BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Missouri Gas Energy and	**)**	
Its Tariff Filing to Implement a General	**)**	Case No. GR-2009-0355
Rate Increase for Natural Gas Service	**)**	

STAFF RESPONSE TO COMMISSION REQUEST

COMES NOW the Staff of the Commission and in response to Commissioner Davis' request for additional information concerning allocations states:

1. During this rate case hearing Commissioner Davis requested Staff provide information concerning corporate allocations.

2. Staff has reviewed various documents and is attaching portions of section section 19.03 [4] [d], "Allocation of Corporate Overhead Costs." Specifically 19-12 to 19-14 as the subsection contain the most direct answer to allocation methods, including the "Massachusetts Formula."

3. This section is from Accounting for Public Utilities, by Robert L. Hahne and Gregory E. Aliff, Release No. 25, October 2008. The excerpt is specifically from Chapter 19 of this text, "Cost Allocations for a Diversified Utility," which is available in the Accounting Department's library and will be made available to any party requesting review of the publication.

4. This is a fairly large text so Staff has included only limited portions of the document in direct response to Commissioner Davis' request (Transcript Vol. 8, p. 89.)

5. Staff would be happy to provide additional information and do additional research on the whole topic of corporate allocations if the Commission wishes.

6. Staff does not necessarily endorse or agree with any of the conclusions or recommendations contained in the text provided.

WHEREFORE Staff requests the Commission accept this answer to Commissioner request and further direct Staff if the Commission requires additional information.

Respectfully submitted,

/s/ Lera L. Shemwell____________
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Certificate of Service

I hereby certify that copies of the foregoing have been mailed, hand-delivered or transmitted by facsimile or electronic mail to all counsel of record this 2nd day of February, 2010.

/s/ Lera Shemwell_______________

In summary, the CASB standards clearly enumerate the following cost allocation principles:

(1) Expenses are to be directly assigned to the maximum extent possible;

(2) Centralized corporate functions or management staff costs should be accumulated into homogenous cost pools;

(3) Such cost pools should be allocated using representative bases that reflect cost causation or benefits, where identifiable; and

(4) Where direct causal relationships or benefits cannot be determined or a directly relevant allocation base cannot be identified, costs pools may be allocated on some other reasonable basis that reflects the benefits of the services received.

Federal Communications Commission. With the deregulation of the telecommunications industry, the FCC issued Report and Order, CC Docket No. 86–111 to establish rules regarding the assignment and apportionment of costs related to both regulated and nonregulated subsidiaries. While providing both general and specific rules regarding cost apportionment, the underlying principles in FCC Docket No. 86–111 are intended to reflect fully distributed cost principles as contained in Section 64.901 of the FCC's rules. The guidelines contained in this docket for assigning and allocating costs to regulated and nonregulated activities include the following provisions:

- Costs shall be directly assigned to either regulated or nonregulated activities whenever possible.
- Costs that cannot be directly assigned to either regulated or nonregulated activities will be described as common costs. Common costs shall be grouped into homogeneous cost categories designed to facilitate the proper allocation of costs between regulated and nonregulated activities in accordance with the following hierarchy:
  - — Wherever possible, common costs categories are to be allocated based upon direct analysis of the origin of the costs themselves;
  - — When direct analysis is not possible, common cost categories shall be allocated based upon an indirect, cost-causative linkage to another category (or group of cost categories) for which a direct assignment or allocation is available;
  - — When neither direct or indirect measures of cost causation can be identified, the cost category shall be allocated based upon a general allocator computed by using the ratio of all expenses directly assigned or attributed to regulated and nonregulated activities.

These cost assignment and allocation principles reflect the results of extended and detailed debate and discussion by inter-exchange carriers, local exchange carriers, customers, regulators, and vendors and provide an indication of the parameters considered relevant and implementable.

Federal Energy Regulatory Commission. There are a number of methods used by the utility industry to allocate residual corporate support service costs that have been accepted as reasonable by state and federal regulatory authorities. Among the cost allocation methods that have been accepted by state and federal regulators as reasonable are those that are based on multi-factor formulas representing the overall business activity levels of utility companies.

Three of the most commonly used multi-factor formulas approved for use by state and federal regulators include the Kansas-Nebraska formula (KN formula), the Massachusetts formula, and the modified Massachusetts formula, or Distrigas Formula, for allocation of certain administrative and general costs. Following is a brief overview of each of these methodologies.

(1) *KN formula.* The KN formula is based on the ratio of direct labor and capital investment of each division to total direct labor and capital investment. The allocation of costs using a multi-factor formula consisting of direct labor and gas plant was initially approved in 1975 in Federal Power Commission Opinion No. 73-1, Kansas-Nebraska Natural Gas Company, Inc., Docket No. RP72-32.

(2) *Massachusetts formula.* The Massachusetts formula is based on the ratio of direct labor, capital investment and gross revenue of each affiliate to total direct labor, capital investment and gross revenue. The unmodified Massachusetts formula is derived from Midwestern Gas Transmission Co. v. Federal Power Com., 32 FPC 993 (1964).

(3) *Distrigas formula.* The Distrigas formula is based on the ratio of direct labor, capital investment and net operating revenue of each affiliate to total direct labor, capital investment and net operating revenues. The allocation of costs using a multi-factor formula consisting of direct labor, capital investment and net operating revenues was initially approved in 1987 in FERC Opinion No. 291, Distrigas of Massachusetts Corporation, Docket No. R.P850125-000.

The choice of whether to use the KN formula or either the Massachusetts formula or Distrigas formula turns primarily on whether separate affiliated corporate entities are involved in the allocation of common overhead costs (Massachusetts or Distrigas formulas), or whether functions or services involve the same legal entity (KN formula).

The only difference between the Distrigas and Massachusetts formulas is the calculation of the revenue factor. The Massachusetts formula is computed based on gross revenue (including purchased gas costs) and the Distrigas formula includes net operating revenues (excluding purchased gas costs). While both methods are acceptable, in certain instances the Distrigas formula may be preferable, as it provides more stability in the allocations from year to year since purchased gas costs (i.e., gas revenues) may fluctuate significantly from year to year. In FERC Opinion No. 291, the FERC stated that it adopted the use of net operating revenue rather than gross income for the third allocation factor because of the significant increases over the years in the portion of a pipeline's total revenues that are related to its purchased gas costs.

In order to develop an effective comprehensive cost allocation system, the goals of rate regulation must be known. A primary objective of utility regulation is to recognize all reasonable costs associated with the provision of utility service and to provide adequate rates to cover these costs. This objective is the same whether a utility functions as an independent entity, an entity with other regulated or unregulated activities, or a member of a holding company group.

[e] Transfer Pricing

Transfer pricing, or the process of pricing goods and services between affiliates, generally should be applied at the transactional level and can reflect either of the following two alternative approaches:

(1) Under the market price alternative, the price charged to the utility should not be greater than the price the utility would incur to obtain the goods or service itself from available outside resources.

(2) Under the cost alternative, the transfer price should include all costs plus an appropriate return on utilized assets for all goods or services provided.

Pricing is largely dependent on types of transactions. These transactions can be classified as transfers of assets, of goods or services for sale, and of goods or services not for sale.

Transfers of assets generally should be priced at fair market value. Of course, any transfer policy would be subject to the original cost rules of regulatory accounting and to limitations on the recognition of intercompany profits under GAAP. (See Chapter 4 for a discussion of original cost concepts.)

Transfers of goods or services for sale generally should be priced at fair market value, except perhaps for sales involving captive relationships that should be priced at cost. Transfers of goods or services not for sale would generally be priced at cost because of difficulties in determining a comparable market price.

These pricing policies can be viewed as consistent with the goals that were noted above. If the market value of an asset, goods, or services exceeds cost, a policy requiring a transfer to an affiliate at cost would harm the selling entity by causing it to incur a loss or reduced profit. In this situation, the purchasing entity would receive a subsidy if it purchased something at a below-market price. The use of fair market value pricing prevents the subsidization of one affiliated entity at the expense of another. Pricing transactions at fair market value also prevents transactions from occurring that do not have an economic purpose.

The exceptions to fair market value pricing are generally limited to three areas:

(1) immaterial assets;

(2) goods and services not for sale; and

(3) sales involving captive relationships.

For immaterial assets, the time and expense necessary to determine fair market value does not warrant the effort and would not significantly affect the transfer price.