Exhibit No.: _____
Issue(s): Cost of Service/Rate Design
Witness/Type of Exhibit: Meisenheimer/Direct
Sponsoring Party: Public Counsel
Case No.: GR-2010-0171

DIRECT TESTIMONY

OF

BARBARA A. MEISENHEIMER

Submitted on Behalf of the Office of the Public Counsel

LACLEDE GAS COMPANY

CASE NO. GR-2010-0171

May 24, 2010

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Laclede Gas Company's Tariff to Increase Its Annual Revenues for Natural Gas Service.	)))	**Case No. GR-2010-0171**

AFFIDAVIT OF BARBARA A. MEISENHEIMER

STATE OF MISSOURI)
) ss
COUNTY OF COLE)

Barbara A. Meisenheimer, of lawful age and being first duly sworn, deposes and states:

1. My name is Barbara A. Meisenheimer. I am Chief Utility Economist for the Office of the Public Counsel.

2. Attached hereto and made a part hereof for all purposes is my direct testimony.

3. I hereby swear and affirm that my statements contained in the attached testimony are true and correct to the best of my knowledge and belief.

Barbara A. Meisenheimer

Subscribed and sworn to me this 24th day of May 2010.

NOTARY PUBLIC NOTARY SEAL STATE OF MISSOURI

KENDELLE R. SEIDNER
My Commission Expires
February 4, 2011
Cole County
Commission #07004782

Kendelle R. Seidner
Notary Public

My Commission expires February 4, 2011.

DIRECT TESTIMONY
OF
BARBARA A. MEISENHEIMER

LACLEDE GAS COMPANY

(RATE DESIGN)

CASE NO. GR-2010-0171

Introduction

Q. PLEASE STATE YOUR NAME, TITLE, AND BUSINESS ADDRESS.

A. Barbara A. Meisenheimer, Chief Utility Economist, Office of the Public Counsel (OPC or Public Counsel), P. O. Box 2230, Jefferson City, Missouri 65102. I am also employed as an adjunct Economics and Statistics Instructor for William Woods University.

Q. HAVE YOU TESTIFIED PREVIOUSLY IN THIS CASE?

A. Yes. I filed direct testimony on revenue requirement issues on May 10, 2010.

Q. DO YOU HAVE ANY CORRECTIONS TO THAT TESTIMONY?

A. Yes, on page 7 of my May 10, 2010, testimony I incorrectly indicated the Commission could minimize the rate impact of any rate increase on consumers by removing low-income program funding from rates. Prior to Case No. GR-2007-0208, the low-income program was funded through rates. However, unused funds began to accumulate. The Stipulation and Agreement in GR-2007-0208

addressed the surplus of funds by replacing the existing funding mechanism that collected funds in advance with a regulatory asset account that recovers costs after the costs are incurred.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. My testimony addresses Public Counsel's class cost of service studies and rate design recommendations for the Laclede Gas Company (Laclede or the Company) service area.

Q. WHAT INFORMATION HAVE YOU REVIEWED?

A. I reviewed the Company's proposed tariff sheets, portions of the Company's current tariff, the Missouri Public Service Commission Staff's (Staff's) workpapers, Accounting Schedules and Cost of Service Report, customer complaints and comments filed with the Missouri Public Service Commission (Commission) and data request responses provided to the Staff and Public Counsel by Laclede Gas Company.

Residential and Small Commercial and Industrial Rate Design

Q. PLEASE DISCUSS LACLEDE'S CURRENT RESIDENTIAL RATES.

A. Laclede currently recovers a portion of non-gas Residential class costs through a fixed customer charge of $15.50. The remaining Residential class costs for each

service area are recovered through a volumetric rate that varies by block and by season as shown below.

Volumetric Rates	Summer May-Oct.	Winter Nov.-April
First 30 Therms	$ 0.20926	$ 0.88954
Additional Therms	$ 0.15900	$ -

Q. IS CHARGING A $0 VOLUMETRIC RATE FOR WINTER USE ABOVE 30 THERMS PER MONTH CONSISTENT WITH COST CAUSATION?

A. No. Monthly consumption over 30 therms provides no contribution toward variable system costs even though peak demand is a significant cost driver.

Q. PLEASE DESCRIBE THE IMPACT ON THIS VOLUMETRIC RATE DESIGN ON THE EFFECTIVE PRICE PER THERM PAID BY LACLEDE'S RESIDENTIAL CUSTOMERS.

A. Based on monthly weather normalized volumes Laclede customers pay the following effective rates per therm:

Month	Ave. Volumetric Rate per Therm
October	$0.1981
November	$0.3705
December	$0.1936
January	$0.1376
February	$0.1589
March	$0.2251
April	$0.3798
May	$0.1971
June	$0.2072
July	$0.2089
August	$0.2069

Laclede's customers pay the lowest effective volumetric rate per therm in January and February.

Q. IS THE RESULT SIMILAR FOR THE SMALL COMMERCIAL AND INDUSTRIAL CLASS?

A. Yes. The General Service Commercial and Industrial 1 (C&I 1) class pays a fixed customer charge of $20.25 per month and volumetric rates that vary by block and by season as shown below:

Volumetric Rates	Summer May-Oct.	Winter Nov.-April
First 50 Therms	$ 0.14450	$ 0.85088

The effective volumetric rates per therm are:

Month	Ave. Volumetric Rate per Therm
October	$0.1310
November	$0.2885
December	$0.1614
January	$0.1049
February	$0.1197
March	$0.1860
April	$0.2610
May	$0.1310
June	$0.1310
July	$0.1306
August	$0.1332
September	$0.1249

Similar to the result for the Residential class, C&I 1 volumes above 50 therms provide no contribution to the recovery of variable system costs and produce the lowest effective volumetric rates during peak demand months.

Q. WOULD A MODERATE CUSTOMER CHARGE COUPLED WITH A UNIFORM BLOCK RATE STRUCTURE BE PREFERABLE?

A. Yes. A uniform block rate structure better aligns rates with costs and provides an incentive to conserve within the volumetric rate structure.

Q. DO YOU BELIEVE RECOVERING COSTS THROUGH A TRADITIONAL RATE STRUCTURE IS PREFERABLE TO LACLEDE'S CURRENT RATE STRUCTURE OR ALTERNATIVE DECOUPLING MECHANISMS?

A. Yes. Under traditional rate design, consumers have better ability to control the non-gas portion of their bill by reducing use and the Company and customers shared the risk associated with weather. Later in this testimony I discuss the benefits and appropriateness of traditional rate design in greater detail.

Q. WHAT IS PUBLIC COUNSEL'S RECOMMENDATION REGARDING THE RESIDENTIAL AND SMALL COMMERCIAL AND INDUSTRIAL RATE STRUCTURE?

A. Public Counsel encourages the Commission to adopt a traditional residential rate structure, which recovers a portion of costs through a $16.50 fixed customer charge and the remaining portion through a uniform volumetric rate. Similarly, Public Counsel proposes a traditional rate design for small commercial and industrial customers served under rate schedule General Service Commercial and Industrial 1. Public Counsel proposes a $23.05 fixed customer charge with the remainder recovered through a uniform volumetric rate.

Class Cost of Service Study Results

Q. HAVE YOU PREPARED A CLASS COST OF SERVICE STUDY AND A CLASS REVENUE REQUIREMENT RECOMMENDATION?

A. Yes. The class cost of service study results and class revenue requirement recommendations are summarized below. Later in this testimony I describe the

class cost of service methodology. The class cost of service study is attached as Schedule BAM DIRECT RD-3.

Q. WHAT ARE THE RESULTS OF PUBLIC COUNSEL'S CLASS COST OF SERVICE STUDY?

A. The results of my class cost of service studies are shown below:

Revenue Neutral Shift Percentage to Equalize Class Return

Residential	General Service C&I 1	General Service C&I 2	General Service C&I 3	Large Volume	Transport	Interruptible
0.61%	8.32%	-20.93%	-12.20%	-24.78%	49.78%	28.37%

Based on my study, the Residential class would need to increase by less than 1% to equalize the rate of return among classes. The Transport and Interruptible classes would need to increase significantly to equalize the rate of return.

Schedule BAM DIRECT RD-1 provides additional detail on the derivation of these revenue neutral adjustments. The current rate of return for each class is shown on Line 16, of Schedule BAM DIRECT RD-1. The revenue neutral shift required to equalize the class rates of return is shown on Line 24, of Schedule BAM DIRECT RD-1.

Q. WHAT LEVEL OF RESIDENTIAL CUSTOMER CHARGE IS SUPPORTED BY YOUR CLASS COST OF SERVICE STUDY?

A. My cost of service study results indicates that the direct customer costs related to serving the customer premises are $16.49 for the Residential customer class and $23.05 for the General Service Commercial and Industrial 1 customer class. These amounts include a return on the Company's investment in meters,

regulators, service lines and other customer premises, operating and maintenance expenses associated with those investments, meter reading expenses and billing expenses. The customer cost calculations are shown on Page 8, of the class cost of service study included in this testimony as Schedule BAM DIRECT RD-3.

Class Revenue Requirement Recommendations

Q. WHAT CLASS REVENUE REQUIREMENTS DO YOU PROPOSE BASED ON YOUR CLASS COST OF SERVICE STUDY RESULTS?

Generally, Public Counsel recommends that, where the existing revenue structure departs greatly from the class cost of service, the Commission should impose, at a maximum, class revenue shifts equal to one half of the "revenue neutral shifts" indicated by Public Counsel's class cost of service study. Revenue neutral shifts are shifts that hold overall company revenue at the existing level but allow for the share attributed to each class to be adjusted to reflect the cost responsibility of the class. In addition to moving half way to the revenue neutral shifts, if the Commission determines that an overall increase in revenue requirement is necessary, then no customer class should receive a net decrease as the combined result of: (1) the revenue neutral shift that is applied to that class, and (2) the share of the total revenue increase that is applied to that class. Likewise, if the Commission determines that an overall decrease in revenue requirement is necessary, then no customer class should receive a net increase as the combined result of: (1) the revenue neutral shift that is applied to that class, and (2) the share of the total revenue decrease that is applied to that class.

Q. HAVE YOU PREPARED A SCHEDULE ILLUSTRATING THIS METHOD OF DETERMINING CLASS REVENUE REQUIREMENTS?

A. Yes. Line 1 of Schedule BAM DIRECT RD-2 shows the revenue neutral shift required to equalize class rates of return. Line 5 illustrates one half of the revenue neutral shift. Line 7 illustrates the spread of a net increase of $9M. Lines 10-13 illustrate the adjustments to ensure that no class receives a reduction if another class would receive an increase as the result of the combined impact of ½ the revenue neutral shift and the net increase. In this case, because the Residential class required less than a 1% revenue neutral shift, the Residential impact was not reduced. Lines 15-16 illustrate the resulting revenues and revenue percentages.

Q. CAN THIS METHOD OF DETERMINING CLASS REVENUE REQUIREMENTS BE USED FOR ANY NET INCREASE OR NET DECREASE APPROVED BY THE COMMISSION?

A. Yes.

Class Cost of Service Study Method

Q. WHAT IS THE REGULATORY PURPOSE OF A CLASS COST OF SERVICE STUDY?

A. A class cost of service study is a tool used by regulators to aid in determining an appropriate rate structure. It can be used as a guide in identifying, on a cost causative basis, the cost of serving a particular group of customers. A class cost of service study can also be used to evaluate the relative cost of service among classes. This comparison of relative cost is the focus of Public Counsel's study and is reflected in the study assumption that the Company's revenue requirement is equal to the level of current revenue.

Q. WHAT IS THE RELATIVE IMPORTANCE OF CLASS COST OF SERVICE STUDY RESULTS IN RATE DESIGN?

A. A class cost of service study provides the Commission with a general guide for a service based on costs to determine just and reasonable rates. The Commission must, on a case by case basis, balance the results of a cost of service study with other relevant factors that go into the rate making decision process. Other relevant factors include the value of a service, the affordability of service, rate impacts, and rate continuity, to highlight a few.

Q. WHAT COSTS ARE REFLECTED IN YOUR CLASS COST OF SERVICE STUDY?

A. Public Counsel's class cost of service study includes non-gas or margin costs associated with storing, transporting and delivering gas to customers. Gas costs recovered through the purchased gas adjustment rate are generally determined in a separate proceeding.

Q. WHAT ARE THE REPRESENTATIVE CLASSES INCLUDED IN PUBLIC COUNSEL'S CLASS COST OF SERVICE STUDY?

A. For class cost of service study purposes, customers are grouped into "classes" based on type of customer and utilization patterns. My class cost of service studies include the same customer classes as the Staff's study: Residential, Commercial & Industrial 1, Commercial & Industrial 2, Commercial & Industrial 3, Large Volume, Transport and Interruptible.

Q. ON WHAT DATA ARE YOUR CLASS COST OF SERVICE STUDIES BASED?

A. The Accounting Schedules filed with the Staff's direct revenue requirement testimony were the source of most of the investment and expense data that I used in my studies. The Accounting Schedule data is associated with a test year ending September, 30, 2009, updated through March 31, 2010. I used data based on Company responses to Staff data requests related to customer counts, revenues and usage patterns to develop allocation factors for assigning revenues and costs to customer classes. Except where specified, my use of Staff and Company information should not be viewed as an endorsement of either Staff's or the Company's methods for calculating accounting costs, billing determinants, peak demands or allocation factors.

Q. IS THERE A POSSIBILITY THAT SOME INFORMATION USED IN YOUR STUDY WILL BE UPDATED AND REVISED AS THE CASE PROGRESSES?

A. Yes. It is common for the Staff and Company to update or reconcile information as cases progress. I will update my studies accordingly.

Q. PLEASE DESCRIBE THE ASSIGNMENT OF COST TO THE CUSTOMER CLASSES.

A. The assignment of costs to customer classes involves a three-step process in which costs are first functionalized, then classified, and finally allocated to customer classes based on factors that reflect cost causation.

Q. PLEASE DESCRIBE THE FUNCTIONALIZATION OF COSTS.

A. Functionalization involves categorizing cost accounts by associated function. Functional categories include; Production, Storage, Transmission, Distribution, Customer Accounts and Administrative and General (A&G).

Q. PLEASE DESCRIBE THE CLASSIFICATION OF COSTS.

A. Classification is achieved by further categorizing costs into customer related, commodity related, demand related or "other related" costs. Some costs are categorized as having multiple cost components.

Q. PLEASE DESCRIBE CUSTOMER RELATED COSTS.

A. Customer related costs vary directly (in fixed proportion) with the number of customers served. Examples of customer related costs include: expenses associated with meter reading, billing, and the return on investments associated with metering equipment and service connections.

Q. PLEASE DESCRIBE COMMODITY RELATED COSTS.

A. Commodity related costs vary with the quantity of gas purchased. While Missouri's local distribution companies recover purchased gas cost through the PGA, other plant accounts may still be categorized as commodity related.

Q. PLEASE DESCRIBE DEMAND RELATED COSTS.

A. Demand related costs vary with the capacity requirement of plant or equipment. They are related to the maximum system requirements that reflect the capacity

necessary to serve demand during peak periods. Demand related costs include most production, transmission and storage costs and expenses associated with these types of plant. In addition, some distribution plant and related expenses are demand related costs.

Q. PLEASE DESCRIBE THE ALLOCATION PROCESS.

A. Following functionalization and classification, allocation factors are applied to distribute a reasonable share of jurisdictional costs to each customer class. Some costs are uniquely attributable to, and therefore directly assignable to, a particular customer class. For costs that are jointly attributable, in measurable proportions, to a group of customer classes, the costs are assigned to each customer class based on factors that reflect each class's share of joint use. Finally, cost accounts associated with common facilities or common overheads that cannot be directly or jointly assigned are allocated to classes based on general factors. Typical allocation factors include measures of usage, sales, or weighted measures of customer counts.

Q. WHAT TYPES OF PLANT INVESTMENTS ARE ALLOCATED IN A CLASS COST OF SERVICE STUDY?

A. Common types of plant allocated in a class cost of service study include intangible plant, production plant, storage plant, transmission plant, distribution plant and general plant.

Q. HOW ARE INTANGIBLE PLANT ACCOUNTS ALLOCATED?

A. Intangible plant accounts include expenses related to organizing the enterprise, obtaining franchise and consent and other miscellaneous items. (Accounts 301, 302, and 303) These costs are not directly or jointly attributable to particular customer classes, instead they are common costs allocated on the basis of the portion of overall net non-general plant assigned to each customer class.

Q. HOW ARE PRODUCTION PLANT ACCOUNTS ALLOCATED?

A. Laclede has limited investment in LP production plant. I allocated these investments and associated revenue based on the annual sales volumes associated each customer class.

Q. HOW ARE GAS STORAGE PLANT ACCOUNTS ALLOCATED?

A. I allocated storage related investments based on the winter sales volumes associated each customer class.

Q. HOW ARE TRANSMISSION PLANT ACCOUNTS ALLOCATED?

A. Transmission plant accounts are allocated based on a transmission allocator that reflects peak sales.

Q. HOW ARE DISTRIBUTION PLANT ACCOUNTS ALLOCATED?

A. Mains transport gas throughout the Company's service area and represent a significant portion of distribution plant. The system of mains serves three primary purposes. It is designed to reach customers throughout the service area,

to provide gas year round and to satisfy periods of peak demand. Therefore, I developed an allocator for Mains (Account 376) that reflects these three purposes.

The first component of my mains allocator is related to reaching customers throughout the service area. Although I do not recognize any portion of mains costs as directly related to the number of customers, I do recognize that indirectly the number of customers and the dispersion of customers affect the cost of mains. To reflect the indirect affect of customers on mains costs, I have used a "customer related" component 35% in allocating mains. The remaining 65% of the Mains allocator is divided between a commodity related component based on average use and a demand related component based on peak day demand.

The commodity related component of my mains allocator is related to the use of mains to deliver gas throughout the year. I allocated 19% of Mains (Account 376) based on each customer class's share of annual system sales volumes measured in Ccf.

The demand related component of my mains allocator (the remaining 46% of Mains (Account 376) is related to the use of mains to deliver gas during periods of peak use. I allocated this portion of Mains (Account 376) based on each customer class's share of peak day demand.

Land and Land Rights, Structures and Improvements (Accounts 374 and 375) are closely related to the system of distribution mains. I allocated these costs on the same basis as Mains (Account 376).

Measuring and Regulating Station Equipment (Accounts 378 and 379) are related to the year round flow of gas and are therefore classified as commodity

related. I allocated these costs based on each customer class's share of annual throughput.

Accounts 380 through 385 include cost directly related to serving customer premises. For example, services connect the customer premise to distribution mains. Similarly, meters and regulators at the customer premise measure and regulate gas flow at the premise. While these types of cost may differ by customer class, for example the cost of a typical meter associated with residential use is less expensive than the typical meter used to serve a large industrial customer, within each class; the costs tend to vary directly with the number of customers served. Based on this direct relationship between the number of customers served and costs, I classified these costs as customer related and developed allocation factors based on customer numbers weighted to reflect cost differences between customer classes. The type of allocation for each account is shown below:

Table 3

Account	Description	Allocation based on
380	Service Lines	Weighted services
381	Meters	Weighted meters and regulators
383	House Regulators	Weighted meters and regulators
385	Meas. and Reg. Station Equip. - Industrial	Large Volume customers

Q. HOW ARE GENERAL PLANT ACCOUNTS ALLOCATED?

A. General plant accounts excluding Communications Equipment Account 397 are allocated to customer classes based on each class's allocation of net non-general plant. Communications Equipment Account 397 allocated to residential and commercial customers based on the number of bills.

Q. HOW ARE OTHER RATE BASE ITEMS ALLOCATED?

A. Other rate base items include additions and deductions to net plant in service. For each, I selected an allocator that seemed most clearly related to the cost causation. The types of cost and allocation factor used in my studies are listed below:

Table 4

Rate Base Additions	Allocation Factor
Cash Working Capital	Cost of Service
Materials and Supplies	Total Net Plant
Prepayments	Cost of Service
Prepaid Pension Asset	Labor
Natural Gas Stored Underground	Winter Sales
Unamortized Balances	Rate Base
Insulation Financing Loans	Residential Bills
Energywise	Residential and Commercial Bills

Rate Base Deductions	Allocation Factor
Interest Offset	Cost of Service
Federal Income Tax Offset	Rate Base
State Income Tax Offset	Rate Base
City Tax Offset	Rate Base
Accumulated Amortization	Total Net Plant
Customer Advances	Weighted Meters
Customer Deposits	Bills
Deferred Income Taxes	Rate Base

Q. PLEASE DESCRIBE HOW OPERATION AND MAINTENANCE EXPENSES ARE ALLOCATED IN YOUR CLASS COST OF SERVICE STUDIES?

A. For allocating most of the accounts in this category, I used the "expenses follow plant principle". For example, the operations and maintenance expenses related to mains and services are allocated to customer classes on the same basis as the mains and services plant accounts. Similarly, operations and maintenance expenses related to storage are allocated on the basis of winter sales. For cost accounts not directly associated with a corresponding plant account, I selected an allocator that seemed most clearly related to the cost causation. The types of operation or maintenance expense and allocation factor used in my study are listed below:

Table 5

Operations

Account	Description	Allocation based on

870	Supervision & Engineering	Mains
871	Load Dispatch	Mains
874	Mains and services	Net Mains/Services Plant
875	Measuring & Regulating Stations	Annual Throughput
876	Measuring & Reg. Commercial	Large Ind. Bills
877	Measuring & Regulating City Gate	Annual Throughput
878	Meter & House Regulating	Weighted Meters and Regulators
879	Customer Installations	Weighted Meters and Regulators
880	Other Expenses	Mains
881	Rents	Net Distribution Plant

Maintenance

Account	**Description**	**Allocation based on**
885	Supervision & Engineering	Mains
886	Structures & Improvements	Mains
887	Mains	Mains
889	Measuring & Regulating Stations	Annual Throughput
890	Measuring & Reg. Commercial	Large Ind. Bills
891	Measuring & Regulating City Gate	Annual Throughput
892	Services	Weighted Services
893	Meters & House Regulators	Weighted Meters and Regulators
894	Other Equipment	Net Distribution Plant

Q. HOW ARE CUSTOMER ACCOUNTS, CUSTOMER SERVICE, AND SALES PROMOTION EXPENSES ALLOCATED?

A. Customer service expenses and sales promotions are indirectly related to the number of customers and are allocated on the basis of number of customer bills. Meter Reading (Account 902) was allocated based on the number of bills per customer class. Customer Records and Collections (Account 903) were allocated on the basis of weighted meters. I allocated Supervision (Account 901) based on the number of bills. I do not view uncollectibles as having a direct relationship to the number of customers or to the paying customers within the same class, so I allocated Uncollectibles (Account 904) on the basis of overall cost of service. For each account the type of expense and allocation factor used in my study are listed below:

Table 6

Customer Accounts

Account	Description	Allocation based on
901	Supervision	Bills
902	Meter Reading	Bills
903	Customer Records and Collection	Customer Accounts Expense
904	Uncollectible Accounts	Cost of Service
905	Miscellaneous	Customer Acct. Expense

Customer Service and Information

Account	Description	Allocation based on
908	Customer Assistance	Bills

909	Inform & Instruct Advertising	Bills

Sales

Account	Description	Allocation based on
911	Supervision	Bills
912	Demonstrating and Selling	Bills
912	Advertising	Bills
912	Misc. Expense	Bills

Q. HOW ARE ADMINISTRATIVE AND GENERAL (A & G) EXPENSES ALLOCATED?

A. Property insurance (Account 924) is allocated on the basis of net non-general plant. Expenses related to salaries, supplies, administration, outside services, injuries and damages, and employee pensions and benefits (Accounts 920, 921, 922, 923, 925 and 926) are allocated on the basis of payroll. The remainder of A & G expenses are allocated on the basis of the overall class cost of service.

Q. HOW ARE TAXES ALLOCATED?

A. Property taxes are allocated on the basis of the total net plant previously allocated to each class. Franchise taxes are allocated on the basis of rate base. Payroll taxes are allocated as a function of payroll expense. Income taxes are allocated according to the rate base attributable to each class.

Benefits of Traditional Rate Design

Q. DO YOU BELIEVE THAT A TRADITIONAL RATE DESIGN THAT RECOVERS A PORTION OF COSTS IN A CUSTOMER CHARGE AND A PORTION IN A VOLUMETRIC RATE PER UNIT PROVIDES A GREATER INCENTIVE FOR CUSTOMERS TO CONSERVE?

A. Yes. The traditional rate design provides a greater incentive for customers to conserve because, increasing consumption has a greater impact on the non-gas charges a customer must pay than would a SFV or other decoupling mechanism.

Q. HOW IS COST CAUSATION INCORPORATED INTO SETTING THE PORTION OF COSTS TO BE RECOVERED THROUGH THE CUSTOMER CHARGE AND THE PORTION TO BE RECOVERED THROUGH VOLUMETRIC RATES?

A. It is common in regulated industries for companies to recover costs that are incurred independent of usage in a fixed fee and to recover costs that vary with usage through a usage based fee. Recovering a usage based cost through a usage based fee insures that those who did not cause the cost are not required to pay for it. This objective can be met through establishing a fixed component and a variable component of rates. The cost of meters that tend to be similarly sized for the majority of residential customers can be described as being independent of use and therefore reasonably recovered through a uniform fixed fee. However, the cost of other facilities and equipment are driven by consumption or peak demand and should be recovered on a volumetric basis. For example, storage facilities are

associated with consumption during winter months and are reasonably recovered based on consumption. The cost of distribution mains is driven in large part by peak demand requirements and is another example of costs most reasonably recovered through volumetric rates.

In the context of class cost of service studies, we assign the portion of investments and expenses that are incurred based on demand and commodity related considerations to classes based on demand and commodity related factors. It is reasonable to collect these costs from each class through usage based charges.

Q. HOW CAN TRADITIONAL RATE DESIGN ENCOURAGE HIGHER SUBSCRIPTION TO THE SYSTEM?

A. Traditional rate design composed of a customer charge component and a volumetric component can benefit both low and high use customers. Low use customers benefit by retaining access to utility service. High use customers and other customer classes benefit by not having to make up the revenue lost when low use customers disconnect service.

Q. IS THE TRADITIONAL RATE DESIGN THAT CORRELATES HIGHER USE WITH HIGHER CHARGES CONSISTENT WITH THE PURPOSE OF REGULATION?

A. Yes. Utility regulation is intended to mimic the outcomes and market environment that is faced by competitive firms. The use of utility regulation to simulate a competitive environment and encourage the benefits that would accrue if the industry were suitable for a competitive structure has been referred to as the competitive market paradigm. This paradigm was described by Dr. James

Bonbright on page 93 of *Principles of Public Utility Rates* in the following manner:

> Regulation, it is said, is a substitute for competition. Hence its objective should be to compel a regulated enterprise, despite its possession of complete or partial monopoly, to charge rates approximating those which it would charge if free from regulation but subject to market forces of competition. In short, regulation should be not only a substitute for competition, but a closely imitative substitute.

Q. IS THE TRADITIONAL RATE DESIGN THAT CORRELATES HIGHER USE WITH HIGHER CHARGES CONSISTENT WITH PRICING IN COMPETITIVE SERVICE MARKETS?

A. Absolutely. In highly competitive markets, it is common for firms to recover all cost through only usage based fees. Even in more concentrated markets, rate structures that recover some portion of costs through volumetric charges are the norm. For example, telephone rates typically include a fixed minimum fee charged for basic access to the telephone network and additional usage based incremental fees that recover a portion of the investment and associated expenses. If customers demand either more services "over the pipe" or "a larger pipe" the customer pays more.

It is also the norm in competitive markets for customers to have some control over the charges they pay to the service provider. This is not the case with the SFV rate design. From a rate design perspective, recovery of all costs through a flat fixed rate is a recovery method of choice for firms with sufficient market power to impose flat fees or enough regulatory support to impose them. Rate

designs that consist of a customer charge and volumetric charge are supportable based on recognizing that the value of service is both in having access to gas as well as in using gas so cost would not be uniformly allocated to customers. In my opinion, recovery through a customer charge and volumetric rate is reasonable and fair from both an economic and policy perspective. Historically, this Commission has determined that it is appropriate for those who use more to pay more. Public Counsel encourages the Commission to adhere to this policy.

Q. IS THE TRADITIONAL RATE DESIGN CONSISTENT WITH MIMICKING THE RATE OF RETURN OPPORTUNITIES AND RISK THAT EXISTS IN COMPETITIVE MARKETS?

A. Yes. The Commission's ordered non-gas revenue requirement is not a fixed or guaranteed level of revenue that a Company is entitled to recovery each year. Instead, the level of revenue requirement approved by the Commission is a target level of costs including expenses, taxes and return on investment that an efficiently run company, barring unforeseen events has the opportunity to recover under long term average weather conditions. The Commission approved revenue requirement accounts for and is intricately related to potential weather variations that may affect costs and revenues from year to year. The process of normalizing demand determinates to account for weather and establishing a rate of return sufficient to attract investment despite the risk of weather variations are probably the two most obvious elements linking weather variations to revenue requirement. After the revenue requirement is determined, rates are set at a level anticipated to recover the target level of costs. However, the ratemaking process only reflects the anticipated cost and revenues at a snap shot in time. It does not guarantee or limit levels of either future costs or revenues and is not designed or intended to provide uniform recovery each year. Once rates are set, by improved efficiency or

circumstances, a Company has an opportunity to earn a return above that incorporated in the revenue requirement. Likewise, by inefficiency, a Company faces the potential to earn a return below that incorporated in the revenue requirement. This process mimics a competitive business environment by creating incentives for the Company to minimize costs.

Utility regulation does not create an "entitlement" for the utility to earn a Commission determined return that fully compensates the utility for its cost of service. If that were the case, there would be no reason to determine an appropriate level of a risk adjusted return that should be included in a utility's rates. Instead, utility regulation is intended to mimic the outcomes and market environment that is faced by competitive firms. While viewed by investors as undesirable, earnings uncertainty serves an important role in the efficient operation of competitive markets by providing inherent protections for consumers. Earnings uncertainty motivates competitive business entities to minimize costs and to strive for customer satisfaction. Eliminating earnings uncertainty in a regulated environment would have a similar detrimental effect on consumers as would eliminating earnings uncertainty in an unregulated market. However, in a competitive environment, consumers retain the ability to reduce or forgo purchases in response to excessive prices or poor service.

In recognition and in consideration of the service it provides as a natural monopoly, a local gas distribution company is granted an additional concession not ordinarily available in a competitive business environment. It is allowed to request a rate review to, when justified, realign revenues to costs. This concession together with other concessions made by the Commission and other governmental entities more than adequately addresses issues of potential under

earnings. For example, direct pass-through of costs such as those flowed through the PGA have substantially shifted weather related risks to consumers. It is undesirable and unnecessary to shift greater earnings risk to consumers.

Q. CAN YOU CITE ANY ANALYSIS BY A RECOGNIZED UTILITY INDUSTRY EXPERT THAT SUPPORTS YOUR BELIEF THAT UTILITY COMMISSIONS GENERALLY SET RATES AT A LEVEL WHICH ALLOWS UTILITIES THE OPPORTUNITY (AS OPPOSED TO A GUARANTEE) TO ATTAIN THEIR AUTHORIZED RETURN?

A. Yes, the following quote from page 202 of A. J. G. Priest's *Principles of Public Utility Regulation* supports this widely recognized regulatory principle:

> ...the utility's return allowance might be compared with fishing or hunting license with a limit on the catch. Such a license does not guarantee that the holder will catch anything at all; it simply makes the catch legal (up to a specified limit) provided the holder is successful in his own efforts.

Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

A. Yes.