CUT to be fair to both the Company and customers, approval of the CUT must be associated with a substantial and effective conservation initiative by Piedmont to assist its customers with the high natural gas prices that they face today.[2]

Piedmont was ordered to double its $250,000 conservation and efficiency program proposal to a $500,000. This demonstrates that some form of offset needs to be made to reflect the reduction in shareholder risk. In Iowa, the Iowa Utilities Board (IUB) recently concluded that a "significant flaw" in a rate design proposal "was the absence of an adjustment to the return on equity to reflect the reduced risk that would accompany the approval of the" proposal. The IUB found no support for a return on equity that "did not reflect any consideration of what an appropriate return on equity should be for low-risk revenue recovery mechanisms…"[3]

MGE and the Staff propose ROE percentages that admittedly fail to consider the reduction in risk that should result from a rate design that eliminates most of MGE'S business risk. (Tr. 66-69, 223-224). MGE's ROE witness admitted that he did not study the rate designs of his proxy companies in any detail to determine whether the business risk for the comparable group was similar to MGE's risk under the proposed rate design. (Tr. 66-69). In fact, all of the proxy companies retain a level of weather volatility, unlike the decoupling proposal before the

[2] In the Matter of Application of Piedmont Natural Gas Company, Inc., et al. for the Consolidation of Their Revenues, Rate Bases and Expenses, a General Increase in Rates and Charges, Approval of Various Changes to and Consolidation of Their Rate Schedules, Classifications and Practices, and Approval of Depreciation Rates, *Order Approving Partial Rate Increase and Requiring Conservation Initiative,* 246 P.U.R.4th 287, November 3, 2005.

[3] Iowa Utilities Board, *Final Order on Rehearing and Granting of Waiver*, Docket Nos. RPU-05-2 and WRU-06-16-225, *In re. Aquila, Inc. d/b/a Aquila Networks,* 2006 Iowa PUC LEXIS 394, September 12, 2006.

Commission. (Tr. 101). Staff's ROE witness also admitted that he too did not look at the corresponding rate designs of his proxy companies to determine comparable risks. (Tr. 226-228). The proxy companies identified by the Staff do not have similar risks because they do not operate under rate designs where weather is not a factor. Where this issue has been considered elsewhere, the conclusion has been to reduce the company's return on equity to correspond to the reduction in risk. Mr. Trippensee provides an analysis that factors this reduction in risk into the return on equity calculation that should be adopted if the Commission decouples rates.

B. Income Statement - Expenses

1. Unrecovered Cost of Service Amortization

MGE seeks to recover revenue losses of $15.6 million from January 2006 to June 2006 in future rates in violation of clearly defined legal principles regarding retroactive ratemaking and revenue neutrality. Retroactive ratemaking is a concept that has been well settled by the Supreme Court of Missouri as unlawful. In *State ex rel. Utility Consumers Council of Missouri, Inc. v. PSC,* 585 S.W.2d 41, 49 (Mo. 1979), the Supreme Court stated that the Commission could not redetermine rates already established to the detriment of the consumer without depriving the consumer of his property without due process.

Revenue neutrality is a related concept that has been recently explained by the Missouri Court of Appeals for the Western District. In MGE's appeal of the Commission's 2005 Cold Weather Rule, the Court found "no statue, rule, or case supporting the utilities assertion of revenue neutrality, i.e. that they have a property right to a defined level of revenue." *State ex rel. Missouri Gas Energy v. P.S.C.,* 2006 Mo. App. LEXIS 1645 (2006). Requesting to add the alleged $15.6 million deficiency into future rates is an attempt to achieve revenue neutrality.

MGE argues against itself on this issue when Mr. Noack, addressing a separate property tax issue argues that "it would be wrong to allow the company, when it incurs a shortfall, to attempt to recoup that shortfall through future rates." That is exactly what MGE is requesting of the Commission through the $15.6 million meant to recover a supposed shortfall from January 2006 through June 2006. The Commission should reject this proposal to unlawfully recover the $15.6 million in future rates

2. Environmental Response Fund

Public Counsel opposes MGE's proposal to force future ratepayers to be potentially liable for funding the cleanup costs for past hazardous substance releases at numerous Superfund sites. The facts supporting an order rejecting MGE's environmental response fund proposal include the following: 1) MGE and Western Resources, Inc. (WRI) have already accepted liability for the remediation costs through an Environmental Liability Agreement; 2) The sites are not used and useful in providing service to current customers; 3) Remediation costs are not incurred because of the gas service MGE provides to current customers; 4) Shareholders are already compensated for site investigation expenditures through the risk premium inherent in the equity portion of MGE's weighted average rate of return; 5) Shareholders, not ratepayers, receive the benefits of any gains or losses of any sale or removal from service of MGE's land or investment; and 6) Automatic recovery from MGE customers may reduce MGE's incentive to seek partial or complete recovery of the costs from other potentially liable parties. (Ex. 205, p. 11).

Two years ago the Commission rejected MGE's attempt to establish this same environmental surcharge that MGE is requesting in this case. And two years ago the Commission rejected it for very good reasons. In Case No. GR-2004-0209, the Commission concluded that the environmental cleanup costs were "based entirely on speculation regarding

costs that may never incur." MGE is again asking for costs the company may never incur. The Commission's Report and Order went on to find that the environmental fund would be a disincentive to Southern Union to "ensure that only prudently incurred and necessary costs are paid." The Commission also found that recovering upfront from ratepayers would deter Southern Union from simply paying ratepayer funds to settle claims brought against it.

Southern Union was aware of the possible environmental costs associated with purchasing the assets of WRI. The Company negotiated a purchase price that recognized these environmental liabilities and entered into an agreement with WRI to apportion those liabilities. (Ex. 205, p. 12; Tr. 914). MGE's request also violates basic regulatory principles. First, the "costs" allegedly related to MGP clean up are not "known and measurable." MGE and Southern Union do not know what the expected future remediation cost will be. (Ex. 205, p. 19). Second, these costs do not relate to the provision of gas service to customers.

The environmental liability extends to owners of land upon which such wastes are found and those previous owners in the chain of title, not consumers. Under the agreement, if the Commission rejects this attempt to put ratepayers on the line for environmental remediation costs, Southern Union and WRI have agreed to split that responsibility. (Tr. 1241-1242). This attempt to mitigate the liability Southern Union voluntarily assumed should be rejected, thus triggering the agreement to split responsibility between Southern Union and WRI. Rejecting this proposal will have absolutely no material impact on MGE's financial position. (Ex. 205, p. 21).

3. Infinium Software Amortization

The Commission should disallow the entire unamortized balance for the recently replaced Infinium Software and require MGE to write off such disallowance as a non-recoverable loss. By replacing the Infinium software with new software, current and future

ratepayers will not receive any benefit and the concept of basing rates on "used and useful" property would be violated. (Ex. 205, p. 22). Traditionally, stockholders rather than ratepayers have been required to bear the responsibility for any utility investment that is not used and useful to provide service to ratepayers. The Missouri Court of Appeals for the Western District in *State ex rel. Union Electric v. P.S.C.,* 765 S.W.2d 618 (Mo. App. 1988), upheld the Commission's decision to deny the costs of canceling Union Electric's Callaway II nuclear unit and held:

> The utility property upon which a rate of return can be earned must be utilized to provide service to its customers. That is, it must be used and useful. This used and useful concept provides a well-defined standard for determining what properties of a utility can be included in its rate base.

Future ratepayers should not be forced to pay for software no longer in service. Ratepayers receive no useful benefits from the disposal of the assets and should not be required to reimburse MGE for its loss. It is the responsibility and obligation of the regulatory process to ensure fair treatment for ratepayers when it comes to certain types of elective decisions by management that results in increased burdens on ratepayers with no clear offsetting advantages.

In December 2004, a date outside of the test year in this case MGE retired the Infinium software by reducing accumulated depreciation $4.5 million and by booking a $2.3 million loss on disposition of the property, which combined equal the total plant cost associated with the Infinium software. Now, however, MGE claims the software was simply reclassified as non-utility plant. Non-utility plant is not usually included in the determination of rates of a regulated public utility in Missouri. Furthermore, MGE's treatment of the booked value of the asset violates Generally Accepted Accounting Principles (GAAP). At the time MGE migrated to the new software, GAAP would have required MGE to record the booked value of the asset to a level that approximates its actual continued usage within MGE. MGE has been unable to provide OPC with information verifying that the value of the plant was booked.

4. Emergency Cold Weather Rule AAO Recovery Mechanism

MGE seeks an Accounting Authority Order (AAO) recovery for costs associated with the Commission's Emergency Cold Weather Rule (ECWR). Staff witness Paul Harrison identifies the $901,331 that MGE claims as ECWR costs as "the difference between the amount that the Company could have collected from these customers under the old cold weather rule and the amount that they actually collected under the ECWR." (Ex. 119, p. 17). These alleged "costs" should be rejected because the $901,331 does not represent any incremental costs to MGE. It simply represents the difference between what reconnected customers paid under the ECWR towards their preexisting arrears (50% of arrears) and what they would have paid in the unlikely event that an equal number of customers were to have reconnected absent the ECWR (80% of arrears). The difference in reconnection payments under the existing rule and the emergency rule is not a cost. The Company has already incurred the costs associated with providing the service that created the existing arrears. Decreasing the amount the customer pays to MGE for reconnection does not alone increase those costs. MGE has not been burdened with any additional costs unless the reconnected customers accumulate any additional arrears.

The only true costs of the ECWR would be any additional arrears that accumulated after a customer was reconnected under the ECWR. This can be calculated by first looking at the amount each reconnected customer owed before paying the reconnection amount. If upon subsequent disconnection the customer owes more than what was owed before reconnection, MGE has an additional cost associated with the ECWR reconnection. Additional arrears should be offset by payments made by the reconnected customers. Allowing the requested AAO cost calculation would simply give MGE a consumer funded windfall, and would violate the ECWR by allowing recovery through an AAO of amounts that are not costs of the rule.

Subsection (F)(c) of the ECWR permits a utility to recover the costs of complying with the ECWR, but prohibits recovery of costs "that would have been incurred in the absence of this emergency rule." The Missouri Court of Appeals for the Western District, in its recent review of the Commission's ECWR, stated that "[t]he AAO is only available for the costs resulting from implementation of the ECWR that would not have occurred otherwise." *State ex rel. Missouri Gas Energy v. P.S.C.*, 2006 Mo. App. LEXIS 1645 (October 31, 2006). To simply include the difference between the normal amount to reconnect and the ECWR amount violates subsection (F)(c) of the ECWR.

C. Rate Design

The Partial Non-Unanimous Stipulation and Agreement filed on December 8, 2006 resolved all Class Cost of Service issues. Under the agreement, any increase in revenue shall be divided among all customer classes on an equal percentage of the normalized current non-gas revenues for each customer class. The Parties agreed there would be no interclass revenue shifts. Unfortunately, the parties were unable to resolve their differences regarding rate design.

1. Residential Rate Design

MGE and Staff propose that the Commission depart from the current and traditional approach at designing rates and turn to a new methodology structured to guarantee that utilities will earn their authorized return rather than following the longstanding standard to provide the utility with an *opportunity* to earn a fair return. Two years ago the Commission set MGE's current rate design at a 55% fixed rate element and a 45% volumetric element, and concluded it would be contrary to good public policy to charge ratepayers more than 55% in a fixed charge. No changes in circumstances have occurred to suddenly make the current rate design unjust and unreasonable. Accordingly, there are no policy implications associated with ordering that MGE

use the current rate design since it has been proven time and time again to be just and reasonable for ratepayers and shareholders.

The President and CEO of MGE's parent company praised MGE's 2005 success, and in 2006 MGE earned less than ¾ of a percent from its authorized rate of return. (Tr. 289). The existing rate design continues to provide MGE with a sufficient opportunity to earn a fair rate of return as required by law, as it did for 2005 and 2006, and should not be abandoned without a replacement that is clearly superior. Other state commissions nationwide are maintaining a volumetric element in their rate design, or are being presented with detailed rate design proposals that aggressively pursue conservation and efficiency programs and thoroughly consider customer impacts when an increased fixed charge is proposed. Even MGE's witness Mr. Feingold testified that he has never recommended a straight fixed-variable rate design to any state commission other than the Missouri Commission. (Tr. 378). In all other rate design recommendations by Mr. Feingold, weather remained a variable. (Tr. 378). This Commission, however, has been presented with an untested and understudied rate design methodology that should be rejected for the numerous shortcomings identified in this brief. Staff witness Ms. Ross testified that the extent of her review of other rate design methodologies was by reading trade journals, and that she did not study specific rate design methods adopted in other states. (Tr. 423). The best resolution of this issue is to continue the current rate design and direct the Staff and the Company to return with any new rate design proposals only after fully considering the rate designs used nationwide, their track records, and the anticipated impacts each would have upon Missouri ratepayers. If any rate design changes include an increase in the fixed charge and a reduction in the volumetric charge, those proposals should be accompanied by nothing less than an aggressive and meaningful proposal for conservation and energy efficiency programs.

a. The Decoupling Rate Design Proposals Will Reduce Ratepayer Incentives to Conserve and to Practice Energy Efficiency

Currently gas utility rates are "coupled" in that they contain both a fixed rate element and a volumetric rate element. Companies recover the fixed element through a fixed customer charge regardless of changes in weather or changes in the consumer's attempts to curtail usage and lower the overall amount of the customer's bill. The volumetric element, on the other hand, is directly tied to the customer's usage. If the consumer conserves usage, the consumer benefits through a lower gas bill. Removing the volumetric element from a portion of a customer's gas bill through decoupling will discourage conservation and energy efficiency. The current rate design allows a consumer to see greater benefit from conservation and energy efficiency practices than a decoupling rate design. (Tr. 1165). This is especially true for a decoupling rate design that removes *all* volumetric elements. The more savings a customer realizes through conservation and efficiency practices, the greater the incentive to continue such practices. Removing this incentive has the negative effect of encouraging consumption. Promoting consumption is wasteful of our natural gas resources and should be discouraged.

The new rate design proposals offer no meaningful programs as an offset to the loss of conservation and efficiency incentives built into the existing rates. The illogical premise that MGE will suddenly begin to promote energy efficiency and conservation once the Commission decouples MGE's rates is blind to the reality that MGE is a business with zero incentive to volunteer to implement efficiency and conservation programs with or without a guaranteed return. Absent a commitment to provide meaningful programs, there is absolutely no guarantee to consumers that the conservation incentives they have given up will be replaced.

Customers expect to see benefits from practicing conservation by lowering the thermostat or using alternative heat sources. Similarly, a customer's ability to lower their bill

through energy efficiency efforts will also be diminished. The energy efficiency benefits achieved today from adding insulation, new windows, or energy efficient appliances will be reduced. During a time when conservation and energy efficiency are more important to consumers than ever, adopting a rate design that impairs those efforts is poor public policy. If the Commission chooses to keep the current rate design, no additional costs will be incurred to achieve the conservation and efficiency benefits that are inherent in a volumetric rate element. If the Commission adopts a straight fixed-variable rate design, additional costs will need to be incurred before conservation and efficiency benefits will be realized.

b. The Commission Recently Found Decoupling Rate Design Proposals to be Contrary to Good Public Policy

The Commission recently addressed this issue when MGE requested a rate design proposal that would increase MGE's fixed rate element and reduce MGE's volumetric rate element. The Commission found that placing more than 55% into a fixed charge to be poor public policy. The Commission rejected MGE's weather mitigation proposal and held:

> 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. … 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. 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.

The Commission determined that the "current ratio between fixed and volumetric rate elements, whereby MGE recovers approximately 55% of its residential distribution revenues from fixed

elements, is appropriate." Nothing has changed to make what was poor public policy two years ago now good public policy. MGE would recover 100% of its residential distribution revenues from fixed elements. Customers would not receive as much of a benefit from warmer than normal weather, and would have less ability to lower their bills by conserving energy.

c. The Decoupling Rate Design Proposals Harm Low-Volume and Low-Income Users

The proposed decoupling rate design would create negative impacts on low use ratepayers by shifting revenue responsibility within the residential rate class from high-volume users to low-volume users. (Ex. 202, p. 6; Tr. 387). This shift caused Staff witness Dr. Michael Proctor to oppose Laclede's rate design proposal in Case No. GR-2002-356 to recover all non-gas costs in the customer charge. (Ex. 202, p. 8). Dr. Proctor concluded:

> While the Staff favors using rate design as a weather mitigation measure, because of the detrimental impact on small users, the Staff was not wiling to recommend recovering all of the non-gas costs in either the customer charge, first block rate or a combination of these rate components.

Customers expect the Commission to design rates that follow the proven concept of charging more to customers who use more and receive more benefit. Adopting the decoupling rate design will force single ratepayers living in small efficiency apartments and using gas only for water heating or cooking to pay the same as a large family in a large home using gas for space heating, water heating, cooking, and gas fireplaces. The decoupling proposals would increase rates for low usage customers as much as forty-three percent (43%), while lowering rates for high usage customers as much as fifty-eight percent (58%). (Ex. 202, p. 6).

MGE presents a study comparing census zip code data to support its claim that low-income consumers consume *more* gas than high-income consumers. MGE's study contradicts previous testimony by Mr. Roger Colton before the Commission that presented information from

the U.S. Department of Energy, the U.S. Department of Health and Human Services, and the U.S. Bureau of Labor Statistics Consumer Expenditure Surveys "demonstrating that low-income consumers actually have **below average** natural gas usage" (Ex. 203, p. 10). These findings make sense. Low income consumers tend to live in smaller homes and are more likely to be on a fixed income. (Tr. 353-354). MGE's witness Dr. Thompson admitted that his study used income levels well above what the Federal Poverty Guideline considers to be low income. (Tr. 347-348). Only one data point used in that study even came close to those guidelines. (Tr. 348). Dr. Thompson also admitted that the higher incomes, more than double the Federal Poverty Guideline income levels, drove up the average usage level used in the study. (Tr. 350).

Ms. Meisenheimer also cites to Mr. Colton's paper published in the April 2002 Electricity Journal, which concluded that moving "a greater proportion of utility bills to fixed monthly charges are regressive in nature and will tend to impose adverse impacts on low-income consumers." (Ex. 201.5). Ms. Meisenheimer confirmed Mr. Colton's findings when she performed a study based on individual household income and consumption data from the U.S. Department of Energy's 2001 Residential Energy Consumption Survey to calculate average consumption by categories of income and found that lower income categories had progressively lower gas consumption. (Ex. 203, p. 12). Clearly the low income community will be most impacted by a decoupling rate design.

d. The Straight Fixed-Variable Proposal Wrongly Assumes Low and High Volume Users Incur the Same Cost on the Distribution System

The current rate design combines a fixed rate with a volumetric rate which allows MGE to recover the fixed costs specifically attributed to an individual consumer – the meter, the regulator and the service line. The remainder of MGE's costs are collected through a volumetric rate that has distinct advantages: 1) It specifically allows the users that place most of the demand

on the system and which were the impetus for the sizing of the mains serving all consumers, to pay their appropriate share of costs; and 2) The current rate design encourages conservation by allowing a customer to see benefits through conservation and efficiency practices. The new and untested rate design proposal is based upon the misguided premise that the cost associated with every consumer is categorically identical. The proposed straight fixed-variable rate design would charge low and high volume residential consumers an identical charge to recover the non-gas costs incurred by MGE. MGE and Staff allege that this result is justified because the cost to serve low volume users is identical. However, during cross-examination Staff witness Ms. Ross admits that the Staff did not perform a cost study to verify that the costs to serve each customer were identical. (Tr. 421). Likewise, Staff did no study to determine the relationship between distribution main sizing and customer usage. (*Id.*).

In prior cases the Commission recognized that the cost to serve customers differs according to the number of customers served, customer locations, and the maximum amount of flow needed to meet demand, which determines distribution main diameter. In MGE's 1998 rate case, the Commission recognized that costs can be separated into "customer-related" and "demand-related" components.

> MGE used a two inch diameter minimum system study to allocate distribution system costs to its various classes of ratepayers. The basic purpose of the minimum system study was to segregate the actual cost of mains in the existing distribution system by recognizing that this cost depends on the number of customers to be served, the locations (which determines main length), and the maximum amount of gas that has to flow through the mains to meet customer demands (which determines main diameter). In other words, it separates the embedded cost of mains in the existing system between customer-related and demand-related components. Customers must be connected to the system of distribution mains with at least a minimum size pipe if they are to receive any service. This portion of the mains costs is the customer-related component. The remainder of the costs of mains relates to the sizing of the mains to meet the

> demands customers place on the system. This portion of the mains costs is the demand-related component.[4]

High volume residential consumers understandably place a greater demand on the system than low volume residential consumers, and therefore, serving high volume residential consumers incurs a greater need for a larger diameter distribution main than low volume consumers. Under the existing rate design, including a volumetric element in rates accounts for that difference in cost causation by requiring the high volume consumer to pay more towards the demand-related component than the low-volume consumer. Moving to the straight fixed-variable rate design would require the low-volume users to pay more for the demand-component than is necessary to serve that consumer. If a distribution system served only low-volume consumers using gas for cooking, it is not hard to understand why the diameter of mains needed to serve that system would be less than a system serving only high-volume users that consume ten to twenty times the volume of gas and require larger distribution mains. Without a study by either Staff or MGE showing the costs are identical for each residential consumer, these parties have not met their burden of proving a rate design making that assumption is just and reasonable.

e. The Decoupling Rate Design Proposals Reduce MGE's Incentives to Operate Efficiently by Guaranteeing a Set Return

Decoupling will reduce incentives for MGE to operate efficiently. The weather risk associated with traditional rate design creates an incentive for utility companies to mitigate that risk by operating the utility efficiently. If the utility experiences warmer than normal weather and the lower consumption levels reduce earnings, any cost savings realized through efficient improvements will help mitigate the impact of the decreased earnings. By reducing the company's risk as proposed by the decoupling rate design, the utility has less incentive to create

[4] Re Missouri Gas Energy, Case No. GR-98-140, *Report and Order*, 188 P.U.R.4th 30 (1998).

efficiencies because the utility is ensured a level of earnings. Stated another way, the decoupling rate design proposals before the Commission violate the competitive market paradigm. Utility regulation is intended to mimic the outcomes and market environment faced by competitive firms. (Tr. 381). It is a substitute for competition. Earnings uncertainty motivates businesses to minimize costs and strive for customer satisfaction. Earnings *certainty*, however, removes those incentives and harms ratepayers in the long run. (Ex. 200, p. 11).

MGE argues that weather variability has had harmful impacts on MGE. However, over time the variability in weather balances out with the result being no winner and no losers. (Tr. 423). These vagaries in weather, which have been a manageable part of ratemaking as long as utilities have been regulated, have kept the utility wary of its expenses and have forced the utility to maintain efficiency. A similar case can be made for MGE's argument that a decline in usage necessitates the need for a rate design change. Any usage declines should further MGE's incentive to reduce costs and operate more efficiently. This is especially relevant today when inflated corporate salaries and incentives demand that utilities look inward during a time of revenue shortfall rather than looking first to the consumer. Even if usage declines were to be addressed, MGE's evidence fails to prove there is a usage decline that is not substantially tied to weather. MGE witness Mr. Feingold admits his non weather related theories on why usage has declined lacks supporting evidence. (Tr. 383-384). The evidence presented by MGE indicates rises in usage during cold periods and usage declines in warm periods. (Tr. 385-386). No study was provided showing the impact conservation and efficiency has had on MGE. Removing the impact weather variability and other reasons for declining usage will in turn remove an incentive for MGE to improve efficiencies and reduce costs.

The decoupling rate design proposal appears to be based on the misguided legal premise that utilities should be guaranteed a certain level of revenues. Rates are "not set or designed to provide uniform recovery each year." Rates are set to provide an opportunity to earn a return incorporated in the revenue requirement. The U.S. Supreme Court established that the opportunity to be afforded public utilities should simulate that of a similar unregulated enterprise in light of the risks taken by such enterprises. Bluefield v. Public Service Company, 262 U.S. 679, 693 (1923). Similar unregulated enterprises retain a certain level of business risk and are not guaranteed to earn a particular return. Guaranteeing a return for MGE is contrary to the Supreme Court's decision in *Bluefield.* In *State ex rel., Missouri Public Service Co. v. Fraas*, 627 S.W.2d 882 (App. W.D. 1981), the Western District held that a tariffed rate is intended to only permit an opportunity to make the percentage return approved by the PSC, and guarantees no specific return. The Court compared this opportunity to a hunting or fishing license, which does not guarantee that the holder will catch anything at all - it simply makes the catch legal provided the holder is successful in his own efforts.

The decoupling proposals before the Commission would essentially guarantee a specific return and ensure revenue neutrality for MGE by allowing MGE to recover its revenue requirement regardless of weather volatility or customer attempts to conserve. The Missouri Court of Appeals for the Western District recently concluded that there is no legal basis for ensuring revenue neutrality for MGE. In MGE's appeal of the Commission's 2005 Cold Weather Rule, MGE argued that the Commission could not adopt a rule that increased costs for the utility without ensuring recovery of such costs through the concept of revenue neutrality. The Court found no legal basis for MGE's "assertion of revenue neutrality, i.e. that they have a property right to a defined level of revenue." *State ex rel. Missouri Gas Energy v. P.S.C.,* 2006

Mo. App. LEXIS 1645, WD66666 (October 31, 2006). The Court was clear in its finding that "there is no requirement to provide a particular return on rates." As the Court recognized in *Fraas*, rates should be set only to allow a reasonable opportunity to earn their revenue requirement. Allowing an *opportunity* to earn a specific level of revenue acts to mimic a competitive market and ensure the utility has incentive to operate efficiently – an incentive that would be lost should the Commission *guarantee* that MGE recover its entire revenue requirement notwithstanding changes in weather or consumer conservation efforts.

f. The Decoupling Rate Design Proposal Contradicts Ratepayer Expectations

In resolving a Missouri-American Water rate case in 2000, the Commission concluded in its order that a "factor for consideration in determining just and reasonable rates is public perception."[5] The proposed decoupling rate design is contrary to good public policy because it would be deny ratepayers their expectations that consuming less gas will lower the non-gas portion of the customer's bill. Even Staff witness Ms. Anne Ross acknowledges that customers may feel the rate design proposal is unfair. Unfortunately, consumers were not notified of the decoupling proposal when they received the rate increase request notice. As such, consumers were unaware of the proposal to require low-volume users to pay the same as high-volume users, and the proposal to impair conservation and energy efficiency rewards. During the public hearings, the customers in attendance were first alerted to the idea of removing the volumetric element from non-gas costs through a handout. Of the customers that chose to voice their opposition to the rate increase, one such customer, Ms. Blanche, acknowledged the decoupling proposal and testified as follows:

[5] In the Matter of Missouri-American Water Company's Tariff Sheets Designed to Implement General Rate Increase for Water and Sewer Service Provided to Customers in the Missouri Service Area of the Company, Case No. WR-2000-281, *Report and Order***,** 9 Mo. P.S.C. 3d 254, August 31, 2000.

> However, it [referring to the handout] also says that Staff is proposing to eliminate the volumetric rate and go to a fixed delivery charge. I do have an issue with this. It does not seem equitable to have a fixed delivery charge. I live in a two-person household. It doesn't seem fair that we would be required to pay the same amount as a larger household. Also, we only use natural gas for heating. We do use a lot of wood heat in the winter to moderate costs. So we would be paying potentially the same for just heating the house occasionally, as a customer who used natural gas for heat, water heating and cooking, et cetera. So I think that would not be an equitable proposal. Also I believe using a fixed delivery charge discourages conservation efforts. I am not in agreement with that. The current water delivery system that we have in the subdivision where I live uses a flat rate regardless of usage. I see a lot of waste because of that flat rate. I would have concerns that conservation would not be in people's minds with the fixed delivery charge.[6]

While it is not clear what percentage of the customer base shares Ms. Blanche's concerns, her testimony suggests that a portion of customers believe it is unfair to require low usage customers to pay the same as high usage customers. Ms. Blanche also recognizes that the result of the rate design will be to discourage a ratepayer's conservation efforts and would promote waste. Ms. Blanche's testimony is consistent with Staff witness Ms. Ross' testimony that consumers will object. Ms. Ross states that due to these likely objections, "intensive customer education" is needed. (Tr. 426-427). However, Ms. Ross offers no programs, tools or ideas on how this education would occur.

The Florida Public Service Commission (FPSC) specifically rejected a straight fixed-variable proposal when it concluded:

> This Straight Fixed Variable (SFV) rate structure concept involves the principle that fixed costs should be recovered through fixed charges, and variable costs should be recovered through variable (i.e., per therm) charges. … Traditionally, we have established customer charges for natural gas utilities so that they recover no more than the costs that are classified as customer-related in the cost of service study, such as service laterals, meters, meter reading, and billing expenses. While we acknowledge that a large proportion of the costs recovered through base rate charges do not vary with therm usage, <u>we also recognize that customer acceptance</u>

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[6] Public Hearing Transcript, Volume 3, p. 60, Kansas City, MO, October 26, 2006.

> is an important criterion for judging the reasonableness of a rate structure. [emphasis added].
>
> It is often difficult for retail customers to understand why they are paying large fixed charges even in months when they use few therms. Chesapeake's proposed large increases in the customer charges will also result in large rate increases for those customers who use fewer therms relative to other customers in their rate class… Because of these concerns, we are approving customer charges that are lower than those requested by the company.[7]

Here the FPSC makes several findings that are relevant to the rate design issue before the Commission today. First, they recognize that variances in demand-related costs do exist for residential consumers. This is inconsistent with the unsubstantiated argument addressed earlier where the Staff and MGE argue that the cost to serve each customer is identical, justifying one single customer charge. Second, they recognize the importance of customer acceptance and identify the difficulty consumers will have when forced to pay large fixed charges even when their usage is low or non-existent. The same recognition should occur here in Missouri – customers were not advised of this proposed change and do not see it coming. The acceptance of a normal decoupling rate design that moves *more* charges into the fixed rate could be difficult for customers to understand. However, the acceptance of a straight fixed-variable rate design that moves *all* margin costs into a fixed rate could be very problematic and objectionable to a large number of consumers. MGE's witness Mr. Feingold acknowledged that customers installing energy efficient appliances or implementing energy efficiency and conservation practices would not see a benefit on the non-gas portion of their bill. (Tr. 388). This is contrary to consumer expectations.

[7] In re: Petition for authorization to establish new customer classifications and restructure rates, and for approval of proposed revised tariff sheets by Florida Division of Chesapeake Utilities Corporation, Florida Public Service Commission, Docket No. 040956-GU; Order No. PSC-05-0208-PAA-GU, February 22, 2005

g. Consumer Impacts are Not Mitigated Under the Decoupling Rate Design Proposal

The most troubling aspect of a finding that low income consumers will shoulder the burden of the new rate design is the lack of effort on the part of MGE and Staff to attempt to determine just what those impacts would be. Staff acknowledged that it did no study to determine the number of customers that would get an increase in their bill under the decoupling proposal. (Tr. 422). It did no study to determine the impact on low income consumers. (Tr. 422). And it did no study to estimate the number of consumers that would drop off the system as a result of the rate design. (*Id.*). Accordingly, the impact that this rate design would have on consumers served by MGE is completely unknown. Adopting a rate design where the impact on consumers, especially the most vulnerable consumers, is unknown could initiate a considerable consumer backlash. Customer impacts can be lessened from rate change impacts through a concept known as "gradualism." By gradually increasing rates over time, the ultimate rate increase is achieved over an extended period thereby decreasing the impact that a one-time rate shift would produce. This is especially important where, as would occur through the proposed decoupling, rates for low volume users would increase dramatically. MGE's witness Dr. Thompson testified that gradualism within a class is an important consideration and "should be one of the many factors examined." (Tr. 353). However, gradually increasing rates has not been proposed by MGE or Staff. In the past, the Commission recognized the importance of lessening customer impacts by gradually increasing rates when adopting significant rate design changes. In 1979, when the Commission first allowed the Great River Gas Company of Hannibal to move away from a strictly volumetric block rates and adopt a customer charge for the first time, the Commission employed gradualism:

> [I]t would be too great of an impact to adopt at this time the customer charge system proposed by the Staff in light of the very small scale of minimum monthly bills now in effect. Therefore, the Commission concludes that there should be a gradual movement towards the Staff's figures. For the present time, a system of customer charges roughly equivalent to one-half of what the Staff proposed should be adopted, i.e., $2.00 for residential customers, $2.50 for commercial customers, and $20.00 for industrial customers.[8]

Customer impacts do not appear to be a consideration by the Staff or MGE in this case. Despite the evidence pointing to large increases for low volume users, which can be very harmful to low income consumers living on fixed incomes, the parties supporting the new rate design changes have offered no proposals to mitigate these impacts. This is just one additional reason among many that support a Commission order retaining the status quo on rate design and rejecting the proposed change. Consumers will be best served by an order directing any party wishing to propose significant rate design changes to carefully consider all consumer impacts and to present those impacts to the Commission, or expect the rate design proposal to be rejected. Such a study should include impact on high and low volume users, including an analysis into the likelihood that customers will drop off the system as a result of the changes. Even if the Commission agrees with the theory behind the straight fixed-variable rate design, it is the impact that determines whether the rate design is just and reasonable. In a 2000 rate case order the Commission concluded that "[i]t is not methodology or theory but the impact of the rate order which counts in determining whether rates are just, reasonable, lawful, and non-discriminating."[9]

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[8] In the matter of Great River Gas Company of Hannibal, Missouri, for authority to file tariffs designed to increase rates for gas service provided to customers in the Missouri service area of the Company, Case No. GR-79-145, *Report and Order*, 23 Mo. P.S.C. (N.S.) 318 (1979).

[9] In the Matter of Missouri-American Water Company's Tariff Sheets Designed to Implement General Rate Increase for Water and Sewer Service Provided to Customers in the Missouri Service Area of the Company, Case No. WR-2000-281, *Report and Order***,** 9 Mo. P.S.C. 3d 254, August 31, 2000.

h. Other State Commissions Do Not Support the Rate Design Changes Proposed by MGE and the Staff

No state commission, to Public Counsel's knowledge, has adopted a revenue decoupling proposal as radical and unfriendly to consumers as the decoupling rate design proposals before the Commission in this case, which attempt to ensure revenue neutrality for MGE. The evidence before the Commission revealed that a straight-fixed rate design proposal before the Commission is not supported by other state commissions, with the exception of one gas utility in North Dakota and one in Georgia. (Tr. 401). The untested straight fixed-variable proposal would be a gamble at the ratepayer's expense.

During opening statements, counsel for MGE accurately stated that the interstate pipeline wholesale gas delivery rates have operated under a SFV rate design. When the FERC restructured the interstate natural gas pipeline industry in 1992, it adopted a straight fixed variable (SFV) rate design in order to promote competition. The significant differences in the industries – retail distribution versus competitive wholesale delivery, are a distinct reason why at least one commission did not adopt a SFV rate design. When facing a proposed SFV rate design, the District of Columbia Public Service Commission (DCPSC) recently concluded, "as a goal or objective, FERC's SFV rate design approach may ***not*** be appropriate for [the LDC's] retail gas utility operations." The DCPSC took comfort in the fact that the Company's witness testified that in moving towards a higher fixed charge, it was not their objective to move to a SFV rate design. The DCPSC noted that even the LDC opposed the SFV rate design when it was originally proposed for the wholesale gas delivery industry, arguing it was "not based on sound legal or policy grounds."[10]

[10] In The Matter of the Application of Washington Gas Light Company, District Of Columbia Division, for Authority to Increase Existing Rates and Charges for Gas Service, District of Columbia Public Service Commission, Order No. 12986, 229 P.U.R.4th 177, November 10, 2003.

The Indiana Utility Regulatory Commission (IURC) took the approach Public Counsel asks this Commission to take in rejecting a decoupling proposal, which is to direct the parties proposing a historic change in rate design to do their homework and come back only after carefully reviewing the rate designs being offered around the nation, and only after including all interested parties in the development of the proposal. The IURC stated that there was no evidence the utility considered other options beyond what was proposed, and encouraged the gas utility to investigate a decoupling mechanism that reflects "the careful and thorough consideration of the various approaches to the development of decoupling mechanisms generally" and that it be "based upon a collaborative effort between" interested stakeholders. A similar approach, if adopted by this Commission, would ultimately result in the best outcome that could become a pattern for all proposed rate design changes.[11]

i. The Commission Should Reject MGE's Alternative Weather Normalization Adjustment Proposal

MGE's second choice is its Weather Normalization Adjustment (WNA) proposal. The proposed WNA rate design would ensure revenue neutrality by increasing rates when usage declines due to warmer than normal weather or due to consumer conservation and efficiency efforts. There are many flaws in this rate design as well, and for reasons similar to the flaws in the decoupling rate design proposal. The policy implications of this rate design is that it would

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[11] Petition of the Board of Directors for Utilities of the Department of Public Utilities of the City of Indianapolis, as Successor Trustee of a Public Charitable Trust, d/b/a Citizens Gas & Coke Utility for Authority to Increase its Rates and Charges for Gas Utility Service and for Approval of a New Schedule of Rates and Charges Applicable Thereto, Approval Under IC 8-1-2.5 of an Alternative Regulatory Plan Implementing an Uncollectible Expense Adjustment Mechanism, a Demand Side Management and Rate Decoupling Mechanism and Approval of Other Changes to its General Terms and Conditions for Gas Service, Case No. 42767, *Order,* October 19, 2006.

diminish a customer's ability to benefit from conservation and efficiency efforts, and would erase any benefits ratepayers now see during warmer than normal weather.

To the extent the Commission may wish to allow weather normalization adjustments, requests for such adjustments before Senate Bill 179 rules are adopted are unlawfully premature. (Ex. 202, p. 2). Rate adjustments outside of a rate case can only be adopted under SB 179 since the prohibition against single-issue ratemaking otherwise makes such a rate design unlawful. In addition, SB 179 contains certain protections such as an annual true-up that were not proposed by MGE in this case. Section 386.266.4(2) RSMo (Cum. Supp. 2005). Essential to a rate design that allows a utility to recover a fixed amount from every customer is an annual or monthly true-up mechanism that ensures the company is not over-earning. Over-earning would occur if MGE were to add to its customer base. And the evidence before the Commission indicates that MGE is, in fact, increasing its customer base annually. (Tr. 382). Without a true-up mechanism MGE would begin over-earning immediately after approval of a decoupling or WNA rate design.

2. Seasonal Disconnects

Public Counsel urges the Commission to reject the tariff language proposals that would penalize customers that disconnect service for a period of time, and later reconnect, regardless of the reasons for such disconnection. This tariff change should be rejected for several reasons. First, it forces consumers to pay for a service they did not use. Second it fails to take into account the multitude of reasons consumers would need to disconnect. Those reasons include hospitalization for treatment of illness, military personnel deployed to serve overseas, and college students leaving during the summer. (Tr. 1094). Under the "seasonal disconnect" proposal, which by name is meant to prevent consumers from disconnecting during the warm weather seasons and reconnecting in the cold seasons, customers that disconnected for reasons

completely unrelated to the seasons would be penalized. Third, the revenue requirement is not reduced by the roughly $140,000 in additional revenue this proposed tariff change is expected to generate. (Tr. 1086).

The premise behind this proposal is that the utility has invested in customer specific facilities, and therefore, is entitled to recover the costs associated with those facilities even if the customer disconnects. However, coupling this proposal with a proposal to include all non-gas costs in a single customer charge will require disconnected customers to pay upon reconnection for more than just the customer-specific facilities. The fixed charge under the current rate design is calculated to recover the customer specific costs such as the service line, meter, and regulator, and nothing more. (Tr. 419). The decoupled rate, on the other hand, is designed to collect all non-gas costs, even those that are not customer specific. Requiring a disconnected customer to pay for more than the customer-specific costs is not just and reasonable, and is contrary to the stated purposes of this seasonal disconnect proposal.

D. Miscellaneous Issues

1. Kansas Property Tax AAO

Public Counsel's witness Mr. Ted Robertson testified that the AAO is inappropriate because the costs to be deferred are not known and measurable. (Ex. 204, p. 19). In the event MGE later becomes responsible for the Kansas property tax, the appropriate remedy would be for MGE to seek emergency relief for the actual expenditures incurred. Mr. Robertson testified that "utilization of the AAO process in this instance is an inappropriate aberration of the original purpose of an AAO." (Ex. 204, p. 21). Unlike other AAOs, costs supporting the deferral have never actually been incurred. (*Id.*). The current AAO should be discontinued and the deferrals

associated with it removed until it is determined whether MGE will actually become responsible for the Kansas property tax.

E. Conclusion

The primary purpose of the Commission is to serve and protect ratepayers. *State ex rel. Capital City Water Co. v. P.S.C.*, 850 SW2d 903 (Mo. App. W.D. 1993). The protection given the utility "is merely incidental." *State ex rel. Electric Co. of Missouri v. Atkinson*, 204 SW 897 (Mo. 1918). All parties recognize that rate design is the most important issue before the Commission in this case. The decoupling rate design proposal would shift business risk from shareholders and onto the shoulders of the ratepayer public. The public is not served by a Commission decision that guarantees revenue recovery for the utility while providing no benefits to ratepayers. The evidence shows that MGE is in a strong financial position, as asserted by Southern Union's CEO and as proven by MGE's achieved return during the test year. With this in mind, Public Counsel asks that the Commission carefully consider each and every issue to best develop an outcome that places ratepayers first and the utility second.

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 15th day of February 2007:

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