Exhibit No.:	
Issues:	*Corporate Costs; Lobbying Activities; Prepaid Pensions; Pensions and OPEBs; Cost of Removal; Miscellaneous Adjustments; and True-Up Audit*
Witness:	*Charles R. Hyneman*
Sponsoring Party:	*MoPSC Staff*
Type of Exhibit:	*Direct Testimony*
Case No.:	*GR-2004-0209*
Date Testimony Prepared:	*April 15, 2004*

MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

DIRECT TESTIMONY

OF

CHARLES R. HYNEMAN

MISSOURI GAS ENERGY

CASE NO. GR-2004-0209

Jefferson City, Missouri
April 2004

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

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

AFFIDAVIT OF CHARLES R. HYNEMAN

STATE OF MISSOURI	)	
	)	ss.
COUNTY OF COLE	)	

Charles R. Hyneman, being of lawful age, on his oath states: that he has participated in the preparation of the following direct testimony in question and answer form, consisting of 37 pages to be presented in the above case; that the answers in the following direct testimony were given by him; that he has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of his knowledge and belief.

Charles R. Hyneman

Charles R. Hyneman

Subscribed and sworn to before me this 14th day of April 2004.

Toni M Charlton

TONI M. CHARLTON
NOTARY SEAL
NOTARY PUBLIC
STATE OF MISSOURI

TONI M. CHARLTON
NOTARY PUBLIC STATE OF MISSOURI
COUNTY OF COLE
My Commission Expires December 28, 2004

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CHARLES R. HYNEMAN

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DIRECT TESTIMONY

OF

CHARLES R. HYNEMAN

MISSOURI GAS ENERGY

CASE NO. GR-2004-0209

Q. Please state your name and business address.

A. Charles R. Hyneman, Fletcher Daniels State Office Building, Room G8, 615 East 13th Street, Kansas City, Missouri 64106.

Q. By whom are you employed and in what capacity?

A. I am employed by the Missouri Public Service Commission (Commission) as a Regulatory Auditor.

Q. Have you previously filed testimony before the Commission?

A. Yes. Schedule 1, attached to this testimony, lists the cases and issues on which I have filed testimony before the Commission.

Q. With respect to Case No. GR-2004-0209, have you made an examination of the books and records of Missouri Gas Energy (MGE) an operating division of Southern Union Company (Southern Union)?

A. Yes, with the assistance of other members of the Commission Staff (Staff).

Q. What are your principal areas of responsibility in this case?

A. As Lead Auditor, I am responsible for the preparation of the Staff Accounting Schedules, which include the Staff's recommendation for MGE's revenue requirement in this case. My other areas of responsibility include the overall level of corporate costs allocated to MGE from Southern Union's corporate headquarters in Wilkes-Barre, Pennsylvania. These costs include corporate expenses (payroll, non-payroll and insurance), plant in service, depreciation reserve and deferred income taxes.

I am also sponsoring the Staff's adjustments to MGE's pension and other postretirement benefits expense (OPEB). I am sponsoring an adjustment to include a normalized level of cost of removal expense in MGE's cost of service.

I am sponsoring other miscellaneous income statement adjustments, several of which MGE has included in its direct filing in this case. Finally, I am supporting the Staff's recommendation that a true-up audit be performed in this case.

Q. Please list the Staff witnesses who are sponsoring the individual Staff Accounting Schedules.

A. The Staff witnesses who are sponsoring specific Staff accounting schedules are:

Schedule 1	Revenue Requirement	Charles R. Hyneman
Schedule 2	Rate Base	Lesley R. Preston
Schedule 3	Total Plant in Service	Lesley R. Preston
Schedule 4	Adjustments to Total Plant	Lesley R. Preston
Schedule 5	Depreciation Expense	Lesley R. Preston
Schedule 6	Depreciation Reserve	Lesley R. Preston
Schedule 7	Adjustments to Depreciation Reserve	Lesley R. Preston
Schedule 8	Cash Working Capital	Dana E. Eaves
Schedule 9	Income Statement	Charles R. Hyneman
Schedule 10	Adjustments to Income Statement	Charles R. Hyneman
Schedule 11	Income Tax	Paul R. Harrison

Q. Please describe Accounting Schedule 1, Revenue Requirement.

A. Line 14 of Accounting Schedule 1, Revenue Requirement reflects the range of the Staff's recommended revenue increases for MGE as a result of its audit of MGE's financial records for the test year ended June 30, 2003, updated for known and measurable changes through December 31, 2003. MGE's net operating income (NOI) requirement is calculated by multiplying its net investment in plant and other assets (rate base) by the rates of return recommended by Staff witness David Murray of the Financial Analysis Department. MGE's adjusted jurisdictional net operating income from Accounting Schedule 9, Income Statement, is subtracted from this amount to arrive at the additional income needed to earn the recommended rate of return (line 5). Finally, the additional current income tax expense required as a result of the additional income (line 9) is added to the additional income needed which results in the total recommended revenue increase.

Q. Please list the adjustments to Accounting Schedule 9, Income Statement that you are sponsoring in this case.

A. I am sponsoring the following adjustments to Accounting Schedule 9, Income Statement. These adjustments are individually listed on Accounting Schedule 10, Adjustments to Income Statement:

Adj No.	Description
S-22.1	Annualize cost of MGE's new IT Dept -MGE Adjustment H-29
S-47.3	Annualize cost of MGE's new IT Dept -MGE Adjustment H-29
S-48.1	Remove transition costs related to sale of Southern Union Gas Co.
S-49.2	Include MGE Adjustment H-25 Non Utility Activities
S-49.3	Annualize cost of MGE's new IT Dept -MGE Adjustment H-29
S-49.4	Include MGE's proposed level of corporate payroll costs
S-49.5	Include MGE's proposed level of corporate nonpayroll costs
S-49.6	Adjust MGE's proposed level of corporate payroll costs
S-49.7	Adjust MGE's proposed level of corporate nonpayroll payroll costs
S-51.4	To annualize MGE corporate allocated insurance expense
S-52.1	Adjust pension expense to reflect ERISA Minimum funding level
S--52.2	Annualize FAS 106 expense
S-52.5	Include amortization of MGE's prepaid pension asset
S-53.6	Remove legal costs associated with nonregulated activities
S-54.3	Remove transition costs related to sale of Southern Union Gas Co.
S-56.2	Annualize cost of MGE's new IT Dept -MGE Adjustment H-29
S-58.1	Include 5-year average of net cost of removal costs
S-63.1	Annualize state franchise taxes

S-49.8	Remove nonrecurring outside services
S-35.3	Annualize customer collection charges MGE Adjustment H-23
S-49.9	Annualize tax compliance costs MGE Adjustment H-26

Q. Please describe Accounting Schedule 9, Income Statement.

A. Accounting Schedule 9, Income Statement, contains the Staff's adjusted gas revenues, expenses and net income for MGE for the test year ended June 30, 2003, updated for known and measurable changes through December 31, 2003.

Q. Please explain Accounting Schedule 10, Adjustments to Income Statement.

A. Accounting Schedule 10 contains a listing of the specific adjustments that the Staff has made to the unadjusted test year income statement to derive the Staff's adjusted net income. A brief explanation for each adjustment and the name of the Staff witness sponsoring the adjustment is listed in Accounting Schedule 10.

MISCELLANEOUS INCOME STATEMENT ADJUSTMENTS

Q. Please describe adjustment S-22.1, S-47.3, S-49.3 and S-56.2.

A. These adjustments annualize the nonpayroll cost of MGE's Information Technology (IT) department.

Q. Why was this adjustment necessary?

A. Prior to December 2002, substantially all of Southern Union's IT functions were consolidated and coordinated through Southern Union's corporate headquarters in Austin, Texas (Southern Union's corporate headquarters subsequently moved to Wilkes-Barre, Pennsylvania). The IT department costs were charged to the corporate books and allocated to MGE and Southern Union Gas (SUG) when these operating divisions filed rate cases in their respective jurisdictions. SUG was Southern

Union's local gas distribution company (LDC) located in Austin, Texas. Like MGE, it operated as a division of Southern Union Company.

On October 16, 2002, Southern Union Company announced the agreement to sell its SUG division to ONEOK, Inc. (ONEOK) headquartered in Tulsa, Oklahoma. The sale was completed in January 2003. As a result of this sale, MGE had to create its own IT department and operate more as a stand-alone utility. MGE's new IT department initially consisted of many of the IT employees that were on the corporate books before the sale of Southern Union Gas.

Because the new IT department was not in place until January 2003, only approximately one-half of the IT department's costs were included in MGE's books and records for the test year ended June 2003. These adjustments annualize the nonpayroll costs of the IT departments to reflect an annual level of costs. This adjustment was proposed by MGE in adjustment H-29. The Staff's annualization of the payroll costs of MGE's IT department is part of Staff Auditing witness Dana E. Eaves' overall MGE payroll annualization which is discussed within his direct testimony.

Q. Please describe adjustments S-48.1 and S-54.3.

A. These adjustments remove as nonrecurring charges the payments to ONEOK from MGE and payments received by MGE from ONEOK as a part of the Southern Union/ONEOK transitional services agreement. The transitional services agreement was related to the sale of SUG to ONEOK and was designed to ensure essential utility functions were not interrupted as a result of the sale. This adjustment is included in MGE's accounting schedules as adjustment H-24, Shared Services.

Q. Please describe adjustment S-63.1.

A. This adjustment to annualize state franchise tax payments was included in MGE's accounting schedules as adjustment H-17, State Franchise Tax. However, the Staff revised MGE's proposed adjustment by removing Southern Union's goodwill assets from the calculation of franchise taxes. Goodwill, or acquisition adjustments, are not considered for ratemaking purposes in Missouri.

Q. Please describe adjustment S-49.8.

A. This adjustment removes the cost of outside consultant as nonrecurring. The consultant was hired by MGE as a full time employee and this employee's payroll cost is included in the Staff's payroll annualization in this case.

Q. Please describe adjustment S-49.9.

A. This adjustment annualizes the franchise and property tax compliance service for MGE provided by Deloitte and Touche. This adjustment was included in MGE's accounting schedules as adjustment H-26.

Q. Please describe adjustment S-35.3.

A. This adjustment annualizes customer collection software usage and maintenance services provided by Brazen Software. This adjustment was included in MGE's accounting schedules as adjustment H-23.

LOBBYING ACTIVITIES

Q. Please explain adjustment S-49.2.

A. This adjustment removes expenses booked by MGE in the test year that relate to lobbying, are nonrecurring, or otherwise should not be included in MGE's cost of service. This adjustment was included in MGE's accounting schedules as adjustment H-25, Remove Non-utility Activities. Missouri Energy Development

Association (MEDA) dues were removed in Staff adjustment S-54.6, sponsored by Staff Auditing witness Lesley R. Preston.

Q. Did MGE make an adjustment in its direct filing to remove the dues it paid to MEDA?

A. Yes. MGE made a $40,000 adjustment to remove MEDA dues from Account 930, Miscellaneous General Expenses. This adjustment was included in MGE's accounting schedules as adjustment H-21.

Q. Does the Staff believe that any costs incurred by MGE that are associated with MEDA should be included in MGE's cost of service?

A. No. The Staff considers MEDA to be a lobbying organization designed to promote the interests of utility shareholders. As such, all costs related to MEDA should be booked below-the-line for ratemaking purposes and be absorbed by the utility's shareholders.

Q. How does the Staff define the word "lobbying?"

A. The Staff considers the word lobbying to include any attempt to influence the decisions of legislators. All such costs associated with lobbying activities, both direct and indirect in nature should be excluded from a utility's cost of service.

Q. Is it the Staff's position that only non-payroll expenditures related to lobbying activities should be recorded below-the-line?

A. No. The Staff believes that both payroll and nonpayroll charges related to lobbying should be recorded below-the-line. The Staff believes that a utility employee's time spent on lobbying or lobbying-related activities should be recorded in the employee's time sheet. When the utility files a rate case, it should determine a normalized level of time spent on lobbying activities and remove that cost from the utility's cost of service.

Q. Did MGE remove any payroll costs related to the time its employees spent on lobbying activities from this rate case?

A. No.

Q. Why is it improper ratemaking for MGE not to make an adjustment to exclude from its cost of service the payroll cost related to the time its employees spend on lobbying activities?

A. It is improper ratemaking because it shifts the burden of making the adjustment from the Company, where it belongs, to the Staff.

Q. During its audit of MGE, did the Staff determine that certain employees spend time on lobbying activities?

A. Yes. MGE's primary employee in the area of lobbying activities is Mr. Paul Snider, whose title is "Legislative Liaison." During an interview with the Staff, it was determined that Mr. Snider supervises MGE's four outside lobbying firms and well as participates in MEDA meetings and MEDA activities.

Q. Did the Staff find that other MGE employees spend time on lobbying activities?

A. Yes. The Staff found that Mr. Robert Hack, Vice-President of Regulatory Affairs, and Mr. James Oglesby, MGE's President and Chief Operating Officer also participates in MEDA activities.

Q. Is the Staff proposing an adjustment to remove certain of MGE's employees' payroll costs on the basis that they are related to lobbying activities?

A. Yes. The Staff determined substantially all of Mr. Snider's time is spent on lobbying activities. As such, the Staff is proposing to charge 100 percent of Mr. Snider's payroll costs below-the-line for ratemaking purposes in this case. The Staff also determined that, although to a lesser extent, Mr. Oglesby and Mr. Hack spend time on lobbying activities. The Staff determined that a 10 percent allocation of Messrs. Oglesby's and Hack's time to below-the-line lobbying activities is appropriate in this case.

Q. Are you sponsoring the Staff's adjustment to allocate payroll costs of Messrs. Snider, Hack and Oglesby to below-the-line lobbying activities?

A. Yes. Although the actual mechanical adjustment is included in the payroll workpapers of Staff witness Eaves, Mr. Eaves made the calculation under my direction and I am the Staff witness sponsoring this adjustment.

Q. Is the Staff's adjustment to charge 100 percent of Mr. Snider's payroll costs and 10 percent of the payroll cost of Mr. Hack and Mr. Oglesby to lobbying based on mathematical certainty that this is the percentage of time these employees spend on lobbying activities?

A. No. The Staff does not have the data necessary to make an exact determination. The Staff's adjustment is based on interviews with Mr. Snider and Mr. Hack, as well as the expense reports, time sheets and appointment calendars for these employees. The information provided by MGE to the Staff in response to Staff data requests was not complete and did not provide the data necessary for the Staff to make an adjustment with mathematical certainty.

Q. Would the Staff be able to more accurately allocate employee costs to lobbying activities if the appropriate information was available and complete?

A. Yes. The Staff has a desire for its allocation of MGE employee costs to lobbying activities to be as accurate as possible. In order for this to happen, MGE must record and maintain adequate documentation to provide to the Staff. Therefore, the Staff is requesting the Commission order MGE to keep detailed time reporting on the amount of time each employee works on lobbying and lobbying related activities.

Q. Please explain adjustment S-53.6.

A. This adjustment includes a normalized level of regulatory outside legal costs. In its review of legal costs booked to account 928, Regulatory Commission Expense, the Staff found that approximately $35,000 of charges were related to MGE's nonregulated activities including lobbying activities. The Staff removed these charges from account 928.

COST OF REMOVAL AND SALVAGE

Q. Please explain adjustment S-58.1.

A. This adjustment includes a five-year average of MGE's cost of removal less salvage proceeds. This is sometimes referred to as "net salvage."

Q. What is cost of removal and salvage?

A. Cost of removal is incurred when utility property is retired and removed from service. Generally, removing property from service causes the utility to incur costs to abandon, physically dismantle, tear down or otherwise remove the property from its site.

Salvage is the proceeds received from the residual value or scrap value that some property has when it is dismantled and removed from utility service. After a piece of property is dismantled or removed from service, utilities can in some instances sell or receive some value for the displaced property. Utilities track the costs relating to removal costs and salvage value on an ongoing annual basis.

Typically, removal costs exceed salvage value, resulting in a positive net expense to the utility. MGE's five-year average of net cost of removal is $673,327 (Staff Data Request No. 246).

Q. Why is this adjustment necessary?

A. This adjustment is necessary to include an annual normalized level of cost of removal and salvage proceeds in MGE's cost of service. Cost of removal expenditures, like other expenses (maintenance, payroll, fuel expense, etc.) are ongoing costs incurred by the utility to provide service to its customers. Therefore, like these other costs, the Staff has determined a normalized level for annual cost of removal, netted against any normalized salvage proceeds received by the Company.

Q. Why did the Staff use a five-year average to determine the level of cost of removal and salvage value to include in the revenue requirement?

A. A five-year average was used because the costs of removal and salvage amounts fluctuated from year to year during the period examined. Using a five-year average for fluctuating costs removes or smoothes out the differences from one year to the next. Averaging costs to mitigate the impact of fluctuations is commonly used in the ratemaking process and is consistent with how other costs have been treated in this case.

The average over the last five years is the most representative of the annual normal ongoing level of expense for this case.

Q. Have cost of removal and salvage value been treated this way in prior MGE rate cases?

A. Yes. This was the method that the Staff used in the last MGE general rate case, Case No. ER-2001-292.

Q. Has the Staff treated cost of removal and salvage amounts in other rate cases consistent with the way that they have been treated in this case?

A. Yes. This approach has been used the last several years in many rate cases filed with the Commission. The cases that cost of removal has been treated as an expense item netted against any salvage amounts are:

Company	Case No.	Case Status
Ameren/Union Electric Company	GR-2000-512	Stipulated
Ameren/Union Electric Company	EC-2002-1	Stipulated
Ameren/Union Electric Company	GR-2003-517	Stipulated
Citizens Electric Company	ER--2002-217	Stipulated
Laclede Gas Company	GR-2001-621	Ordered
Laclede Gas Company	GR-2002-356	Stipulated
St. Louis County Water Company	WR-2000-844	Rejected
Missouri American Water Company	WR-2003-500	Stipulated
Missouri American Water Company	WC-2004-0168	Stipulated
Empire District Electric Company	ER-2001-299	Ordered
Empire District Electric Company	ER-2002-424	Stipulated
Missouri Gas Energy	GR-2001-292	Stipulated
UtiliCorp United, Inc. (Aquila Inc)	ER-2001-672	Stipulated
Aquila Inc	ER-2004-0034	Pending
Aquila Inc	HR-2004-0024	Pending
Aquila Inc	GR-2004-0072	Pending
Peace Valley Telephone Co.	TT-2001-118	Stipulated
Holway Telephone Company	TT-2001-119	Stipulated
KLM Telephone Company	TC 2001-120	Stipulated
Northeast MO Rural Telephone	TT-2001-344	Stipulated
Oregon Farmers Mutual Telephone	TT-2001-328	Stipulated
BPS Telephone Company	TC-2002-1076	Pending

Green Hills Telephone	TT-2001-115	Stipulated
Iamo Telephone Company	TT-2001-116	Stipulated
Ozark Telephone Company	TC 2001-402	Stipulated

PENSION EXPENSE AND OPEB EXPENSE-FAS 106

Q. What level of pension expense is the Staff proposing in this case?

A. The Staff is proposing that MGE change its method of calculating pension expense from the Statement of Financial Accounting Standards No. 87, *Employers' Accounting for Pensions* (FAS 87) method which, for the past several years has resulted in a significant pension credit (negative expense), to a minimum funding method designed to ensure the pension fund is adequate to meet current and future pension obligations. This method is referred to as the Employee Retirement Income Security Act of 1974 minimum (ERISA minimum) method. The provisions of Title I of ERISA, which are administered by the U.S. Department of Labor, were enacted to address public concern that funds of private pension plans were being mismanaged and abused. ERISA was the culmination of a long line of legislation concerned with the labor and tax aspects of employee benefit plans.

Q. Has the Staff proposed this change in prior rate cases?

A. Yes. The Staff proposed this change in the method of calculating pension expense in the most recent rate cases involving AmerenUE, Case No. EC-2002-1; Laclede Gas Company, Case No. GR-2002-356; Empire District Electric Company, Case No. ER-2002-424; and Aquila, Inc., Case Nos. ER-2004-0034, HR-2004-0024 and GR-2004-0072.

HISTORICAL RATEMAKING TREATMENT – PENSION AND OPEB COSTS

Q. Please explain FAS 87 and FAS 106.

A. Statement of Financial Accounting Standards No. 87, *Employers' Accounting for Pensions* (FAS 87) and Statement of Financial Accounting Standards No. 106, *Employers' Accounting for Postretirement Benefits Other than Pensions* (FAS 106) are the Financial Accounting Standards Board (FASB) approved accrual accounting methods used for financial statement recognition of annual pension cost and OPEB expense over the service life of employees.

Q. When were the accrual accounting methods for pension and OPEBs costs, FAS 87 and FAS 106, adopted for ratemaking purposes in Missouri?

A. House Bill 1405 (Section 386.315, RSMo), approved by the Missouri Legislature in 1994, required the adoption of FAS 106 for setting rates for OPEBs costs. In Commission cases subsequent to the date that House Bill 1405 became law, the Staff recommended the use of the accrual accounting method for pension costs, FAS 87. This recommendation was based on the desire for consistency in the accounting for very similar types of retirement costs.

Q. What method was used for setting rates for pension expense and OPEB expense prior to the requirement to use FAS 106 under House Bill 1405?

A. Prior to House Bill 1405, rates were set on a "pay as you go" or "cash" basis for both pension and OPEB expense. The ERISA minimum contribution was used for pension expense and the utility's actual paid claims to retirees was used for OPEB expense.

Q. What is the purpose of the 1974 ERISA federal legislation?

A. The ERISA funding requirements are intended to ensure that Defined Benefit Pension Plans in the United States are adequately funded.

Q. Since the change in the Staff's position in recommending the adoption of FAS 87 for determining pension cost for setting rates, has there been a considerable difference of opinion between the Staff and utility companies regarding the proper assumptions to be used in calculating pension cost under FAS 87?

A. Yes. The methodology to be used in calculating pension cost under FAS 87 has been vigorously debated and tried in numerous cases involving the major electric, gas and water utility companies in Missouri.

Q. What have been the primary issues between the Staff and utility companies regarding the assumptions used in calculating pension cost under FAS 87?

A. The most important issue raised by the Staff addressed the use of assumptions by utility companies that do not accurately reflect the funded status of the pension plan. FAS 87 pension calculations that do not accurately reflect the funded status of the pension plan result in pension costs that are excessive when compared to the actual cash funding requirements under ERISA regulations. Annual pension cost under FAS 87, which was significantly higher than the amounts actually required to be contributed to the pension fund, resulted in a cash windfall to the utility and excessive rates to ratepayers.

The second most important issue involving pension cost calculated under FAS 87 is whether the result is so volatile from year-to-year that it becomes inappropriate for setting rates. While an important consideration, the "volatility" issue should never take precedence over the primary issue, which is to make sure that the assumptions used to address volatility do not result in a pension cost which is significantly higher than the actual funding requirements of the plan.

Q. How does the funded status of the pension plan impact the pension cost calculated under FAS 87?

A. One of the assumptions used in FAS 87 is the expected rate of return assumption. The expected rate of return represents the annual income expected from investing the existing pension funds in debt and equity securities. Annual pension cost under FAS 87 will only be positive when the annual earned returns from investing the funded assets is less than the additional annual costs including, primarily, service and interest costs related to additional benefits earned by employees and the annual interest on the accumulated benefit obligation.

Prior to the significant devaluation of the stock market in 2001 and 2002, most pension funds for major utilities, like MGE's pension fund, were so well-funded that pension cost under the Staff's FAS 87 method was a negative amount due largely to the fact that the actual returns earned on the pension fund assets were significantly higher than the expected returns. When the earned returns on the fund assets exceed the annual additional cost (primarily service and interest) under FAS 87, then the net result is a negative expense, or more appropriately called a "pension credit."

Q. What other factors can have a significant impact on pension cost under FAS 87 and on annual volatility in year-to-year results?

A. As discussed in my previous answer, significant differences often occur between "expected" results and "actual" results. These differences, as well as others described below, result in a gain or loss under FAS 87.

The expected rate of return assumption is an estimate based on an assumed long-range (20 to 30 years) return estimated by the Company's actuary. Significant differences can and do occur between actual short-term returns and the expected rate of return. These differences between expected and actual result in a gain (actual return exceeds expected) or a loss (actual return is less than expected). Changes in other assumptions made by the actuary for the discount rate and interest rate, for example, will also result in a gain or a loss under FAS 87.

The appropriate time frame to be used in recognizing gains and losses under FAS 87 has been a significant issue between the Staff and major utilities since FAS 87 has been adopted by the Commission for setting rates. FAS 87 provides for considerable flexibility in choosing the time period used in recognizing (amortizing) gains and losses in calculating pension cost. The FAS 87 method recommended by the Staff in prior cases reflected gains and losses over a five-year period.

<u>RECOMMENDATION FOR PENSION COSTS</u>

Q. What method for determining pension cost is Staff recommending for this case?

A. The Staff is recommending that pension cost be calculated based upon the ERISA minimum contribution. Since MGE has not made a contribution to its pension fund in the past five years, the Staff is proposing a $0 level of pension expense in this case. The Staff's proposed level of pension expense is reflected in Staff adjustment S-52.1.

Q. Why is the Staff recommending that FAS 87 no longer be used for determining pension cost for ratemaking purposes?

A. As stated previously, one of the primary difficulties in using FAS 87 for calculating pension cost for ratemaking purposes is limiting the annual volatility to an acceptable level. The devaluation of the stock market in recent years has had a dramatic impact on FAS 87 pension costs for major utility companies in Missouri.

Q. What other FAS 87 result makes it undesirable for use in setting rates for a regulated utility?

A. All pension plans for Missouri's major utility companies were well funded until the recent decline in the market value of equity investments. The annual earned returns on pension fund assets were significantly higher than the annual service cost and interest cost components of pension cost under FAS 87. This condition routinely resulted in a net negative pension cost under FAS 87. Using a negative pension cost in setting rates reduced the utility's current cash flow. It was the Staff's expectation that negative results under FAS 87 would be a short-term result as benefits were paid with no additional cash contributions to the well-funded plans. However, the actual earned returns on the pension fund assets were so high during the 1990s that a negative pension cost under FAS 87 became an annual occurrence. Using a negative pension cost for setting rates is not a reasonable long-term result. Since the minimum contribution under ERISA will always be $0 or higher, a negative pension cost will no longer occur when the ERISA minimum contribution is used for ratemaking purposes.

Q. How is the ERISA minimum contribution used to determine an annual level of pension cost for ratemaking purposes?

A. Under normal circumstances, the Staff will use an analysis of the actual historical fund contributions required under ERISA regulations. If the annual contributions have been stable in regard to the amount of the contribution required, then the most recent contribution can be used for the annual level of pension cost to be included in cost of service for setting rates. However, if there has been significant annual volatility (fluctuation in the level of contributions from year to year) in the annual fund contributions, then an average is appropriate for determining a normalized level for ratemaking purposes.

PREPAID PENSION ASSET

Q. Please explain the prepaid pension asset calculated under FAS 87.

A. FAS 87 provides the Generally Accepted Accounting Principles (GAAP) method used for recognizing the annual pension cost liability for financial reporting purposes. The ERISA regulations address the funding of the same pension plan liability. Annual differences occur because the actuarial methods used assign cost differently over the service lives of employees. Annual differences between pension cost under FAS 87 for financial reporting and cash contributions to the fund are accounted for as either a prepaid pension asset (cash contribution exceeds FAS 87 accrual) or an accrued liability (FAS 87 accrual exceeds cash contribution).

Q. Please explain the regulatory implications of the prepaid pension asset.

A. With regard to major utility companies in Missouri, the change in the prepaid pension asset has resulted primarily from a negative pension expense under FAS 87 and a zero ERISA minimum contribution since the adoption of FAS 87 for setting rates. As discussed previously, a negative pension expense reduced cash flow to the utility. The excess of fund assets over the pension liability in prior years could not be withdrawn and used to offset the negative cash flow that resulted from reflecting a negative pension cost under FAS 87 in setting rates. The prepaid pension asset, in effect, represents a cash flow benefit (reduction in rates), which, in theory, should reverse over the service life of the employees used to accrue pension cost. In other words, there should not be any permanent difference between the recognition of the pension liability for financial reporting over the service life of employees and the funding of the same liability. However, as a practical matter, the prepaid pension asset continued to grow rather than reverse as a result of the better than expected returns earned on the pension fund assets since the early 1990s. What was expected to be a temporary, short-term timing difference between the accrual of pension cost under FAS 87 and the funding of the plan has, in reality, been a recurring reduction in cash flow resulting from the recognition of a negative pension cost under FAS 87 in rates.

Q. How should the prepaid pension asset be treated in setting rates as result of the Staff's recommended change to use the ERISA minimum contribution for determining pension cost for setting rates?

A. The prepaid pension asset is in effect the opposite of the accumulated deferred income tax reserve. Deferred income taxes represent income tax paid through rates that exceed the Company's current income tax liability. The deferred taxes represent a cash flow benefit to the utility and are returned to customers over the life of the assets generating the accelerated tax deductions used in calculating current income tax. The prepaid pension asset represents the accumulated reduction in rates that has occurred as a result of reflecting negative pension cost in rates under FAS 87. It was intended to be a temporary timing difference that would reverse over time. With a change in pension cost determination to the ERISA minimum funding requirement, the only mechanism to reverse the prepaid asset is to amortize the balance over a reasonable period of time. The appropriate time frame is the number of years that FAS 87 has been in effect for ratemaking purposes.

MGE adopted FAS 87 for ratemaking purposes in Case No. GR-96-285. The rates for that case went into effect in February 1997. Therefore, the accumulation period for the prepaid pension asset was from February 1997 through December 31, 2003, (the update period in this case), or a period of seven years.

Q. Please explain adjustments S-52.5.

A. This adjustment amortizes MGE's prepaid pension asset to expense using a seven-year amortization period.

OPEBS - FINANCIAL ACCOUNTING STANDARD (FAS) 106

Q. Please explain adjustments S-52.2.

A. This adjustment annualizes OPEB expense calculated under FAS 106 for MGE's employees. OPEB expense reflects MGE's current liability to provide retiree medical payments to its current employees as well as its retired employees.

Q. How did the Staff determine the level of OPEB expense to include in this case?

A. The Staff used the $1,150,000 FAS 106 cost reflected in a letter from MGE's actuary, Rudd and Wisdom, dated July 8, 2003. This letter provides FAS 106 expense estimates for the fiscal year ended June 30, 2004.

In addition, the Staff made no adjustment to MGE's $2.6 million amortization of the Transition Benefit Obligation (TBO amortization). This obligation or liability was assumed by MGE upon its acquisition of its Missouri gas properties from Western

Resources in 1994. This liability of $43 million dollars reflects MGE's liability for medical payments to retirees of the former owner of MGE's gas distribution properties, Western Resources, Inc. This liability is being amortized over a period of approximately 16 years and will be fully amortized in December 2012.

Q. Does this FAS 106 expense level reflect the five-year rolling average amortization of gains and losses agreed to by the Staff and MGE in MGE's last rate case, Case No. GR-2001-272?

A. Yes, it does.

Q. If both the OPEB expense and pension expense are similar types of expenses, and the Staff is recommending a change from the FAS 87 pension accrual method to the less volatile ERISA minimum method, why isn't the Staff recommending a change from the FAS 106 OPEB accrual method to the pay-as-you-go method which reflects the actual cash payments made to retirees?

A. As discussed earlier, state law requires the Commission to use FAS 106 for OPEB expense in setting rates.

<u>CORPORATE COSTS</u>

Q. Please describe adjustments S-49.4 and S-49.5, S-49.6, S-49.7 and S-51.4.

A. These adjustments incorporate MGE's proposed level of corporate overhead payroll (S-49.4) and nonpayroll (S-49.5) expense to MGE's cost of service in this case. Staff adjustment S-49.6 adjusts MGE's proposed level corporate payroll expense to the Staff's recommended level and adjustment S-49.7 adjusts MGE's proposed level corporate nonpayroll expense to the Staff's recommended level. Staff adjustment S-51.4 included MGE's proposed level corporate insurance with no Staff adjustment. Southern Union allocated MGE 12.65 percent of its total company insurance cost. The Staff used this percentage multiplied by Southern Union's 13-month average of prepaid insurance premiums to calculate the Staff's proposed level of prepaid insurance in rate base. Staff witness Eaves sponsors this rate base component.

Q. How does MGE account for corporate allocated costs from Southern Union?

A. The only corporate allocated expense that MGE records in its books and records is its share of Southern Union's total company insurance costs. These costs are recorded in account 925, Injuries and Damages. While MGE does capitalize corporate overhead costs to its plant records as a component of the original cost of utility plant throughout the year, it does not record corporate allocated operations and maintenance (O&M) expense on its books and records until it files a rate case. In its rate case applications, MGE treats corporate allocated O&M expenses as an "outside service" and records them as an adjustment to account 923, Outside Services Employed.

Q. What level of corporate allocated costs is MGE proposing to include in its test year cost of service in this case?

A. Total allocable corporate costs including payroll, nonpayroll and insurance is $31,719,928. Of this amount Southern Union allocated to MGE $6,554,017. The chart below is a summary of Southern Union's corporate cost allocations to MGE:

	Total Corporate	Percent to MGE	MGE Allocated
Payroll	$10,350,205	26.06	$2,697,175
Nonpayroll	$9,350,634	24.99	$2,336,318
Subtotal	$19,700,839	25.55	$5,033,493
Insurance	$12,019,089	12.65	$1,520,524
Total	$31,719,928	20.66	$6,554,017

Q. What types of services are provided to MGE from Southern Union's corporate offices?

A. The corporate division of the Company provides MGE with the resources of its financing, financial reporting, corporate governance, risk management, human resources, legal and environmental departments. These types of services are reflected in the names of the corporate departments that are included in Southern Union's Joint and Common Cost allocations model (JCC model). The names of these departments are shown below. Corporate services are provided by 11 departments consisting of 52 employees. The total allocable payroll and benefits costs for the employees in these departments for the updated test year period ended December 31, 2003, is $10, 350,205 per Southern Union's JCC model. Of this amount, MGE is charged $2,697,175, or approximately 26 percent.

Corporate Department	No. Employees
Internal Audit	4
Chairman	4
President and CFO	4
Accounting	13
Human Resources	5
Information Technology	6
Corporate Communications	3
Legislative Affairs	1
Legal	5
Risk	2
Treasury	5
Total	52

[In Southern Union's JCC model, the Information Technology, Corporate Communications and Legislative Affairs employees are classified under the Human Resources department].

CORPORATE COSTS - MASSACHUSETTS FORMULA

Q. What primary allocation method did Southern Union use to allocate substantially all of its corporate payroll and nonpayroll costs to MGE and its other divisions and subsidiaries (business units)?

A. Southern Union is allocating most of its corporate payroll and non payroll costs through the use of a four-factor method referred to by Southern Union as the "corporate functions pool" allocator. This method uses the relative amount of each of Southern Union's business units' (1) investment; (2) revenue; (3) expenses; and (4) customers to the total company consolidated level of investment, revenue, expenses and customers, to determine the appropriate allocation percentage for each business unit.

Q. Is it common in the allocation of corporate costs to operating business units to use a general allocator such as Southern Union's Corporate Functions allocator?

A. Yes. Ideally, when a corporate department provides a service to a specific business unit, that corporate department will charge that specific business unit with its cost of performing that service. This cost will typically include an hourly labor charge including payroll, payroll taxes and employee benefits (loaded payroll factor). This method of assigning corporate costs to an individual business unit is referred to as the "direct charge" method and is the optimal method of assigning corporate costs to a business unit.

When a corporate employee performs a service that benefits all business units, that employee's cost should be allocated based on a causation factor. For example, the cost of corporate IT department employees who are responsible for maintenance of computers could be allocated based on the relative number of employee computers. The cost of this group of employees that is not directly charged to a specific business unit can be allocated based on this cost causation factor.

There are, however, costs that cannot be directly assigned and cannot be allocated based on a direct cost causation factor. The types of costs included in this category are the general corporate overhead departments, such as the chief executive officer (CEO), chief financial officer (CFO), treasury and investor relations.

Q. What is the optimal method of allocating the costs of the general corporate overhead departments listed above?

A. The ideal method is to allocate the cost of these departments based on the relative amount of direct charges each corporate department made to each business unit during the year. For example, assume a CFO department had $1 million in direct charges during the year and $600, 000 was charged to Business Unit A and $400,000 was charged to Business Unit B. Then the residual cost of the CFO department (cost that remain to be allocated after all direct charges have been made) should be allocated 60 percent to Business Unit A and 40 percent to Business Unit B.

Q. Are there other common methods of allocating general corporate overhead costs to business units?

A. Yes. A common method of allocating the costs of these types of corporate services is referred to as the Massachusetts Formula. The Massachusetts Formula is a general corporate overhead allocations factor based on the three components of revenues, gross plant and payroll.

The Federal Energy Regulatory Commission (FERC) explains the Massachusetts Formula as follows:

> The Massachusetts formula allocates corporate overhead costs among a parent, its affiliates, and subsidiaries based on an average of three ratios: (1) the affiliate's operating revenue to total corporate operating revenues; (2) the affiliate's gross plant to total corporate gross plant; and (3) the affiliate's gross payroll (or labor costs) to total corporate gross payroll. Overhead costs are allocated to the affiliate based upon the average percentage of each of these three items to total company figures for these items. Williams Natural Gas Co., 77 FERC 61,277 at 62,188 (1996).

Q. Is it common for utilities to use different variations of the Massachusetts formula to allocate costs to its business units?

A. Yes. In addition to the original Massachusetts Formula described above, the FERC has allowed the use of similar allocations formulas. For example, in Distrigas of Massachusetts Corp., 41 FERC 61,205 at 61, 554-57 (1987), the FERC modified the Massachusetts Formula to use net incomes rather than gross revenues, in addition to gross plant and gross payroll. This method became known as the "Distrigas Formula."

Q. Did the Staff use Southern Union's proposed "corporate functions pool" allocator in its calculation of the appropriate amount of corporate costs to allocate to MGE in this case?

A. No. Southern Union's inclusion of the component "customers" in the general allocator in this case distorts the relative weighting of the traditional general allocator components of assets, revenue and expenses (or payroll).

Q. Did Southern Union include customers as a component of its corporate functions pool allocator in Case No. GR-2001-272, MGE's most recent rate case?

A. Yes. It is important to note that, at that time, Southern Union was primarily in the gas distribution business where the inclusion of the customer level factor in Southern Union's corporate functions pool allocator did not significantly affect the allocation of costs to its business units. However, in January 2003 Southern Union became the owner of the former Panhandle Eastern Pipeline Company. This Southern Union subsidiary, now Panhandle Energy, is in a different business segment - gas transportation, where the actual number of customers bears no relationship to the other general allocation factors of investment, revenue and expenses. Panhandle Energy is in the wholesale gas transportation business with a relatively low number of customers and cannot be reasonably compared to gas distribution companies in the retail distribution business.

Q. What customer levels are included in Southern Union's Corporate Functions Pool allocator for MGE and Panhandle?

A. Customer levels make up one-fourth of the relative weighting of Southern Union's Corporate Functions Pool allocator. While Panhandle Energy is three times the size of MGE in terms of investment, revenue and expenses, MGE's customer level of 487,602 is more than 800 times greater than Panhandle Energy's 600 customers. While it is reasonable to see a relationship between the relative size of each business unit and the amount of management time and effort focused on that business unit, there is no such correlation for the business unit's number of customers.

Q. What general allocation factor did the Staff use in the development of the appropriate level of costs to allocate to MGE in this case?

A. The Staff used the components of investment, revenue and expenses included in Southern Union's JCC model to develop its proposed level of corporate costs to allocate to MGE in this case. These components are similar to the components used in the traditional Massachusetts Formula and Distrigas Formula.

CORPORATE PAYROLL COSTS

Q. Except for changes in the general allocator, did the Staff make any other changes to MGE's proposed level of corporate allocated payroll costs?

A. Yes. The Staff made three adjustments to MGE's proposed level of corporate allocated payroll costs. First, the Staff did not include corporate incentive compensation costs. Secondly, the Staff adjusted the compensation of Southern Union's Chairman of the Board of Directors, Mr. George Lindemann, and Southern Union's Vice-Chairman, Mr. John Brennan. Finally, the Staff did not include the compensation of Southern Union's Manager of Legislative affairs.

Q. Please explain why the Staff did not include any corporate incentive compensation costs in its recommended level of corporate payroll costs to allocate to MGE in this case.

A. Southern Union's Executive Incentive Bonus Plan (Bonus Plan) was designed by the Compensation Committee of Southern Union's Board of Directors. The sole criteria for executive officers to receive compensation under the Bonus Plan is consolidated net income. In Southern Union's Securities and Exchange Commission (SEC) Form DEF14A (2003 Proxy Statement) filed with the SEC on October 28, 2003, is the following description of the performance criteria under the Bonus Plan:

> Performance Goal
> The Compensation Committee has chosen "Consolidated Net Income" as the measure of performance necessary for the payment of bonuses under the Bonus Plan. For purposes of the Bonus Plan, Consolidated Net Income consists of net income before extraordinary items, as reported in Southern Union's applicable quarterly or annual published financial statements.

Q. Has the Commission consistently excluded incentive compensation costs that were based primarily on criteria that benefit utility shareholders or are not directly related to the provision of safe and adequate utility service in Missouri?

A. Yes. In fact, the Commission addressed this issue in MGE's first rate case in Missouri in 1996. In its Report And Order in Case No. GR-96-285, the Commission stated:

> . . . the costs of MGE's incentive compensation program should not be included in MGE's revenue requirement because the incentive compensation program is driven at least primarily, if not solely, by the goal of shareholder wealth maximization, and it is not significantly driven by the interests of ratepayers.

Q. Has the Staff recommended rate recovery of incentive compensation costs that were based on criteria that benefit utility operations as a whole, such as improvements in safety and customer service?

A. Yes, it has.

Q. Please explain the Staff's adjustment to the compensation levels of Messrs. Lindemann and Brennan.

A. The Staff included compensation of $100,000 for Mr. Lindemann and $100,000 for Mr. Brennan to recognize that their relationship to Southern Union is more as members of the Board of Directors than executive officers. Southern Union's highest compensation for a member of the board of directors is $30,000. Recognizing that Messrs. Lindemann and Brennan play a more significant role in Southern Union's operations than the average Board member, the Staff felt that annual compensation of $100,000 (over three times the highest paid Board member) was reasonable.

The Staff has addressed this issue in each of MGE's previous three rate cases, Case Nos. GR-96-285, GR-98-140 and GR-2001-272. In each of these cases the Staff found that Messrs. Lindemann and Brennan served Southern Union Company more in the capacity as members of the Board of Directors than active executive officers. As such, the Staff in each of MGE's previous rate cases, adjusted Mr. Lindemann's and Brennan's salary to a level more reflective of their actual involvement with the day-to day activities of the Company.

In this case, the Staff has not seen any evidence that Mr. Brennan and Mr. Lindemann are active executive officers of Southern Union. Both individuals continue to work out of an office in New York City. This New York office is leased by the firm Activated Communications, Inc., which is owned by the Lindemann family and Mr. Brennan. Southern Union's headquarters is in Wilkes-Barre, Pennsylvania. This arrangement is described in Southern Union's 2003 Proxy Statement:

> Since 1993 Southern Union has maintained executive offices in New York City for its Chairman and Vice Chairman, and for use by other Company executives and representatives when conducting business there. The space is sublet from Activated Communications, Inc. ("Activated"), an entity owned by Chairman Lindemann and members of his family, and by Vice Chairman Brennan.

Payments to Activated during the fiscal years ended June 30, 2003, 2002, and 2001 for reimbursement of lease expenses were $690,000, $257,000 and $259,000, respectively, which were calculated pursuant to a cost sharing arrangement approved by disinterested directors in 1993. During fiscal 2003 Southern Union renovated the office space at a total cost of approximately $4,650,000, including capitalized furniture and office equipment.

During the renovation, Southern Union leased temporary space at a cost of $313,000 for shared use by Company personnel and representatives, and other non-

Company personnel who officed in the leased space, including Director Adam Lindemann and persons employed by him or businesses he controls.

The Board and the Audit Committee are expected to reevaluate the 1993 cost sharing arrangement and enter into a new arrangement with Activated, which may encompass an assignment of its lease to Southern Union, after considering the foregoing expenses and ongoing use of the leased space.

Q. Please explain why the Staff did not include the compensation of Southern Union's Manager of Legislative affairs in allowable corporate allocated costs.

A. The Staff believes that all payroll and non-payroll costs related to a utility's lobbying activities should be recorded below-the-line and not be considered an allowable cost for the purpose of setting rates.

CORPORATE NONPAYROLL COSTS

Q. Did the Staff make any adjustment to MGE's proposed level of corporate allocated nonpayroll costs?

A. Yes. The Staff made two adjustments to MGE's proposed level of corporate nonpayroll overhead costs. These adjustments are reflected in Staff Adjustment S-49.7.

Q. Please discuss the first adjustment to corporate nonpayroll costs.

A. As discussed above, Messrs. Lindemann and Brennan work out of an office in New York City. Their firm, Activated Communications leases this space and then charges Southern for a portion of this office space. The Staff does not believe that the incurrence of this cost by Southern Union provides any benefit to MGE. The Staff, as it has done in MGE's three previous rate cases, has removed this cost as an allowable cost to MGE.

Q. What is the second adjustment to corporate nonpayroll costs?

A. The Staff removed the allocation of Southern Union's corporate aircraft (SUGAIR) charges to MGE.

Q. Why did the Staff make this adjustment?

A. Included in the corporate nonpayroll pool dollars was $388,586 in travel costs separate and distinct from the SUGAIR charges. The Staff believes that this is more than a sufficient amount of travel costs for Southern Union's corporate employees.

Q. Did the Staff review the passenger manifest of SUGAIR flights in making its decision not to include SUGAIR costs in MGE's regulated cost of service?

A. Yes. The Staff reviewed SUGAIR passenger manifest information for 2002 and 2003. The Staff's review showed that many of the trips were personal in nature and were not related to Southern Union's regulated operations. Those trips that were made to specific Southern Union divisions or subsidiaries should have been directly charged to those business units.

Q. Has MGE been on an aggressive path of mergers and acquisitions over the past five years?

A. Yes. Over the past five years, Southern Union has acquired several gas LDCs in Pennsylvania and New England. In the test year in this case, Southern Union acquired a major gas pipeline company - Panhandle Eastern Pipeline Company.

Q. Would it be reasonable to conclude that Southern Union's senior management spends a significant amount of time on merger and acquisition (M&A) activities?

A. Yes. The Staff is aware that several senior Southern Union executives have spent a considerable amount of time on mergers and acquisition over the past several years.

Q. Did the Staff propose an adjustment to allocate a percent of certain senior executives payroll cost to M&A activities in MGE's last rate case, Case No. GR-2001-292?

A. Yes, I was the Staff witness who audited Southern Union's corporate allocated costs in MGE's previous rate case and proposed this adjustment.

Q. If the Staff made such an adjustment in MGE's last case, and Southern Union recently completed a major acquisition in the test year in this case, why isn't the Staff proposing a similar adjustment?

A. Because the scope of the Staff's audit did not encompass a review of corporate management's M&A activities in this case, the Staff did not make an adjustment to allocate any corporate payroll costs to M&A activities. However, the Staff is requesting that the Commission order Southern Union to keep accurate time reports on the amount of time its corporate employee spent on M&A activities and make these records available to the Staff in any future MGE rate proceeding. The Staff believes that it is important to have these records available in order to make accurate adjustments to M&A activities in future rate cases. Absent adequate documentation, any Staff adjustment may not be as accurate as possible and may either overstate the degree of

M&A activity to the detriment of the Company or understate the degree of M&A activity to the detriment of the ratepayers.

Q. Are you also sponsoring MGE's proposed level of corporate allocated insurance premiums, plant in service, depreciation reserve and depreciation expense?

A. Yes, I am. The Staff made no adjustments to MGE's proposed allocated level of insurance premiums. The Staff includes MGE's proposed level of corporate allocated insurance expense in adjustment S-51.4 to account 925, Injuries and Damages.

Also, the Staff accepted MGE's proposed level of corporate allocated plant and reserve. These amounts are reflected in Staff Accounting Schedule 3, Plant in Service and Accounting Schedule 6, Depreciation Reserve. The Staff did, however, adjust MGE's proposed allocation percentage of 25.04 percent based on its corporate functions pool allocator, to the Staff's calculated allocation percent of 16.87 percent.

Q. Did MGE include any accumulated deferred income taxes on its allocated corporate plant?

A. No.

Q. How did the Staff calculate its proposed level of accumulated deferred income taxes on corporate allocated plant?

A. The Staff used the tax to book basis ratio used by MGE in its last rate case, Case No. GR-2001-292, of 21 percent to calculate an estimated level of deferred income taxes on the Staff's proposed level of corporate plant to include in this case.

TRUE-UP

Q. Has MGE requested a true-up audit in this proceeding?

A. Yes. MGE witness Noack states at page 4 of his direct testimony filed on November 4, 2003, that "MGE is requesting a "true-up" through April 30, 2004..." Mr. Noack then went on to list the particular revenue requirement components MGE believes should be updated in the true-up audit.

Q. Does the Staff recommend that a true-up audit be performed in this case?

A. Yes. The Staff is proposing a true-up audit in this proceeding through April 30, 2004. MGE estimates an increase in plant from December 31, 2003, through April 2004 of approximately $8 million. Also, certain MGE employee pay increases are scheduled to take effect in the first four months of 2004. The Staff believes that these events are significant enough to justify a true-up audit in this case.

Q. What specific revenue requirement items are the Staff recommending be included in MGE's true-up revenue requirement recommendation?

A. The Staff is recommending that all rate base components (excluding changes to the specific revenue and expense lags included in the cash working capital study), MGE's capital structure and embedded cost of debt be included in the true-up audit through April 30, 2004. In addition, the Staff recommends the following income statement expenses be included in the true up audit.

1. Revenue for customer growth;
2. Payroll - Employee levels, current wages and benefits;
3. Rate case expense;
4. Depreciation and amortization expense;
5. FAS 106 OPEB expense;
6. Related income tax effects;
7. PSC Assessment;
8. Bad Debt expense; and
9. Medical expense.

Q. The Staff has not updated revenues for customer growth through the test year update period in this case. Why has it listed this item as an item to be considered in a true-up audit?

A. As discussed in the direct testimony of Staff Auditing witness Paul R. Harrison, Staff has not updated its revenue calculation for customer growth beyond the June 30, 2003, test year because of concerns regarding the underlying customer data. If these concerns are resolved, the Staff will update revenues for customer growth in the true-up audit.

Q. Has the Staff included an estimate of the increase in MGE's revenue requirement as a result of the Staff's true-up audit?

A. Yes. The Staff has included an estimated increase in MGE's revenue requirement as a result of a true-up audit to be approximately $2.5 million. This amount is reflected on Accounting Schedule 1, Revenue Requirement.

Q. Does this conclude your direct testimony?

A. Yes, it does.

Charles R. Hyneman

Schedule of Testimony Filings

Case No.	Company
ER-2004-0034 HR-2004-0024	Aquila, Inc. d/b/a Aquila Networks-MPS and Aquila Networks – L&P
ER-2003-424	Empire District Electric Company
GO-2002-175	Aquila, Inc. d/b/a Aquila-MPS
ER-2001-672	UtiliCorp United, Inc. d/b/a Missouri Public Service
GR-2001-292	Missouri Gas Energy
EM-2000-369	UtiliCorp United Inc. Acquisition of Empire District Electric Company
GM-2000-312	Atmos Energy Corporation Acquisition of Associated Natural Gas Company
EM-2000-292	UtiliCorp United Inc. Acquisition of St. Joseph Light & Power Company
GO-99-258	Missouri Gas Energy
GR-98-140	Missouri Gas Energy
EM-97-515	Western Resources, Inc. Acquisition of Kansas City Power & Light Co.
ER-97-394	UtiliCorp United, Inc.
GR-97-272	Associated Natural Gas Company
GR-96-285	Missouri Gas Energy
EM-96-149	Union Electric Merger with CIPSCO, Inc.
GR-95-160	United Cities Gas Company
ER-94-163	St. Joseph Light & Power Company
HR-94-177	St. Joseph Light & Power Company
TR-93-181	United Telephone Company of Missouri