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

KENNARD L. JONES, Presiding,
SENIOR REGULATORY LAW JUDGE
JEFF DAVIS, Chairman,
CONNIE MURRAY,
STEVEN GAW,
ROBERT M. CLAYTON, III,
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P R O C E E D I N G S

(EXHIBIT NOS. 1, 2, 3, 4, 5, 6, 7 AND 8 WERE MARKED FOR IDENTIFICATION BY THE COURT REPORTER.)

JUDGE JONES: Okay. Let's go ahead and go on the record. Good morning. This is Case Number GR-2006-0422, In the Matter of Missouri Gas Energy's Tariffs Increasing Rates For Gas Service Provided to Customers in the Company's Missouri Service Area.

My name is Kennard Jones. I'm the regulatory law judge presiding over this matter. At this time we will take entries of appearances beginning with Missouri Gas Energy.

MR. BOUDREAU: Let the record reflect the appearance of Paul A. Boudreau, James Swearengen, Russ Mitten, Dean Cooper and Janet Wheeler on behalf of Missouri Gas Energy. The address -- of the firm of Brydon, Swearengen and England, Post Office Box 456, Jefferson City, Missouri.

JUDGE JONES: Thank you, Mr. Boudreau. And from Staff of the Commission?

MR. FRANSON: Good morning, your Honor. The entry of appearance for the Staff of the Public Service Commission is Kevin Thompson, Robert Franson, Lera Shemwell, Robert Berlin, David Meyer and Steven

Reed representing the Staff of the Missouri Public Service Commission, P.O. Box 360, Jefferson City, Missouri 65102.

JUDGE JONES: And from the Office of the Public Counsel?

MR. POSTON: Thank you. Marc Poston appearing on behalf of the Office of the Public Counsel and the public, P.O. Box 2230, Jefferson City, Missouri 65102.

JUDGE JONES: And from the City of Kansas City?

MR. COMLEY: Good morning, Judge Jones. On behalf of the City of Kansas City, let the record reflect the entry of Mark W. Comley, Newman, Comley & Ruth, 601 Monroe, Suite 301, Jefferson City, Missouri 65101.

JUDGE JONES: Central State -- Central Missouri State University?

MR. FINNEGAN: On behalf of Central Missouri State University, University of Missouri-Kansas City and Jackson County, Jeremiah Finnegan, Finnegan, Conrad & Peterson, LLC, 3100 Broadway Street, Suite 1209, Kansas City, Missouri 64111.

JUDGE JONES: And from the County of Jackson, Missouri?

MR. FINNEGAN: Same.

JUDGE JONES: And who else do you represent?

MR. FINNEGAN: I said -- Central Missouri State, Jackson County, Missouri and University of Missouri-Kansas City.

JUDGE JONES: Thank you. And from Midwest Gas Users Association?

MR. FINNEGAN: Mr. Conrad is not here yet. He's on his way down. I think he thought it was at ten o'clock. On behalf of Midwest Gas Users, let me enter the appearance of Stuart W. Conrad, Finnegan, Conrad & Peterson, same address.

JUDGE JONES: I believe that's everyone; is that correct?

MR. BOUDREAU: Judge, I omitted -- I failed to mention that Diana Carter with the firm of Brydon, Swearengen and England will also be making an appearance for Missouri Gas Energy. I apologize for the oversight.

MR. KEEVIL: Judge, you also failed to include Trigen-Kansas City. We have intervened in this but did not prefile testimony so that may have thrown you off.

JUDGE JONES: And the University of

Missouri-Kansas City. That --

MR. FINNEGAN: That's me.

JUDGE JONES: That's you also, Mr. Finnegan?

MR. KEEVIL: Did you want an entry from Trigen?

JUDGE JONES: Yes, from Trigen, yeah.

MR. KEEVIL: Appearing on behalf of Trigen, Jeff Keevil of the law firm Stewart & Keevil. Address is 4603 John Garry Drive, Suite 11, Columbia, Missouri 65203.

JUDGE JONES: Great. Well, first we have a couple of evidentiary issues to clear up. There's been a motion to exclude the testimony of Russ Trippensee. I've read the pleadings on those arguments. If you-all want to argue about it some more, that's fine.

My starting point right now is, one, Mr. Trippensee has been in this business for almost 30 years. Well, enough said on that point. As far as the data that he relies on, I'm taking the understanding he relied on Staff and MGE's data in making his surrebuttal testimony; is that incorrect?

MR. POSTON: (Shook head.)

JUDGE JONES: That's correct, isn't it?

MR. THOMPSON: That's correct, Judge.

MS. CARTER: That is correct.

JUDGE JONES: Okay. Well, if that data isn't reasonably reliable, then we ought to throw out the testimony of everyone here in that regard. So with that said, did you want to say something?

MS. CARTER: Just briefly with regard to that. The fact that Staff witness produced his own data and performed tests on that and the same with MGE's witness, of course, does not make it necessarily such that experts in the field rely only on the filed testimony of other witnesses which I believe is what Mr. Trippensee is relying upon.

When asked if he looked at all outside of filed testimony, he said no, that this was rebuttal testimony and he looked only to what had been filed by someone else.

JUDGE JONES: That's what rebuttal testimony would do in a certain sense, wouldn't it, rebut what has been filed?

MS. CARTER: I believe an expert is obligated at least to some extent to see that the data he's relying upon is accurate, and complete, for that matter. He has gone a separate step with regard to his testimony and is recommending an adjustment or an ROE adjustment without looking to any data that is commonly looked at by experts in the field.

I don't believe Mr. Trippensee can take the stand and say that the data he relies upon is data commonly relied upon and reasonably relied upon by experts in the field, which is the standard by case law.

JUDGE JONES: Okay. We'll give him an opportunity to defend his testimony and we'll also give you an opportunity to expose his ignorance. In that sense, the motion is overruled. And Barbara Meisenheimer, there's been objection to portions of her testimony in that she has cited testimony from a previous hearing; is that correct?

MR. BOUDREAU: Yes, that is correct.

JUDGE JONES: And was that a hearing that MGE was involved in?

MR. BOUDREAU: I believe it was, yes.

JUDGE JONES: So MGE at that time had an opportunity to cross-examine the witness to which she refers?

MR. BOUDREAU: I believe that's correct.

JUDGE JONES: That motion also is overruled. And also there's been a motion by the Office of Public Counsel to strike MGE's prehearing brief in this matter. I'll tell you-all now, that's being considered by the Commission. So there's been no order issued and no determination made.

Are there any other evidentiary issues that I've perhaps overlooked?

MR. BOUDREAU: Not that I'm aware of, no.

JUDGE JONES: Okay.

MR. KEEVIL: Judge, if I could --

JUDGE JONES: Yes?

MR. KEEVIL: -- at this time while you're still on the record, I guess I would like to request that what I've referred to as the standard -- standing leave to be excused at various portions throughout the hearing since I don't anticipate being involved actively throughout every issue in the hearing. There may be other intervenors in a similar situation.

JUDGE JONES: Well, let me say to anyone who doesn't see the need or doesn't want to be here at a particular time, you don't have to come to class. You can skip and do whatever you need to do. It's upon you to protect your interest, it's not upon me to make sure you're here to do that. So just for the rest of the week, if you don't want to be here, don't be here.

Let's see. It seems like there was something else. Oh, also, I'll let you know -- and this is probably something we could talk about off the record -- but just so I don't forget, Friday I know you-all are aware of the AmerenUE situation around the state. I've been asked to give this room up at noon on Friday for a local public hearing. How long that will last, we're not sure. If it looks like it's going to take up time that we need, then we'll just move over to 305 and continue. I don't think it will, and because it begins at noon, it will give them an hour head start while we're at lunch. So I just wanted you-all to know that.

With that, we will go off the record and take care of marking of exhibits and anything else you-all need to discuss.

(DISCUSSION HELD OFF THE RECORD.)

JUDGE JONES: We're on the record now with Case Number GR-2006-0422 and we're starting with opening statements from Missouri Gas Energy, Mr. Swearengen.

MR. SWEARENGEN: Yes, thank you, Judge Jones, members of the Commission. I am Jim Swearengen appearing today on behalf of Missouri Gas

Energy Company. I was going to start by saying that over the next several days you were going to have the pleasure to hear evidence concerning approximately ten issues which remain contested in this case. Perhaps pleasure is not the right word, so I will say you will have the opportunity to hear evidence concerning the remaining contested issues.

This case was, I think, originally scheduled for two weeks, but we managed to narrow the list of issues down and I think we'll be able to finish with all of the contested issues this week.

This rate case was initiated on May 1, 2006, when Missouri Gas Energy filed tariffs which were designed to increase its revenues by approximately $41 million which was about a 6.8 percent proposed rate increase.

As I indicated, though, as a result of settlement discussions, the parties have been able to whittle down the number of contested matters, and the way the case now stands as evidenced by the reconciliation which I think has been filed in this case, the company is entitled to a rate increase in the amount of 19 and a half million dollars, with issues totaling approximately $20 million remaining to be litigated.

By way of a brief background, I'm sure the Commission is aware that Missouri Gas Energy is an operating division of Southern Union Company and has been in business in Missouri since 1994 when Southern Union acquired the Missouri gas distribution properties in the Kansas City area which at that time were owned by Western Resources.

The company's operations are situated in the western third of the state and run from St. Joseph, Missouri on the north, from that area, down through the Kansas City Metro area, down to the areas surrounding Joplin, Missouri on the south. In total the company serves about a half a million customers.

Several local hearings have been held in connection with this rate increase request, and I think it's fair to say that while no one wants a rate increase, there were no real complaints about the quality of service that the company is currently providing. And I say that because I want the Commission to be aware that you can decide this case without the backdrop of customer dissatisfaction, and I think that's important.

This rate case is the fifth rate case that the company will have processed since March 1,

1996. All four of the prior cases resulted in rate increases, but unfortunately, and notwithstanding those increases, the company has experienced a consistent inability to earn its Commission-authorized rate of return, and we think the reason for that is relatively straightforward.

What these last cases have taught us, if anything, is that the company's rates in those cases were established based on assumptions that as it turns out, have not reasonably reflected the reality of Missouri Gas Energy's operations.

Now, for example, the company's rate design in these past cases has been based on volumetric rate elements for cost recovery. This, as you would understand, makes the company's revenues and earnings dependent upon cold weather and the amount of gas sold, even though and notwithstanding the fact that the majority of Missouri Gas Energy's cost structure does not change with -- excuse me -- does not vary with either changes in volumes or weather.

And this problem is further compounded by the fact that the actual per-customer usage experienced by the company rarely, if ever, reaches the level of per-usage amounts used to set rates.

So what has happened is this: In spite of the rate increases that the company has obtained in the last four cases, it has been unable to achieve its authorized rate of return primarily because of volumetric revenue shortfalls it has experienced due to warm weather and because of declining average use per customer.

Now, that's -- that's the brief history. The good news is, we think that this case presents a golden opportunity to break this cycle. And I say that because the Staff in this case has endorsed a residential rate design proposal which, if adopted by the Commission, will go a long way toward solving the company's problem, and we believe it will significantly improve MGE's ability to obtain its Commission-authorized earnings level.

Now, the Public Counsel is not on board with this rate design proposal, and therefore, it will be a contested issue. As in the company's last rate case, the parties in this case have agreed to start the trial of each separate issue with brief opening statements as a way to more timely focus the issues for the benefit of the Commission.

And as a result of that, I'm not going to discuss all of the issues that we're gonna try this week this morning. I'm going to, instead, just concentrate on several of the main issues that I think are overriding and interrelated.

Starting with rate design, I think it's fair to say that from the company's standpoint, rate design is probably the key to this entire case. In its filing, Missouri Gas Energy set out two separate rate design proposals for the Commission's consideration in order to help solve the company's chronic failure to earn its authorized return.

The company's primary and preferred rate design proposal would establish what is often referred to as a straight fixed variable rate structure for the company's residential class. The residential class constitutes about 90 percent of the company's customers.

The proposal would continue the traditional rate structures for the small general service, large general service and LDS rate classes. Then an alternate rate design proposal submitted by the company consists of a weather normalization adjustment mechanism which would be applicable to the company's residential SGS and LGS rate classes.

This alternate proposal is designed to adjust the company's volumetric rates on a monthly basis to account for changes in the weather from the normal levels that are established in the company's current rate case.

I noted that -- and I think it's fair to say that the company and Staff have reached a conceptual agreement that the straight fixed variable rate structure is the most appropriate for MGE's residential customers and should be approved by the Commission.

Under this rate structure, all fixed costs incurred by the company are recovered through fixed charges, and all variable costs are recovered through variable charges.

While this pricing concept may be somewhat new with regard to Missouri local gas distribution companies, it has been used in the interstate gas pipeline industry for many years, and other gas distribution companies in other jurisdictions have similar rate designs.

So we believe that it is certainly not a radical or unprecedented proposal. It's something that's been around for some time. And in fact, I believe the Commission has been introduced to it in the recent Atmos gas rate case.

Under the straight fixed variable rate

structure, residential customers will simply pay a flat monthly fee for the delivery of services provided by Missouri Gas Energy. Those customers will also continue to pay for the amount of gas commodity that they use each month on a volumetric basis through the purchased gas adjustment mechanism.

We believe that this proposal, if adopted by the Commission, will mitigate the effects of weather on the customers' bills as well as the company's earnings.

We believe that this type of rate structure will not only help to achieve a fundamental objective of ratemaking, that is, the proper alignment of costs with revenues and rates, but it will also go a long way toward addressing Missouri Gas Energy's failure over the years to earn its authorized return, which is a problem that the company has experienced and as I indicated, continues to experience largely because of the current traditional rate structure.

Because of this, if the straight fixed variable, or SFV rate design is adopted for the residential class, the company has proposed a rate requirement in this case that is something more than a million dollars lower than if a traditional rate structure is adopted, and we think that's a clear and significant benefit to customers from the Commission's adoption of this rate proposal.

We believe the evidence will also show that the SFV rate structure will eliminate an existing subsidy which the company's -- which, in the company's view, unfairly disadvantages low-income households. And I say that because the evidence will show that low-income customers are high users of gas and as a consequence, they pay more on the volumetric rate design that's in place currently.

The straight fixed variable rate structure will also remove the disincentives that a utility which is reliant on volumetric revenue would naturally have to encourage and assist customers in making conservation and -- and efficiency investments.

And as a result of that, the company in this case has come forward with a set of specific natural gas conservation initiatives that it is willing to implement, assuming the costs of those initiatives are included in rates and the Commission adopts the SFV rate structure which is proposed for the residential class.

So there is a definite and real

connection in our minds between the SFV rate design concept and conservation.

A second issue which I mentioned and I'll touch on briefly is the weather normalization adjustment. As I indicated, that's the company's alternative to the SFV rate design proposal. The weather normalization mechanism which is specifically contemplated by the Missouri General Assembly through the passage of Senate Bill 179 in 2005 would adjust rates up or down based on differences between actual weather and weather assumed in the rate setting process to hold both the company and its customers harmless from revenue impacts that are attributable to those weather variations.

This is an approach which has been adopted for many companies in many jurisdictions across the country, and we think it would go a long way toward remedying Missouri Gas Energy's chronic revenue problem. But it would not address the continuing phenomena of declining average use per customer setting aside weather impacts. And as a result, as I indicated, our preferred approach -- approach to the rate design question is the straight fixed variable rate structure.

Another important but separate and

related issue is the appropriate measure of normal weather to be used in calculating MGE's revenue requirement and the billing determinants to be used in establishing the company's volumetric rate elements.

Missouri Gas Energy proposes to use a ten-year heating degree day average to normalize its annual gas volumes for ratemaking purposes. The Commission will recall that historically the Staff has used a 30-year heating degree day average computed by the National Oceanographic and Atmospheric Administration to normalize its gas volumes for weather.

We believe that the 30-year average in the past has contributed in significant part to the company's volumetric revenue shortfalls and have contributed to the failure of the company to earn the return on its investment that this Commission has authorized.

We believe that the use of a ten-year heating degree day average will result in improved forecasting for normalizing MGE's gas volumes and will better reflect the expected normal weather conditions during the period in which rate -- base rates established in this case will be in effect.

The third key issue in this case is cost of capital, and I think the Commission is aware that traditionally there are two basic components to the cost of capital issue, and that is capital structure and return on common equity. This case is no exception and those are the issues you'll hear later today when that issue is presented to you.

I think the Commission recognizes that because Missouri Gas Energy is an operating division of Southern Union Company, it has no common stock in and of itself, and it also has no discretely identifiable capital structure. As a result of this, in the past for ratemaking purposes, the Commission has elected to use the capital structure of Southern Union Company which can sometimes be referred to as the parent of MGE.

Now, whether or not that may have been appropriate in past cases, we believe that given changes that have occurred since that last case, given the makeup of Southern Union Company, the current makeup, that the continued use of the Southern Union capital structure for ratemaking purposes for the Missouri Gas Energy operating division is clearly inappropriate.

I say that because the changes that have taken place with regard to Southern Union, it is now clear that it is a company made up of various diverse financial interests that have risk characteristics which differ significantly from those of Missouri Gas Energy, which is a local gas distribution company.

Although MGE is one of Southern Union's many business units because investors view MGE and its corporate parent as being engaged in different businesses with different risks, we submit that it is not appropriate to use the Southern Union capital structure as a proxy for MGE in determining an overall rate of return for the company in this case.

We think that to accurately reflect the business risks that MGE faces as a regulated local gas distribution company, a hypothetical capital structure should be used for ratemaking purposes in this case. And in this regard, the company is proposing a capital structure consisting of 54 percent total debt and 46 percent common equity.

Now, this proposal will be explained in detail by the company's witness on this topic, Frank Hanley. He will testify that his rate of return recommendation -- excuse me, that his capital structure recommendation was based on an analysis of two proxy groups of local gas distribution companies that over a five-year period had an average debt component that ranged from 53 percent to 55 percent and an average equity component that ranged between 47 percent and 45 percent.

The other part of the cost of capital issue that you're familiar with is the appropriate return on common equity that should be used to calculate the company's cost of service. MGE is recommending that the Commission authorize a common equity cost of 11.75 percent.

The evidence will show that this recommendation reflects current capital market conditions based upon the application of four established market-based cost of equity models with which you are familiar. These include the discounted cash flow, or DCF method, the risk premium method, the capital asset pricing method and a comparable earnings approach.

The results for these models as will be indicated by Mr. Hanley's testimony -- to the -- to the results of these models, I should say, that Mr. Hanley will testify to, he has added an upward adjustment of 45 basis points to the risk associated with Missouri Gas Energy's relatively small size.

He thinks that's worth 30 basis points.

And the company's lack of protection from the effects of weather fluctuations, he thinks is worth 15 basis points, and that gets him to his 11.75 recommendation.

However, if the Commission adopts the straight fixed variable rate design that the company is proposing, Mr. Hanley's testimony will indicate that MGE's 11.75 percent required ROE should be reduced by 25 basis points or down to 11 and a half to reflect the lower risk resulting from the ability of the company to recover its fixed cost from fixed instead of volumetric charges. And that 25-basis-point reduction would be worth about a million dollars in revenue requirement. And that's, we think, as I indicated earlier, is an added benefit of the SFB rate design proposal.

By contrast, on return on equity, the Staff is at a range between 8.65 percent and 9.25 percent, and the OPC takes the position that if the straight fixed variable rate design proposal is adopted by the Commission, the company's return should be between 7.7 percent and 8.65 percent.

So clearly, there's a connection here between the rate design issue and the return on common equity that the Commission ultimately decides to award in this case.

Let me mention one last issue, and that's conservation. I think I indicated that rate design, the rate design proposal is connected to the conservation issue. Under existing traditional rate design, if the -- if the company encourages gas conservation, it harms its revenue stream and its earnings.

But under the straight fixed variable rate design, that disincentive to promote natural gas conservation would be removed. And that's an added benefit, and for that reason the company says that if the straight fixed variable rate design proposal is approved, the company will undertake several gas conservation initiatives that are described in detail in the testimony of his witnesses.

In conclusion, I would like to repeat and emphasize that rate design is the key issue here. We believe there are clear benefits to everyone involved from implementing the straight fixed variable rate design. It will send the correct price signals to customers because it is based in the actual cost of providing service.

Second, there will be less seasonal variation in customer bills, and in particular, we think it will lower winter bills. As indicated, that rate design will remove the disincentive that MGE might have to actively promote natural gas conservation, and the company's purchased gas adjustment clause will retain the incentive for customers to conserve on natural gas usage.

Fourth, as I indicated, because of the 25-basis-points adjustment to ROE, the overall revenue requirement would be a million dollars lower under the SFV rate design than under the traditional rate design.

Fifth, we think the company's customers should be able to find their bills easier to understand under the SFV rate design than currently.

And finally, hopefully, if that is a -- the rate design is adopted by the Commission, the company will be able to break the cycle of regular rate cases which should result in lower cost to customers and free management to focus on its principal mission, which is to provide safe and reliable gas service to the customers. Not that I have anything personally against rate cases, but understand that there is that added benefit. Thank you very much for your time this morning.

COMMISSIONER CLAYTON: I have a couple

of just very -- very brief legal questions and, I guess, overall policy questions which I thought would be appropriate here. Mr. Swearengen, you just said that the most important issue in the case is rate design?

MR. SWEARENGEN: We believe that's the case, yes.

COMMISSIONER CLAYTON: Okay. And the straight fixed variable rate design plan where all the fixed costs are placed in one monthly charge regardless of usage is important and would be of benefit to the company?

MR. SWEARENGEN: We think so.

COMMISSIONER CLAYTON: Okay. Are there any down sides to the company for implementing such a rate design?

MR. SWEARENGEN: Not that I'm aware of.

COMMISSIONER CLAYTON: Okay. With regard to that rate design, you said that you agree that energy efficiency and conservation measures are appropriate items of discussion in putting together an overall package of rate design.

MR. SWEARENGEN: That's correct. There's a -- there's an inherent disincentive under the present rate structure for the company, for any utility to promote gas conservation.

COMMISSIONER CLAYTON: Okay. The --

MR. SWEARENGEN: And that would be eliminated.

COMMISSIONER CLAYTON: I understand. I have not thoroughly studied the conservation and energy efficiency proposals that are -- that are in the package. I know that there are some in here. Could you assess how aggressive those suggestions are from MGE?

MR. SWEARENGEN: They're very sincere about those proposals.

COMMISSIONER CLAYTON: I know they're sincere, but are they aggressive steps or are they first steps, are they baby steps? How would you characterize them?

MR. SWEARENGEN: You know, that might be a better question that you could ask Mr. Hack when he gets on the stand as the policy -- the company policy witness. I think he'd be in a better position to speak to that than I would.

COMMISSIONER CLAYTON: Is the company willing to have additional conversations about those issues as this hearing progresses if we are talking about the rate design, also talking about creative approaches to energy efficiency and conservation?

MR. SWEARENGEN: I'm sure they would be.

COMMISSIONER CLAYTON: Okay. The legal question that I wanted to ask you relates to the issue associated with property tax refunds, and then the item listed as unrecovered cost of service --

MR. SWEARENGEN: Yes.

COMMISSIONER CLAYTON: -- that your -- I think they're ranked right in a row in the briefs?

MR. SWEARENGEN: They are.

COMMISSIONER CLAYTON: From your standpoint, is there a legal difference in those two issues?

MR. SWEARENGEN: No.

COMMISSIONER CLAYTON: You see them as being identical?

MR. SWEARENGEN: Yes.

COMMISSIONER CLAYTON: I don't think I have any other questions. Thank you.

MR. SWEARENGEN: Thank you.

JUDGE JONES: We'll now move on to opening statements from the Staff of the Commission.

MR. THOMPSON: Thank you, Judge. May it please the Commission. What exactly is Staff's role in a rate case? I think the first thing that I would like to touch on briefly is the role of the Staff. We act as a party, but we have no stake. The result of this rate case isn't going to have any financial impact on Staff, unlike every other party here today, including Public Counsel, who represents the great mass of ratepayers served by Missouri Gas Energy, and whose bills will certainly have a financial impact.

So Staff is the party with no financial stake. In fact, under any calculation of normal legal principles, Staff is not a party at all. We are a party by convention. We are a party by practice. Our job is to represent to you the neutral, unvarnished truth with respect to each issue before you.

Our job is to assist you in your deliberations by providing you with information that you may use as a touchstone against which to measure the positions argued to you by the other parties, the real parties, the parties with financial incentives to argue to you in a way that will have a beneficial impact and outcome on them.

They tell you that in litigation you should have a theme, and Staff's overall theme in keeping with that role is that of reason. That's our theme. We're going to be the voice of reason in this case.

And the first thing I will tell you is that Staff agrees that Missouri Gas Energy needs a rate increase. We agree that a rate increase is warranted. We do not agree on the size of that rate increase. As Mr. Swearengen told you, coming into the hearing, there's approximately $19 million of rate increase that is no longer in dispute, and there's approximately $20 million of issues that remain in dispute. So you might say that Staff's position is a $19 million rate increase, and the company's position is a $39 million rate increase on an annual basis. We believe a rate increase of $19 million is warranted.

The second thing I'm going to tell you is that we agree with Missouri Gas Energy that fixed costs must be uncoupled from variable rate elements. We agree with the company that it makes no sense to collect costs that are the same month after month, regardless of the weather, regardless of the amount of gas that's used through bill elements that are volumetric. We agree that that traditional rate design has resulted in serious and significant revenue shortfalls.

I told you I would be the voice of

reason and I'm -- and I'm doing that. So our theme on rate design is fairness. Fairness. It's fair to the company that fixed, unvarying costs should be collected through fixed, unvarying rate elements. That's fair. As Mr. Swearengen told you, you've seen this idea before in the recent Atmos case. You are going to see it again in gas cases yet to come.

It's important to recognize that the traditional design has been unfair not only to the company, but also to the ratepayers. Large users pay more than their fair share when fixed costs vary with volume. People who use a lot of gas are gonna pay more than the actual cost of delivering that gas to them. People who use a little gas are going to be subsidized. They're going to pay less than the actual cost of getting that gas to them.

An additional issue where the fixed costs vary volumetrically, the customer will pay a larger share of their annual fixed-cost contribution in the winter months when they're using more gas, when they're also being hit with large commodity costs. It's a double whammy. It's not fair. It's not fair to the ratepayers. We've already heard that it's not fair to the company. Staff urges you to adopt its rate design proposal in this case.

Our opponent on this issue is, of course, not MGE, it's the Public Counsel. Public Counsel complains that Staff's rate design proposal will shift substantial costs to low-usage users, and that's right, that's true, because it will remove the subsidy that those users have enjoyed heretofore. But what's unfair about having them pay their way? What's unfair about asking that each customer pay a contribution that is equivalent to the cost of getting them the service? I suggest that that is fair.

Public Counsel also complains that Staff's rate design proposal will reduce customer conservation incentive. Nothing could be farther from the truth. Customers will still pay volumetric charges relating to usage of the commodity. They will still be encouraged to conserve by turning down the thermostat so that they will not face outrageously high costs for the natural gas itself.

Cost of capital is the largest single issue on the table in the case, and Staff's theme here is voodoo economics. Cost of capital has two parts: The capital structure itself, and then the cost of the components of that capital structure. And typically, the only component at issue is common equity which has to be estimated, which is the subject of expert testimony.

Missouri Gas Energy is, in fact, Southern Union Company. It is simply Southern Union Company doing business in Missouri as an LDC under an assumed name. So when they tell you that MGE has no capital structure, that's not actually the truth. MGE is Southern Union Company, and Southern Union Company very certainly has an actual capital structure.

In the past, this Commission has used Southern Union Company's actual capital structure and actual embedded costs for elements other than common equity in coming up with a rate of return, and Staff urges you to continue to use that traditional approach.

With respect to the costs of the various components of the capital structure, MGE asks you to use not only a hypothetical capital structure, one which includes a great deal less debt than Southern Union actually has in its capital structure now and has always had in the past, they also ask you to use hypothetical costs, hypothetical costs. The result, not surprisingly, would be very favorable for Southern Union Company.

Turning to the cost of common equity, Staff's witness proposes a range of 8.65 to 9.25, still in the single digits. The hired expert representing MGE proposes 11.75 percent, which, if you adopt Staff's rate design proposal, he suggests should be reduced to 11.5. So you've got 8.65 to 9.25 on one hand, and 11.5 on the other.

Well, this Commission has just issued two rate decisions. I refer to the Empire decision and the Kansas City Power & Light decision. And in those decisions, this Commission has continued a benchmarking process that it began with MGE's last rate case. The Commission has relied heavily on a concept of a zone of reasonableness. This zone is 100 basis points on either side of the average of ROE awards in the nation.

The evidence will show you that the third quarter average for 2006 is 9.6 for gas LDCs. So your zone of reasonableness extends from 8.6 to 10.6. Guess what? While Staff's recommendation is within the zone of reasonableness, the recommendation offered by MGE is not. It's outside the top end of the zone of reasonableness that this Commission has used in at least four recent rate decisions.

In the Kansas City Power & Light case

recently concluded, in its Report and Order the Commission summarily discarded the expert common equity recommendation offered by the expert witness for the United States Department of Energy, Dr. Woolridge, because it was below the low end of the zone of reasonableness. In this case the recommendation by Missouri Gas Energy's expert is above the high end of the zone of reasonableness.

Unrecovered cost of service. Missouri Gas Energy seeks in each of the next five years to receive just over $3 million in revenue requirement to reflect cost of service that it did not recover due to unexpectedly warm weather. Well, our theme on this point is outrage. And that, I think, would be the response of all of the ratepayers when asked to go back to time periods and billing periods already concluded to give the company extra money because it just didn't make as much as it had hoped it would. That's what we call retroactive ratemaking.

Ratemaking is not a quasi adjudicative process, even though we use contested case procedures. Ratemaking is a quasi legislative process. You are sitting in for the legislature when you make rates, and your rates are prospective. They operate in the future.

Taking a historic test year as a starting point, that test year is normalized and regularized to serve as a predictor in the future because that's when the rates you set will operate, in the future. That system cannot rationally include any unrecovered cost of service. That money is just gone.

I will close simply by pointing out that the property tax refund issue and the unrecovered cost of service issue that we've just been talking about are not identical by any means. And we will treat those in more detail in the opening statement to be given at the start of that segment of the case. Thank you.

JUDGE JONES: Thank you. Now we'll have opening statements from the Office of Public Counsel.

MR. POSTON: Good morning. May it please the Commission. My name is Marc Poston and I represent the Office of the Public Counsel.

I'd like to start by jumping right into the issues and addressing the issue of rate design. MGE's customers deserve a far better approach to rate design than simply dumping all nongas costs into a single fixed rate. It is an overly simplistic approach that ignores why the current rates are designed with both a fixed and a volumetric rate element.

It's very telling that only two states have adopted straight fixed variable rate designs, and straight fixed -- straight fixed variable rate designs were also proposed recently in two other states: Michigan and Kansas. In both states the parties stipulated to their Staff's proposed traditional rate design approach rather than the company's proposal. The straight fixed variable rate design isn't winning many takers and for good reason.

First, it eliminates MGE's incentives to cut costs and operate more efficiently, cost cuts that could be passed onto consumers. The current rate design preserves the incentives to reduce costs.

Second, it removes an incentive for customers to conserve energy. This Commission was very aware of this issue two years ago when it rejected MGE's attempt in its last rate case to implement a weather mitigating rate design.

The Commission stated at page 55 of its Report and Order, quote, "High fixed monthly customer charges tend to defeat customer efforts to reduce their bill by conserving natural gas. As a result, the Commission finds that the public interest is best served by setting customer charges as low as reasonably possible."

The Commission went on to find that the current ratio between fixed and volumetric rate elements whereby MGE recovers 55 percent of its residential distribution revenues from fixed elements is appropriate.

And on page 57 of that order, the Commission stated that customers would not receive as much of a benefit from warmer than normal weather and would have less ability to lower their bills by conserving energy. The Commission stated, quote, "Such a result is contrary to good public policy. Nothing has changed. Such a result is still contrary to good public policy."

If incentives for energy efficiency and conservation are removed, we believe the Commission and all the parties should take an aggressive approach at implementing valuable programs to encourage energy efficiency and conservation to reverse the harmful effects of the proposed rate design changes.

A third reason to reject the revenue to coupling on a straight fixed variable rate design is that it shifts a portion of the residential revenue requirement from large-volume users to low-volume users. For the low-income low-volume user who is already likely struggling to pay their bill, this shift could be devastating.

And we're all aware of Senate Bill 179, now section 386.266 of the statutes. This is the legislation that gave the Commission the authority to approve adjustments outside of a rate case in response to increases and decreases in gas usage due to weather conservation.

Under the statute, one important feature for a weather or conservation adjustment is the requirement for an annual true-up to remedy any over- or under-collections. The rate design changes proposed by Staff and MGE lack this protection.

The statute also gives the Commission the specific authority to reduce the company's return to reflect the reduction of business risk. And the statute says the Commission cannot approve any such adjustment without rules in place.

Not only do both the straight fixed variable rate design proposal and the weather normalization proposal lack annual true-up, but if approved, there are no rules in place to approve a weather normalization adjustment as required by law.

We urge the Commission to maintain the current rate design which it found to be just and reasonable just two years ago.

On the issue of an appropriate return on equity, if the Commission adopts the rate design that substantially removes earnings variability, it only makes sense to reflect that reduction in business risk in the company's approved return. MGE witness Mr. Hanley also recognizes the need to reduce the ROE. But if you maintain the current rate design structure, there's no reason to consider the risk reduction issue.

MGE also seeks a $15.6 million adjustment for alleged uncollected revenue under the current rates. I really don't intend to spend much time on this issue during the hearing. It is essentially a legal argument and the law is clear, retroactive ratemaking is prohibited.

MGE also wants to establish an environmental response fund to force -- force ratepayers to pay for cleaning hazardous waste sites. The Commission rejected this type of proposal two years ago and it should reject it again. Southern Union and Western Resources have already worked out a liability agreement that will take care of this --

the cleanup costs without forcing customers to pay for something that is no longer used and useful.

MGE wants consumers to pay half a million into the fund with no matching shareholder dollars, but if MGE is successful in getting reimbursed from another party that is also responsible for cleaning the site, MGE wants to only give 50 percent back to the ratepayers. This proposal is extremely -- extremely lopsided, and consistent with the last time the Commission considered it, it should be rejected.

Regarding the Infinium software issue, Southern Union made a choice to switch to a new software knowing that MGE was still using a fully functional software that did not need to be replaced but they did it anyway. MGE's customers should not be held responsible for this and should not have to pay for two different software programs that do the same thing. Rejecting the software from inclusion in rates will send a signal to Southern Union not to be wasteful.

MGE also seeks to defer over 900,000 that it claims were costs incurred as a result of the Emergency Cold Weather Rule. MGE's claiming as costs the difference between the normal 80 percent of arrears reconnection fee and the Cold Weather Rule's 50 percent reconnection fee. But the rule disallows costs MGE would have otherwise incurred absent the rule.

Absent the rule, MGE would not have collected 80 percent from every customer as it is assuming. Plus, the 900,000 does not appear to be offset by amounts that MGE did collect which would further reduce costs associated with this rule.

And the last issue I'll mention is the seasonal disconnect issue. This proposal attempts to remedy a specific problem, seasonal disconnects, through a one-size-fits-all approach. We believe that the proposed tariff language will force customers to pay for service they did not use regardless of whether they have a legitimate reason to disconnect service such as hospitalization or military obligations. We hope the Commission rejects this proposal.

Those are all the issues I will address in my opening remarks. I'll address these and remaining issues in my brief. Thank you.

JUDGE JONES: Thank you, Mr. Poston.

COMMISSIONER MURRAY: Judge, just one question.

JUDGE JONES: Commissioner Murray?

COMMISSIONER MURRAY: Mr. Poston, do you have a citation for the Report and Order that you quoted from?

MR. POSTON: I'm not aware -- you mean the case number?

COMMISSIONER MURRAY: Yes.

MR. POSTON: I don't have it with me right here. I imagine MGE would know the number. Somebody would.

MR. HACK: GR --

MR. POSTON: Sir?

MR. HACK: GR-2004-209.

MR. POSTON: GR-2004-209.

COMMISSIONER MURRAY: Thank you. That's all.

JUDGE JONES: Now we'll hear from the City of Kansas City.

MR. COMLEY: May it please the Commission. I'm Mark Comley. I represent the City of Kansas City in this case. And as it is done customarily in the previous rate cases filed by MGE, the City of Kansas City has appeared to show support for the Low-Income Weatherization Program which the city and MGE have partnered in providing for the area in Kansas City and the counties in which Kansas City has some jurisdiction and MGE provides service.

Our sole witness on this is Mr. Robert Jackson. He has been a frequent witness before the Commission, and his recommendation is for you to reconsider the amount that you should direct MGE to contribute to the program.

I would want to point out to you, Mr. Jackson was originally scheduled to appear before the Commission on the 10th of January, and I've advised the parties of a conflict that's developed for him, and they have very generously agreed to have him appear today.

And I wanted to give that advice to the Commission in case there were any issues that you wanted to raise with him. We're gonna try to have him on today, but we will go ahead and submit the finer parts of that recommendation in the city's brief. Thank you.

JUDGE JONES: Commissioner Clayton has a question.

COMMISSIONER CLAYTON: Mr. Comley, I just wanted to ask, Mr. Jackson's position -- and we've heard from him on many different occasions so I apologize for asking this question -- but is his charge simply low income and weatherization issues or does he -- does his office also have the charge of energy efficiency and conservation opportunities that may be out there as well?

MR. COMLEY: Yes, I think that covers that, and Mr. Jackson can give you a little bit better guidance on the extent of his duties. But, yes, I do think that his office handles not only low-income weatherization but any available energy efficiency and conservation program.

COMMISSIONER CLAYTON: Okay. Thank you.

JUDGE JONES: And now we'll hear from Midwest Gas Users Association.

MR. CONRAD: If your Honor please, we don't have a prepared opening statement to share with the Commission at this time. I think I might reserve to go on individual issues on several of the issues. We find ourselves in support of the Staff's position, although for very different reasons than those mentioned by Staff counsel.

I would at this point just simply, so the record is not left in that -- in that state, just comment that while I certainly agree that setting aside the issue where Staff witnesses may live, the concept that Staff has no particular bias or agenda in a rate case and therefore is vastly trustworthy and much more so than any of the parties who have -- who have actual pecuniary financial interests in the case is I think a little bit of a stretch. But I understand counsel arguing why his witnesses speak true and none others do.

In general, Midwest's position has always been that rates should follow how costs are incurred and cost causers should be cost payers. I think we've been pretty consistent with that over the years. Variable costs are so called because they vary and they vary with usage. Fixed costs are so called because they're fixed and they don't vary with usage.

It comes down to a matter of allocation. We have placed before the Commission a stipulation on class cost of service which we signed and do support, and at the appropriate time we would -- if the Commission chooses to take that up and ask questions about that at the appropriate time, then we would be prepared to address things in that stipulation, your Honor. But beyond that, I'll not burden the record this morning. Thank you.

JUDGE JONES: Thank you. Do we have an opening statement from UMKC, Jackson County and CMSU?

MR. FINNEGAN: At this time, your Honor, just very briefly. We do support the Staff on the cost of capital issue. It's a very important issue in this case. We hope that the Commission in this case will consider more the impact on the ratepayers as well as the shareholders on effects of rate design -- I mean on cost of capital.

And if the Commission does determine to follow the -- to come up with a flat rate rather than the fixed variable rates that we are -- whatever the rates we have now, which are not flat rate, that accordingly, the return on equity is reduced substantially because this, from what we hear from all of the testimony, that this is going to reduce the need for rate increases and the company's going to earn what it's allowed to earn. So in that particular case if that happens, we think it should be definitely near the lower end of the range of reasonableness. Thank you.

JUDGE JONES: Thank you, Mr. Finnegan. And from Trigen?

MR. KEEVIL: I would waive opening, Judge. Thanks.

JUDGE JONES: All right. With that, then, we'll move to our first --

COMMISSIONER CLAYTON: Can I ask just a couple of general questions?

JUDGE JONES: Yes. Commissioner Clayton?

COMMISSIONER CLAYTON: I know I'm getting on the judge's nerves by asking these questions. The reason why I want to ask just a few of these clarifying questions is because with all the local public hearings we have, I may miss a witness, and I know the parties aren't going to want to be held up.

First of all, I wanted to ask the parties if a dollar amount value has been assigned to the seasonal disconnection issue, about how much revenue that seasonal disconnect charge would raise? Does anyone have any idea?

(NO RESPONSE.)

COMMISSIONER CLAYTON: We don't know? Will there -- a witness will know that, I assume?

MR. SWEARENGEN: Perhaps.

COMMISSIONER CLAYTON: Critical issue, huh? Okay.

MR. POSTON: Commissioner, I believe Staff witness, Mr. Ensrud, I believe he may have been looking into that issue. He may -- and I'm not sure when he's scheduled to testify.

MR. FRANSON: I'm sorry. I can't agree with that. I don't know what knowledge Mr. Poston may have, but Mr. Ensrud is not scheduled to testify on the rate design issue. It's a seasonal disconnect. I'm not sure if that was the same issue.

COMMISSIONER CLAYTON: That's exactly the issue.

MR. FRANSON: I'm sorry. I misunderstood.

MR. POSTON: Ms. Meisenheimer may also be able to testify on that dollar amount.

COMMISSIONER CLAYTON: Well, the seasonal disconnect issue is supposed to replace the monthly fixed charge if we adopt the new rate design, so I was assuming there would be a dollar amount that someone would know.

Mr. Swearengen, are the property tax issues that you-all claim are retroactive ratemaking, the same property taxes that are discussed in the property tax AAO that are also at issue in this case?

MR. SWEARENGEN: Let me consult and make sure. I don't want to give you bad information. The answer is no.

COMMISSIONER CLAYTON: They're

different -- different taxes. Okay. And who is the -- who is the company -- company witness on those issues?

MR. SWEARENGEN: Mr. Noack.

COMMISSIONER CLAYTON: Mr. Swearengen, on the environmental response fund, the only other example I think that would be comparable, I believe, is a nuclear decommissioning trust fund that we see in electric cases. Is this supposed to operate in the same fashion?

MR. SWEARENGEN: In somewhat the same fashion, yes.

COMMISSIONER CLAYTON: I mean without federal sanction, obviously. Are there any other examples of a -- of a fund similar to this?

MR. SWEARENGEN: Other than the decommissioning, the nuclear decommissioning fund?

COMMISSIONER CLAYTON: Yes.

MR. SWEARENGEN: Not that I can think of right now.

COMMISSIONER CLAYTON: Nothing else, okay.

MR. SWEARENGEN: Nothing that this Commission has dealt with. There may be in other jurisdictions, but if you're talking about what has this Commission dealt with, the answer is that would be the only thing.

COMMISSIONER CLAYTON: Well, it's different in the fact the money would be separated out rather than just in an accounting mechanism; it's actually separated out into a fund, I believe, is the nature of it.

MR. SWEARENGEN: Right.

COMMISSIONER CLAYTON: So I was wondering if we'd had any other occasions where we've done that. There's one other question that I had and I can't remember. I'll just stop right there. Thank you.

JUDGE JONES: Now, I realize Mr. Jackson is testifying today out of turn. I forget, did it matter whether he went first or did he need to go after someone else?

MR. SWEARENGEN: Well, we'd like to get our cost of capital witness on and off today. He needs to be out as well, and so I'm prepared to call him at this time.

MR. THOMPSON: We would prefer to do Mr. Jackson first.

MR. FRANSON: I don't think he's here yet, is he, Mark?

MR. COMLEY: He won't be here until 11:30.

JUDGE JONES: Staff, serious, you have an interest in whether or not Mr. Jackson goes on first or are you just kidding around?

MR. THOMPSON: I'm not kidding around, Judge. I think it would make more sense to take him first and then start the cost of capital because you don't know how long that's gonna go.

JUDGE JONES: But he's not here.

MR. THOMPSON: But evidently he's not here, so we yield, then, to Mr. Hanley.

JUDGE JONES: Go ahead and start with Mr. Hanley.

MR. SWEARENGEN: Thank you. And given the fact that I just a few minutes ago made an opening statement that covered the cost of capital issue, I don't intend to make another more abbreviated opening statement at this time. I'm sure the Commission and the law judge remember what I said about that issue.

JUDGE JONES: We do, and thank you.

MR. POSTON: And Judge, I just got word from Ms. Meisenheimer that she has, in fact, calculated that seasonal disconnect dollar amount and so she has that if needed.

COMMISSIONER CLAYTON: Thank you.

JUDGE JONES: Mr. Hanley, will you raise your right hand, please?

(THE WITNESS WAS SWORN.)

DIRECT EXAMINATION BY MR. SWEARENGEN:

Q. Would you state your name for the record, please?

A. Frank J. Hanley, H-a-n-l-e-y.

Q. By whom are you employed?

A. AUS Consultants.

Q. And what is the nature of the business of AUS Consultants just briefly?

A. Well, AUS Consultants is a -- obviously, as the name indicates, a consulting firm specializing in various services to the public utility industry. My particular area, of course, involves a ratemaking aspect.

Q. Now, have you caused to be prepared for purposes of this proceeding certain direct, revised rebuttal and surrebuttal testimony in question and answer form?

A. Yes, I have.

Q. And do you have copies of that testimony with you this morning?

A. I do.
Q. I believe the reporter has been given copies and the company has indicated that, Mr. Hanley, that your direct testimony should be Exhibit No. 001, your revised rebuttal testimony 002, and your surrebuttal testimony Exhibit No. 003.
Let me ask you this question: With respect to your direct testimony, are there any changes or corrections that need to be made with regard to that testimony?
A. Yes, there are, Mr. Swearengen. I believe I indicated to you that the -- in what is marked as schedule FJH 1, page 3 is incorrect somehow in the reproduction process. Page 4 got in twice as supposedly page 3 and page 4, and I have provided you prior to the hearing the correct page 3.
MR. SWEARENGEN: Judge, I have that and whatever your pleasure is, we can do. We can mark that as a separate exhibit if you want or it can be simply substituted for -- in schedule FJH 1 to Exhibit 1, whatever you ask.
JUDGE JONES: Does anyone have an objection to it being substituted?
(NO RESPONSE.)
JUDGE JONES: Then we'll substitute as

page 3.

MR. SWEARENGEN: Okay. And I'll hand that out.

BY MR. SWEARENGEN:

Q. Mr. Hanley, are there any other changes that you need to make with respect to your direct testimony, Exhibit 1?

A. Yes. On -- again, on schedule FJH 1, page 5, in note six there is an incorrect reference on the first line, it says "PG Energies," it should be "MGE's."

Q. And again, for the record, what schedule is that?

A. Schedule FJH 1, page 5 in note 6, the first line.

Q. Yes.

A. And also the same correction in note 7, on line 1 and line 4. In each of those instances, it should be "MGE," not "PG Energy." And that would complete all of the corrections that I have with regard to Exhibits 001, 002 and 003.

Q. With those corrections, then, if I asked you the questions that are contained in those exhibits, would your answers today under oath be the same?

A. Yes.
Q. And would those answers be true and correct to the best of your knowledge, information and belief?
A. Yes.
MR. SWEARENGEN: And with that, your Honor, I would offer into evidence Exhibits 1, 2 and 3 and tender the witness for cross-examination.
JUDGE JONES: Any objection to Exhibits 1, 2 and 3?
MR. THOMPSON: No.
JUDGE JONES: Seeing none, Exhibits 1, 2 and 3 are admitted into the record.
(EXHIBIT NOS. 1, 2 AND 3 WERE RECEIVED INTO EVIDENCE AND MADE A PART OF THE RECORD.)
JUDGE JONES: With that, we'll move to cross-examination by the Staff of the Commission.
CROSS-EXAMINATION BY MR. THOMPSON:
Q. Good morning, Mr. Hanley.
A. Good morning, sir.
Q. Mr. Hanley, you do not have a Ph.D. degree, do you?
A. I do not.
Q. And you do not have a master's degree, do you?

A. I do not. I do possess a certified rate of return analyst designation.

Q. In your more than 300 cases and dockets in which you have testified and which you list in appendix A to your direct testimony, I wonder if you could tell me how many cases you testified on behalf of a company rather than the Commission or the public or an intervenor?

A. Well, that would be most of the instances. I have appeared in years past in an ad hoc capacity as Staff to the Delaware Public Service Commission, the Arizona Public Service Commission, and I have testified before the Alaska Commission involving oil pipeline rates on behalf of other than the carriers. In other words, for some independent shippers which I suppose you could look at as intervenors.

Q. Thank you, sir. Isn't it true that Missouri Gas Energy, in fact, is simply Southern Union Company?

A. Taking literally what you have asked me, my answer would be no. It's a clearly distinct and separate division of. And when I say that, I say that in the context that its assets are indeed separately identifiable. And so it is within a portfolio of assets of Southern Union and the rate of return, of course, in this proceeding, as in every other proceeding, will be applied to that rate base, and that's the risk to where the capital invested is put and that's what we should look to.

Q. Now, Mr. Hanley, isn't it true that Missouri Gas Energy has no separate legal existence from Southern Union Company?

A. It's true that it has no separate legal existence --

Q. Thank you, sir.

A. -- but it -- it is true, however --

Q. Judge?

A. -- that assets are identifiable.

JUDGE JONES: Just -- let me just say this to everyone. We're starting at 9:30 every day this week, and to the witnesses and advise your witness's counsel, just answer the question and allow your attorney to bring out whatever it is you would have otherwise added to that answer. That will make for a quicker hearing. So go ahead.

MR. THOMPSON: Thank you, Judge.

BY MR. THOMPSON:

Q. Isn't it true, Mr. Hanley, that Southern Union Company has an identifiable capital structure?

A. Yes.
Q. Do you have any reason to believe that the capital structure as reported by Staff witness David Murray in his true-up direct testimony is not accurate for Southern Union Company?
A. No.
Q. Are you aware of any instances in which this Commission has used a hypothetical capital structure?
A. Yes.
Q. What are those instances?
A. Well, I'd have to look now, but I do recall an instance -- I can't give you the citation without digging perhaps in my bag -- but it was in a circumstance where I believe the Commission felt that the equity ratio of the applicant utility was too high and needed to be reduced.
Q. I'm wondering if you could give me at least a ball park idea of when that decision was issued?
A. Off the top of my head, without looking, I would think that was in the 1990's.
Q. Thank you. Now, you're being paid to testify today, aren't you, sir?
A. Well, I'm being paid by my firm. I get

no direct compensation from the company.

Q. And --

A. And I have no vested interest --

Q. As far as --

A. -- in the outcome.

Q. -- you know, is your firm being paid by the company for your services?

A. Yes.

Q. Do you know what your firm is being paid for your services?

A. Not in total, no. It depends on how much time I spend.

Q. How much have you billed as of today?

A. I don't know off the top of my head.

Q. So you have no idea what's been billed for your services as of today?

A. You know, Mr. Thompson, I'm involved in a lot of things. I would be speculating and I choose not to speculate.

Q. Well, we certainly don't want you to speculate. Who's your contact at Missouri Gas Energy?

A. Well, I have two contacts, principally Mr. Hack and Mr. Noack.

Q. Do you think Mr. Hack would know how

much his company has paid your company for your services?

A. Yes, but I don't know if he knows off the top of his head. You can ask him.

Q. I guess we'll find out when he's on the stand.

A. Yes, sir.

Q. Are you familiar with the recent ratemaking decisions of this Commission?

A. Familiar? I have -- I have read several of the recent orders, two of which you mentioned during your opening statement, yes.

Q. So you are familiar with the concept of the zone of reasonableness that this Commission has applied in its recent ratemaking decisions?

A. Oh, I am, yes.

MR. THOMPSON: No further questions.

JUDGE JONES: Thank you. Do we have cross-examination from the Office of Public Counsel?

MR. POSTON: Yes, thank you.

CROSS-EXAMINATION BY MR. POSTON:

Q. Good morning.

A. Good morning, sir.

Q. In your direct testimony you discuss a proxy group of companies that you selected to gain

insight in the market-based common equity rate for MGE, correct?
A. Yes, two groups.
Q. And you indicate, I believe it's in your surrebuttal testimony, that six out of the 11 have some form of revenue normalization adjustment clause; is that correct?
A. Revenue decoupling mechanisms, yes, some type, yes.
Q. And have you researched the six companies to determine whether they operate in a deregulated or otherwise different regulatory environment from that which MGE operates here in Missouri?
A. Some do and some don't. AGL does, but not all. I think if you were to look at what has been designated schedule FJH 36, which, of course, is part of Exhibit 003 --
Q. That's your surrebuttal testimony, correct?
A. Yes, sir. I believe they're fairly explanatory notes for each of the companies indicated.
Q. And so what -- what are the different regulatory environments that you've found with these

six companies, first starting with AGL?

A. I'm sorry, I don't understand your question.

Q. Of these six, the six that you say have these type of clauses, what is the regulatory environment? Are they deregulated? I mean, how many of these are in a deregulated environment?

A. Well, I guess you have to define for me what you mean by deregulated. You mean are they not under any price regulation by the regulatory agency? I don't think that's the case.

If you talk about rate plans and where in some instances they do not have the ability to come back into the Commission for, say, three years illustratively, and could be at -- somewhat at risk, there's that, but I don't know of any instance where they're completely, forever and a day, not under the regulatory control of the respective Commission.

Q. And you had mentioned, I believe it was, AGL. What did you find when you researched them about their environment, regulatory environment?

A. Well, basically, they have a good and progressive regulatory environment. I've indicated they do, in fact, have in place straight fixed variable rates, and let me just look, if I can, at my notes. Oh, and, well, when they previously had -- I hope I'm not volunteering or -- I don't want to get in trouble here with the judge.

Q. Go ahead. Go ahead.

A. But they previously had a weather normalization adjustment clause, but upon the implementation of the straight fixed variable rates, that WNA ceased. So I think that's sort of in harmony with what Missouri Gas Energy is requesting in this case.

In other words, if the straight fixed variable goes into place, they're not then asking for the weather normalization adjustment as well. That would be foregone in the event of the Commission's approval of the straight fixed variable.

Q. It's my understanding that -- that the AGL, they operate -- and when I say deregulated, I guess I was meaning they -- they use some sort of like a gas marketer; is that -- is that correct?

A. I believe that's correct, yes, sir.

Q. And of your -- your six companies, have you reviewed the rate designs of these companies?

A. Only to the extent indicated in -- in conjunction with Exhibit 003 as discussed and as mentioned previously as laid out in schedule FJH 36 as to some type of protection mechanisms, but all the intricacies, if you will, of rate design, the mechanics, how precisely each one works in detail, no, that would go well beyond the scope of my expertise and certainly goes beyond what I need to know in order to make accurate judgments insofar as the cost of capital is concerned.

Q. And what specifically did you review? Did you review tariffs, orders?

A. Well, my firm and someone in particular who works for me, keeps records for the American Gas Association with regard to various rate mechanisms, so that was a principal source that we get from -- from the participating companies.

And we also subscribe to Regulatory Research Associates who provide information with regard to rate case activity and also rate design issues. And between those two, provides a wealth, a virtual encyclopedia of information with regard to rate design mechanisms.

Q. So you specifically did not review the tariffs or the orders approving those tariffs for these companies?

A. I specifically did not review the actual tariffs themselves, but rather the summation about what has been approved by the regulatory Commission, what type of tariff it is and the essence of how it works, not in intricate detail, however.

Q. Did you research your proxy, your six companies to determine whether the state commissions that authorize those rate designs factored a reduction in business risk into their decisions?

A. Well, yes, and my general experience is, is that over the years, there has largely been a recognition of a reduction in --

Q. I'm asking you what you specifically reviewed.

A. I'm sorry. I'm sorry. Maybe -- would you -- could you ask me again, please?

Q. When you researched your proxy companies -- well, my question was, did you research your proxy companies to determine whether the state commissions that authorized the rate designs factor reduction of business risk into their decisions?

A. Well, I attempted to and I find that in virtually every instance they're somewhat ambiguous, but my general sense is, is that there is and has been some recognition even if not explicitly quantified.

Q. So did you review the orders of these commissions?

A. Not all of them, no. As I -- as I say, that would be quite an undertaking, but I have reviewed some of them, yes.

Q. Can you identify any order where the State Commission considered business risk, specifically considered it in their order?

A. Well, business risk is -- is always considered. I mean, are you asking me in some --

Q. Let me -- let me change that. Are you aware of any order for your six companies where the State Commission specifically reduced risk because of the change in business risk associated with the revenue design that they approved?

A. No. The only thing that really comes to mind of what I did review was with regard to Atlanta Gas Light, of course, which is AGL, which, of course, the quid pro quo was for the weather normalization adjustment to go away.

MR. POSTON: Okay. That's all the questions I have. Thank you.

JUDGE JONES: We'll have questions from the bench now, beginning with Commissioner Murray.

QUESTIONS BY COMMISSIONER MURRAY:

Q. Good morning.

A. Good morning, Commissioner.
Q. I don't have many questions for you. On the short-term debt issue, you added 50 basis points to the LIBOR rate of 4.97. Why did you add the 50 basis points? Would you explain that?
A. Well, because -- yes. That happened to be very close to -- fairly similar to the differential actually paid and the three-month LIBOR rate experienced by Southern Union, and it seemed a realistic assumption to make a similar adjustment, not exactly, as I recall without -- sorry -- without looking, I think the actual experience at the time for Southern Union was 57 basis points, and I simply used 50.
Q. So you were getting closer to the actual experience of Southern Union at the time?
A. Yes.
Q. You've made an adjustment based on a risk factor of lack of protection from the vagaries of weather. How does MGE suffer from lack of protection from the vagaries of weather in a way that would warrant an adjustment for that risk?
A. Okay. I'll answer that in two parts: First, any LDC, and in particular, MGE, suffers without this type of a protection particularly seems

to be pretty much a trend in recent years.

Whether it's global warming or not, I don't know, but when weather is warmer than normal, whatever normal has been defined to be in the rate proceeding in which the level of consumption was anticipated to occur, and when revenues are then recovered only on actual consumption by the customers, of course, weather is normal -- warmer than normal, less revenues are going to be derived based upon those authorized tariff rates than had been anticipated.

And of course, that tends to contribute in large measure, not entirely, to an inferior level of revenues, and as a result, inferior level of earnings at the bottom line.

The second part of that is that I acknowledge that if such a clause were in place, no adjustment -- upward adjustment would be required. What I'm saying, Commissioner is, is that in the absence of any protection through a WNA or a straight fixed variable rate design, in other words, the current status quo, an upward adjustment would have to be made upon any common equity cost rate derived from the proxy LDCs simply because the majority of those LDCs do, in fact, have various types of protection, including weather normalization adjustment clauses.

And as a result, their lessening of risk is reflected in those market data so that if we were then trying to take data -- market data derived from those companies and apply it to MGE but not make such an adjustment or through a WNA, then you have to increase it because it would remain -- continue to remain more risky vis-a-vis the proxies.

Q. So how many of those proxies have straight fixed variable rate design, do you know?

A. Yes, we can determine that. I will try to direct you, if we go to -- if I may, just a moment. Okay. I'm not finding it. Bear with me, Commissioner, please.

Q. Sure.

A. Okay. So if we look -- so, of the final six after the elimination of Cascade and Peoples, New Jersey Resources, Northwest --

Q. Which document are you --

A. -- Piedmont -- I'm actually comparing two different ones. I was looking at schedule FJH 36 which is part of Exhibit 003. I believe that's the way it works, accompanying it.

And then comparing the indicated

mechanisms, those that are indicated as yes against the six companies, the six companies being Laclede, NUI Corp, Northwest, Piedmont, WGL and New Jersey Resources. So the answer is, is that four out of the six have some type of mechanism.

Q. And which -- which states are they located in?

A. Well -- well, New Jersey, of course, speaks for itself. NUI Corp -- no, not NUI Corp. Northwest is -- Oregon has such a clause, Piedmont, South Carolina and Tennessee and WGL which is, of course, Washington Gas, that would be in Maryland.

Q. And so in those states there is the use of the fixed rate -- I'm getting confused.

JUDGE JONES: Variable fixed.

THE WITNESS: Well, they have different -- different names. You know, they call them different things, but what I call is -- a more generic term is a rate decoupling mechanism, so where you're decoupling the fixed charges from the volumetric design regardless of what they call it, you know.

BY COMMISSIONER MURRAY:

Q. Is it -- it could be -- excuse me -- it could be somewhat of a different rate design than exactly what is proposed here; is that correct?

A. They could be slightly different but conceptually they're the same. They all intend to recover fixed charges through, you know, a fixed mechanism rather than through -- through the actual usage of -- of gas.

COMMISSIONER MURRAY: Okay. Thank you.

JUDGE JONES: Commissioner Clayton?

QUESTIONS BY COMMISSIONER CLAYTON:

Q. Good morning.

A. Good morning, Commissioner.

Q. I'll move to the side so you can see me. Your testimony suggests that if the Commission adopts the rate design that you've been discussing here this morning, that it would be appropriate to reduce the return on equity component by 25 basis points; is that correct?

A. Yes, sir.

Q. Okay. And could you explain to me how you quantify 25 basis points?

A. Good question, Commissioner. Yes, I can tell you that. I have experience that really goes to extremes, okay? I once volunteered before the New York Commission 25 basis points for a weather normalization adjustment clause. And how did I get the 25 basis points? It was judgment, okay?

The New York Commission rejected the 25 basis points that was offered on a platter in order to allow a WNA on a trial basis. And they said well, we understand that it will tend to stabilize revenues, but we don't see a necessary correlation of how it's going to stabilize earnings, okay? So they didn't take the 25 basis points that was offered.

Now, I often don't agree with Commission decisions, but I really didn't agree with that one because I think that it does, and common sense tells us that it -- that it does. If you tend to stabilize revenues, it may not be on a parity, dollar for dollar, but you are going to stabilize --

Q. How long ago would you say --

A. That was in the late '80s.

Q. In the late '80s?

A. Late '80s. Now -- now, there is a subsequent case in Connecticut that I'm aware of and I was not a witness in the case, and the Connecticut Commission, how they arrived at it, I don't know, but quantified such a clause at -- the value of such as 25 basis points.

Q. How long ago was that?

A. Oh, golly, stretching my memory. This is 2007. I would say that was in the late '90s.

Q. Okay. So we've got some dated -- dated cases here. I mean, one is potentially 20 years ago and one is potentially ten years ago?

A. Probably a little less, but yes. I understand, right within --

Q. Okay. Well, let's -- let's focus on the New York case where they rejected the 25 basis points. And you suggested that the New York Commission wasn't convinced that -- that rates would be stabilized to warrant such a reduction in ROE, that was their position?

A. Well, let me restate, if I may, what -- what I believe their position was. It was my suggestion that if they permitted the requested weather normalization adjustment clause to go into effect, that a reduction in common equity cost rate of 25 basis points seemed to be warranted because I contended that there would be a stabilization, if you will, of revenues and hence, in earnings. Maybe not to the same degree, but there had to be some benefit fall-out on earnings.

They said -- they agreed that it would tend to stabilize earnings, but they disagreed that there was any necessary correlation -- I mean to revenues, would stabilize revenues, but they disagreed that there would be any necessary correlation to stabilizing earnings.

The Connecticut Commission, as I recall, believed what my proposition --

Q. Before we go to Connecticut, because I don't want to -- I don't want to get too deep into these things, my question is -- and I think I understand the analysis by the New York Public Service Commission.

Have you had an opportunity to review the company in question since that rate design was implemented to evaluate over the last 20 years whether or not its earnings and revenues stabilized because of that rate design?

A. I believe that -- yes, I believe that they have.

Q. Have you reviewed them? Let me ask that first question.

A. I've been a witness for the --

Q. For that utility?

A. -- company, yeah. And as a matter of fact, I'm working on testimony that's gonna be filed later this month for the same company.

Q. How many times do you think you've --

since that original case in the 1980's, how many times have you testified on behalf of that utility? I don't need an exact figure. I just want some context for the reason that you would have to study the --

A. In that jurisdiction?

Q. Uh-huh.

A. Maybe five times.

Q. Five times. Okay. And so that -- being engaged by that utility has given you an opportunity to study earnings and revenues that the company's experienced under rate design?

A. I think so. And I think that it definitely has -- has helped them. Does it obviate the need for rate cases, no.

Q. Has the rate -- has the rate -- I understand. I understand. Forgive me, let me -- let me ask my questions and then if you want to elaborate, we'll do that, but has the rate design in that New York utility example been used since the late 1980's?

A. Consistently for the same company --

Q. Yes.

A. -- is that implied in your question?

Q. Yes.

A. Yes.
Q. Okay. So the company's been operating under that straight fixed variable cost?
A. No. No, no, no. Whether normalization adjustment clause.
Q. It's a weather normalization?
A. They are now in -- I hope I don't have to mention the company because they haven't filed the case yet, but they are now considering -- are going to request a similar type clause as being sought by MGE --
Q. Okay.
A. -- now.
Q. So we're not talking about the straight fixed variable rate design, we're talking about a weather normalization surcharge or clause --
A. Yes.
Q. -- that would be a rider?
A. Yes, sir.
Q. Okay. So that's different than what we're talking about on this specific rate design? I guess the example of the straight fixed variable rate design is different?
A. It's different, yes.
Q. Okay. So is it your testimony that the

25-basis-points reduction is for either method or is it different for the methods that the company's proposing? And I apologize for -- I'm kind of rounding about here in many different ways. I see --
A. Well --
Q. -- one proposal is the straight fixed variable, the second proposal is having some sort of weather normalization adjustment. Is it 25 basis points for both or is it different?
A. Well, as I understand it, both are not being requested here. And in effect, what I'm really doing is saying the straight fixed variable, if permitted to go into effect, really has an impact of 35 basis points? Because the 15 -- the 15 basis points upward, if there was no WNA, came off of the 25 basis points for the WNA, that would have brought my recommendation down to 11.60, and then I took another ten, okay?
So really, what I'm saying is that vis-a-vis the proxies, when you go back to square one, I'm saying that the straight fixed variable is indeed worth somewhat more than the weather normalization because it gives you an opportunity, not a guarantee, but an opportunity to recover -- a better opportunity to recover your fixed costs.

Q. That 35 basis points, how was that number determined?

A. By judgment in truth. Because there's no way in God's earth that you can precisely quantify. There is, you know, and necessarily has to be informed expert judgment. But using the 25 basis points worth for weather normalization adjustment that there is some precedent in Connecticut, notwithstanding New York's prior contention --

Q. Would --

A. -- and just taking an extra ten.

Q. Would that basis-point change vary by state or by utility or would it just be a straight 35-basis-points reduction?

A. Well, I guess it depends on what -- what experts in each instance testify and whatever the Commission finds and decides.

Q. Well, if you're the expert, would it vary? If you were the expert testifying, all things being equal, would it be 35 basis points for moving to that type of rate design across the board in general?

A. I would think that would be a good estimate for what I consider to be a standard typical straight fixed variable. But, now, I want to be clear that I'm not -- I wouldn't say that if they said we keep the WNA in place and we want straight fixed variable. That's a -- that's a different story.

I'm saying just the -- in lieu of the WNA, weather normalization adjustment, if we have the straight fixed variable, it's worth 35. I haven't really had the situation where we're gonna have the double -- the double whammy.

Q. Why would you have -- why would you have both? Could you give me an example when you'd have both an instance of a straight fixed variable rate design and a weather normalization adjustment? Why would you need both?

A. Well, both would be better than one.

Q. How -- if you have a straight fixed variable rate design, how does weather impact revenues of the company?

A. Well, as I understand -- I'm not a rate design expert, mind you -- but as I understand, weather will still have some degree of impact.

Q. How?

A. To the extent it varies from the norm.

Q. But if the -- if the revenues are raised by a straight fixed cost, regardless of usage, why would weather have an impact on the company's revenues?

A. Well, if 100 percent, then I would agree with you, but I don't think they all recover 100 percent of the fixed costs.

Q. Are you aware of what the proposals are in this case?

A. Not in detail, no.

Q. Okay. If you're not aware of the rate design in detail, how can -- how can we rely on the 25 or 35-basis-points reduction? How do we know that that is an accurate reflection if you're not aware of the rate designs that are being discussed here today?

A. Well, I think you can rely upon it based on candor and my experience. I don't have to know the intimate level of detail about rate design because that's a whole other area of expertise that I don't profess to have.

But based on the actual experience that I do have with other companies and with other commissions and how they've reacted, I'm making a judgment that it's worth more than just what a WNA is worth.

Q. Can you -- how many cases have you testified in where a straight fixed variable rate design were 100 percent of distribution costs replaced in a fixed customer charge? How many cases would you say you've testified where that rate design was contemplated?

A. I don't believe that I have. I'm aware of others.

Q. So this would be a first?

A. Where I personally am the witness, yes.

Q. Okay. Is it possible that -- considering that it's your first, would it be possible that because weather would be removed from the equation, that more basis points could be taken from your ROE recommendation to accurately reflect the risk profile of the company? Is it possible, considering it's your first time?

A. Well, no, I don't think it's possible because if 25 is the value of the WNA, we are taking that already out of the equation and then plus ten, so we're saying is the total value if it takes into account weather and recoupment of fixed costs, there's -- you know, there's an additional ten or a total of 35 basis points.

Q. How many cases in the last 12 calendar months have you testified on behalf of a utility? Let's say gas utility. I don't know if you get into other sectors but...

A. I'm just trying to think.
Q. Has it been a good year or a bad year for work?
A. Well, for work it's been a good year. I've been doing a lot of oil pipeline work as well.
Q. Okay.
A. Gas cases, probably four.
Q. Oh, just four in the last 12 months? Okay. And do you recall in those four cases the recommended ROE that you recommended? That's kind of redundant, the recommended ROE that you recommended?
A. Well, they certainly vary depending upon the capital market conditions at the time.
Q. Do you recall -- do you recall what you recommended in each case?
A. Precisely, no, but I would say ranging from pretty much 11 to 12 percent, roughly.
Q. Have you ever recommended anything less than 11 percent for a natural gas distribution company?
A. Yes.
Q. When and where did that occur?
A. Oh, I don't -- I couldn't tell you right off the top of my head, Commissioner, but, yes, depending upon --

Q. Recently within the last couple of years or would it have been 20 years ago?
A. Oh, within the last few years, yes.
Q. And were you -- were you -- in that case were you testifying on behalf of the company or someone else?
A. The company.
Q. But you don't recall which company that was?
A. I don't, no.
Q. Could you, after today, is that something that -- would you mind supplementing the record, just the -- naming the company and the jurisdiction in which you recommended less than 11 percent ROE for common equity?
A. I will try to do that, yep.
Q. Great. You mentioned at the start of your testimony, and I apologize for not thoroughly reviewing this portion of your testimony, but you're a certified rate of return analyst --
A. Yes, sir.
Q. -- is that correct? What -- what college education did you have, the underlying -- and I know it was a few years ago, but were you in finance or accounting?

A. Well, yes, both finance and accounting, but -- and it requires a minimum number of years actually working in the field of public utility ratemaking, and then a comprehensive examination by the Society of Utility and Regulatory Financial Analysts.
Q. That's a private organization that does the certification?
A. Yes.
Q. Do -- is that a -- does it have members that are in the public sector?
A. Absolutely.
Q. And private sector?
A. Yes. Yes.
Q. It does?
A. Absolutely.
Q. What is the minimum amount of time to be certified that you have to work in the field?
A. Well, unless it has changed, it used to be four years. I'm not sure at the moment.
Q. Okay. And the society conducts an evaluation? You actually have a test or --
A. Yes, yes.
Q. Okay. How long ago would you have been certified?

A. I think since early 1991 or '2.
Q. Lastly, I want to go back to weather just for a moment. Is weather -- weather variations, are those the -- one of the most significant risk factors that a natural gas distribution company will face?
A. Well, it's certainly very -- very significant.
Q. What -- would you first -- I guess, would you say it is -- it is a -- would you agree that it is a significant factor?
A. It is a significant factor.
Q. Can you state whether it is the most significant factor?
A. In my -- well, probably. I mean --
Q. What would you rank up with or just beneath weather as other risk factors for a natural gas utility?
A. Regulatory risk.
Q. What does that mean?
A. Well, it means that a utility is -- a star shining or a star falling, in large measure depends upon the regulatory environment and legislatures and so forth. If they preclude or refuse to consider mechanisms that can help or afford

better opportunity for a utility to actually achieve what is authorized, then, of course, that can have a significant impact on the end result.

Q. Okay. What would be next as a risk factor?

A. Oh, well, certainly conservation. Use -- less use based on volumetric rate design and reduced usage combined with, of course, as we already indicated, weather, has been very devastating to many LDCs.

Q. Okay. Any -- any other significant risk factors that you use when evaluating what the ROE ought to be?

A. Well, when evaluating what the ROE ought to be, we look at proxy companies and then try and make judgments for differences such as was done in this case by myself.

It's -- unless there is something public made available with regard to quality or lack thereof of management, some unique problems, quality of service which I understand is not an issue for this company, things like that certainly have an impact as well.

Q. I understand you're gonna do a comparison of companies, and I think I was asking the question in the sense that when you do compare the companies, you're comparing the risk factors faced by each of those companies in evaluating how an -- how an individual utility would stand in the marketplace in attracting capital. Now, is that an accurate way to reflect your analysis?

A. I think that it is a fair assessment and I would just add, however, that by looking at a number of factors, such as the bond rating and so forth, where we know from information provided by the bond rating agencies that their assessments take into account both qualitative and quantitative factors of every sort.

Q. Is the quality of service -- if a company is providing high quality of service, what does that do to your ROE analysis? Does it cause it to go up or cause it to go down, all things being equal?

A. It depends. If there's a reason to be uniquely aware of -- for instance, suppose you had a company that has a very high quality of service and it's not recognized in the regulatory regime that it operates under and is disadvantaged vis-a-vis other companies operating under other regulatory regimes, that wouldn't be well and investors wouldn't take it well.

Q. That would be more of a regulatory risk factor rather than -- I guess that could fall under both; do you agree with that?

A. I believe so, yes, sir.

Q. Okay. Okay. Do you believe -- did you do an analysis of MGE or Southern Union management, and if so, what was your conclusion?

A. Is that a two-part question of --

Q. Well, I guess, did you -- you've listed management as being part of the risk profile analysis in evaluating an ROE, so I was assuming that you did a partial analysis on management to determine whether there was any additional risk that would be applicable to the company. Maybe I misunderstood that.

A. Well -- well, perhaps and perhaps not. I'm not sure. But -- but I'll say this: Unless there is something that stands out and there isn't anything negative that stands out with regard to this company or indeed any of these others that I'm aware of, of the proxies, so I think they all operate pretty good ships, so to speak, with regard to quality of service.

And so -- but as far as -- I think you

mentioned Southern Union, I'm looking at this just in terms of Missouri Gas Energy, not Southern Union, because that's -- management is -- of the collective enterprise really relates to vastly a different kind of entity than a gas distribution company.

Q. In summary, if the Commission were to adopt the straight variable -- straight fixed variable cost rate design where 100 percent of the distribution costs go into a fixed cost rather than it being based on volumetric rates, would you agree with me, yes or no, that in that instance weather is removed from the risk factor calculation?

A. Yes.

Q. Would you also agree with me that conservation in energy efficiency programs are removed from the equation?

A. Yes.

Q. Would you also agree that that is a positive regulatory step and that the regulatory risk associated with the company would be reduced?

A. Yes.

Q. You've suggested that management does not -- does not pose any sort of risk addition because it's either quality management or it doesn't make the radar so there's no additions for risk associated with management; would you agree with that?

A. Yes.

Q. You also agree that if the company provides quality of service, there's no additional risk associated with that factor?

A. Additional risk? Well, no. I mean, in terms of the quality of service, there's no -- no -- I mean, it's good service as far as I know, so there's no extraordinary --

Q. Doesn't increase the risk of the company, there's no risk that the company is going to be punished for bad service, I guess, if I were to phrase it that way?

A. I would hope not.

Q. Yes, okay. Last one that you mentioned was bond rating and we haven't talked about this. Does the bond rating associated with MGE or -- and I'm not sure how the bonds are set up, if any. Does that rating of the company cause any additional risk in your estimation?

A. Well, Commissioner, I need to clarify something. First of all, MGE has no bond rating, no bonds outstanding, no identifiable capital structure of its own. So when we speak about that with regard to MGE, there has been discussion focusing upon Southern Union.

Southern Union bond rating is based upon a recent downgrading of late November of 2006, November 29th, I believe, got downgraded to the bottom of investment grade category, a triple B minus, by Standard & Poor's, and it's now categorized as a midstream company which is a high business risk venture.

And so I believe that any type of comparison of bond rating to a quality gas distribution operation such as MGE and Southern Union just isn't appropriate. First of all, the bottom of investment grade bond rating is --

Q. I'm sorry, what is inappropriate? I didn't catch what was inappropriate.

A. Yeah, any comparison of the Southern Union bond rating would not be appropriate, I don't believe, as applying or inferentially even, as appropriate to MGE a quality gas distribution operation because the bond -- the Southern Union current bond rating is the very bottom of investment grade category.

And that's a dangerous place for a utility -- if we talk about just a gas distribution utility -- to be, because one rating notch down puts it into what we can refer to as a junk bond category, and that would make it, in tight capital markets, difficult, if not impossible, to raise capital -- viewed as a stand-alone that had that situation, to raise capital when necessary. And of course, we know a public utility such as Missouri Gas Energy needs to have available to it all the capitals required when it's required, not just when it's convenient.

Q. So it sounds like the bond rating causes some concern for you in terms of assigning additional risk to the company because of the company's decision to be a midstream company?

A. It -- yes, it does.

Q. It does. Okay.

A. It does.

Q. Is it possible for you to hypothetically set out the first five or six risk factors that you suggested from the company makeup as it is as a midstream company? Is it possible to evaluate MGE as if it stood alone as a natural gas distribution company?

A. Oh, I think so and I think I've done just that. I've done that by --

Q. Okay. So, yes. My question is if

you -- if you separate it out as a stand-alone natural gas distribution company and remove the factors of it becoming a midstream company, it sounded to me like all the risk factors suggested that MGE was not a very risky investment because of -- if we adopt this straight fixed variable rate design. Do you agree with that?

A. I agree with it. However, if you're going to look at it that way, I think you've got to look at it in terms of capital structure as well, which would be the capital structure that I recommend that contains 46 percent equity which puts it on par with these proxy companies from which we make these observations.

Q. So if you were to put the capital structure up at a hypothetical level, assuming that we adopt this rate design, wouldn't you agree that MGE as a natural gas distribution company would be less risky and would warrant a lower ROE than what you've -- than what the average would be in the industry?

A. No, because I've worked from the industry average and looked -- and looked at these proxy companies, and their capital structure is similar, virtually identical to that which I adopt and recommend. And the cost rate that I recommend is derived from those market data of those companies.

It puts it much more on par with these companies than presuming that this high risk midstream organization, Southern Union, is how a -- a good and solid gas distribution operation ought to be financed. It's dangerous for the reasons mentioned in a prior response to you, Commissioner.

Q. Do any of those comparable companies you just referenced have a straight fixed variable rate design?

A. Yes.

Q. Which companies were those?

A. The ones I discussed with Commissioner Murray. In the record -- they should be in the record. I believe they were New Jersey Resources, Northwest, Piedmont and WGL Holdings.

COMMISSIONER CLAYTON: Okay. Thank you very much for your time.

THE WITNESS: You're welcome.

QUESTIONS BY JUDGE JONES:

Q. I just have a couple of questions, Mr. Hanley. You mentioned that --

A. Oh, I'm sorry. It was the judge. I thought it was another one of the attorneys. I was looking around. I'm sorry.

Q. You mentioned that the bond rating for Southern Union was recently downgraded?

A. Yes, sir.

Q. Was that in response to the acquisitions that Southern Union has made?

A. Well, yes, financed largely with debt and getting more and more away from the utility business, if you will, into this midstream --

Q. Now, I don't have a whole lot of experience with this and I'm sure you have quite a bit more, but what bonds normally -- isn't there a negative reaction to any move or acquisition that a company makes, kind of like a watch -- we're gonna down-rate you while we watch and see whether or not you made a prudent decision? Does that happen quite often?

A. You mean by the bond rating agency?

Q. Yes.

A. Well, in this instance, no. Actually, it was quite the reverse. They had been on credit watch. They were removed from credit watch at the time they were downgraded, so they went from a triple B to a triple B minus and taken off credit watch. So the watching is over, the triple B minus is a solid bottom of investment grade rating which is a bad place to be for a real utility which Southern Union isn't.

Q. Okay. And one last question: If I were an MGE customer and I was so happy with their service that I wanted to invest in them and I went to a broker and asked them, "Hey, I want to invest in MGE," how would I do that?

A. Well, the bottom line is you -- you can't -- you can only do it indirectly and that would be by investing in Southern Union. However, with Southern Union's stated goal of really getting out, I think it's just a question of time based on their pronouncements of their CEO, Mr. Lindemann, before they're totally out of the business.

So I'd be a little wary about investing, if I wanted to invest in a gas distribution utility, of sinking my money into Southern Union, because when I invest, I'm looking forward.

Investing is expectational, have expectations of the future. My expectation of the future is Southern Union won't be in the gas distribution business, it will be somebody else, whether it's National Grid or whoever, will wind up the ultimate owner at some point.

Q. Owner of MGE?
A. Yes, sir.
JUDGE JONES: Okay. I don't have anything else. Does anyone have any recross?
MR. THOMPSON: None from Staff.
JUDGE JONES: And Office of Public Counsel?
MR. POSTON: Yes, thank you.
CROSS-EXAMINATION BY MR. POSTON:
Q. Mr. Hanley, how long have you been testifying on rate of return, how many years?
A. 34.
Q. Okay. So you testified on rate of return before you were certified in '92?
A. Yes, sir.
Q. I want to clarify something. You had replied, I believe, to Commissioner Murray and to Commissioner Clayton that four of your proxy companies had a straight fixed variable rate design. And when you say that, are you saying that they have a rate design that recovers 100 percent of the nongas costs into a fixed rate?
A. I cannot guarantee at the moment that it's 100 percent, but I think if it isn't 100 in every case, it's largely or mostly.

Q. And WGL was one of the companies you mentioned, correct, WGL Holdings?
A. Well, yes, that's the parent company, the Washington Gas Light, Maryland jurisdiction.
Q. And Washington Gas has jurisdictions in -- or they serve the jurisdictions of Washington, D.C., Virginia and Maryland, correct?
A. Yes, they do.
Q. And so of those three, you're saying only the Maryland one has a -- has a rate design that you would characterize as a straight fixed variable?
A. Yes, they have requested similar rate design in the District of Columbia. The case is on file at this time, it hasn't been set for hearing yet. And I know for a fact that they're going to request one -- or I'm sorry, that, in fact, that they have requested one in Virginia and that hasn't yet come to hearing.
Q. Can you turn to your schedule FJH 36, please?
A. Okay.
Q. And if you could read the footnote 10 to yourself?
A. Okay.
Q. Now, isn't it true that the Maryland

Washington Gas does not actually recover 100 percent of the nongas charges into a fixed rate? What they have is a rate design that addresses variations in weather?

A. Well, it's a bit more than that. It's just not a -- it's a revenue normalization adjustment. It addresses more than that. As it says, it stabilizes the distribution charge revenues received from Maryland customers.

Q. As a result of changes in --

A. "Deviations in customer usage caused by variations in weather."

Q. How would you define straight fixed variable?

A. How would I define it is, it's a mechanism that decouples from volumetric consumption by customers and provides the ability to collect fixed charges for providing the service but it's not volume-related.

Q. So when you refer to straight fixed variable, are you referring to a rate design that recovers 100 percent nongas costs in a fixed rate?

A. Well, hopefully 100 percent. I'm sure I don't know -- again, I'm not -- it's not my area of expertise, but I would assume it could be designed to permit some portion less than 100 percent.

Q. Okay. So when you say, though, that four of your proxy companies have a straight fixed variable -- variable rate, you're not saying that those four collect 100 percent of their nongas costs in a fixed rate?

A. Well, no, I'm not saying that. For example, if you look at footnote 8 on the same page of FJH 36, it's saying there with regard to Northwest that, "The mechanism coverage from a partial decoupling of 90 percent of residential and commercial gas usage to a full decoupling of 100 percent," so obviously they are now 100 percent but they hadn't -- had not been.

Q. And just one last thing: Commissioner Clayton walked you through various risk factors. Would you agree that eliminating losses due to customers who disconnect in summer would also reduce risk?

A. Well, yes. I don't know if it would be significant, but -- of course, I don't have any idea of how significant that is, but I guess the old adage, every little bit helps.

MR. POSTON: Thank you. That's all I have.

JUDGE JONES: Do we have cross-examination from Midwest Gas Users Association?

MR. CONRAD: Yes, your Honor, thank you. Very briefly.

CROSS-EXAMINATION BY MR. CONRAD:

Q. Mr. Hanley, Commissioner Clayton, I think, asked you a little bit about quality of service. Do you recall that?

A. Yes, I do.

Q. I take it that you subscribe to the idea that a public utility should have another standard of quality of service than keep the customer base sullen but not rebellious?

A. Could you ask me that again, please?

Q. Try to. I take it you have some other standard of quality of service for a public utility than keeping the customer base sullen but not rebellious?

A. I'm not sure how to -- I'm not sure I still understand that. It's not my goal to try and keep them happy, sullen or rebellious but to simply make recommendations based on the economic and financial facts. It's not my concern if they're sullen or rebellious or happy.

Q. Well, would you agree with me that the job of the public utility is to provide high quality of service?

A. Yes, sir, and I would also add the word dependable.

Q. Okay. So we'll add dependable in that. And I take it, then, that you would somehow factor that into your analysis of the rate of return that should be awarded?

A. Well, I think I answered that in response to Commissioner Clayton. The only way -- I mean, I'm not in the management audit business and the only way I would really have an awareness of -- of anything along those lines would be either through a bond rating agency or a regulatory order if they find some particular fault. And that would then be reflected in the market prices paid by investors and, hence, reflected in the conclusions that I would draw which are deduced from those.

Q. Now, you've mentioned, I think, just to pack that just a tiny bit, that you were not sure what your total compensation for this case would be because you didn't know how long it would take, right?

A. Well, that's -- that's part of it. I don't know when --

Q. I understand that. Did you -- did you answer that question that way, though?
A. Well, I don't remember exactly what I said other than the fact that I couldn't say off the top of my head what I'd billed to date. I know because this has been litigated, we've been through three phases of direct testimony, rebuttal testimony, surrebuttal testimony, preparation for the hearings and now being here today. What that all totals up to, I don't know, and I said I chose not to speculate. If --
Q. Do you have a billable rate per hour, sir?
A. I do.
Q. What is that rate?
A. $250.
Q. Do you have multiple billable rates?
A. Well, not for myself but other members in my organization.
Q. Let me ask you this, then: When you quote for a public utility a rate, do you quote them one rate to do an average job, a higher rate for a really great job, and a really -- 10 or 25 percent higher rate if you really want a superb job or do you just quote the one rate?

A. Just the one rate.

MR. CONRAD: Thank you.

JUDGE JONES: I take it that's all you have, Mr. Conrad?

MR. CONRAD: It is, thank you, Judge.

JUDGE JONES: Is there any recross? We'll move on now to redirect.

MR. FINNEGAN: I have --

JUDGE JONES: I'm sorry?

MR. FINNEGAN: I have just a few questions. Actually, I think it's cross because we didn't get to cross.

JUDGE JONES: Well, just ask him questions.

MR. FINNEGAN: Okay. Well, it's not that important.

CROSS-EXAMINATION BY MR. FINNEGAN:

Q. The first question: The term straight fixed variable rate design, you did not coin that term, did you?

A. I did not, sir, no.

Q. All right. If you had, would you have not called it a flat rate?

A. I don't -- I don't -- I don't know. It's not my area of expertise. I couldn't coin the best name for it. I assume that that's a pretty good name since it's used pretty much around the country and also by state commissions and also by the Federal Energy Regulatory Commission. That makes it good enough for me.

Q. Isn't fixed variable an oxymoron?

A. I don't know.

Q. And isn't a flat -- isn't this a flat rate?

JUDGE JONES: You've got to move on. I don't really care what it's called and I don't want to -- I don't care what it's called.

MR. FINNEGAN: Well, I'm having difficulty and I think other people are determining what to -- what to call it.

JUDGE JONES: Well, you know what it does, right?

MR. FINNEGAN: It's a flat rate, yes, I do. Okay.

JUDGE JONES: Okay. Then it doesn't matter what it's called.

MR. FINNEGAN: Okay.

BY MR. FINNEGAN:

Q. You indicated that you testified before 33 state public commissions in your direct testimony?

A. Yes.
Q. And how many LDCs have you testified on behalf of?
A. I don't know. Quite a few over the years.
Q. Have you ever testified on a consumer side?
A. You mean --
Q. In an LDC case?
A. On a consumer side?
Q. Yes.
A. No. I have testified as a Staff witness many years ago on an ad hoc basis but not on a -- for a consumer agency.
Q. How about intervenors or anyone else in these cases?
A. When you say "these cases," could you --
Q. Well, LDC cases --
A. LDC cases?
Q. -- that you've been involved in.
A. No, sir, not in LDC cases.
MR. FINNEGAN: That's all the questions.
JUDGE JONES: Thank you. Is there any other recross -- or cross or questions?
(NO RESPONSE.)

JUDGE JONES: With that, then, we'll move to redirect.
MR. SWEARENGEN: Thank you, Judge.
REDIRECT EXAMINATION BY MR. SWEARENGEN:
Q. Mr. Hanley, let me take you back to some questions that you were getting from Commissioner Clayton which I think really goes to the heart of the matter that we're discussing here this morning.
I think he asked you a question, or do you recall him asking you whether or not you had separated out or tried to separate out Missouri Gas Energy from Southern Union Company; do you recall that?
A. I do, yes, sir.
Q. And I think you went from there into a discussion about how you looked at your two proxy groups of local gas distribution companies to determine a return on equity; do you recall that?
A. Yes.
Q. And just briefly, can you summarize for the Commission, when you did that, what ROE number you came up with and then how you made adjustments to that to get to your 11.75 recommendation? Because I think the record got a little confused at that point.
A. Yes. And in responding now, I want the

record to show that I'm referring to schedule FJH 26, page 2 of 25. I ran through application of the same models as discussed in my direct testimony. Of course, this is being part of the rebuttal which is Exhibit No. 002.

As shown there, based upon the two proxy groups of companies on line 6, I arrived at a cost rate before any adjustment of 11.31 percent. I then made an upward adjustment due to Missouri Gas Energy's small size. And small size, I'm looking at the rate base as the judgment for the size because that's the risk to which we are talking about and to which the rate of return is applied. That, vis-a-vis the proxy companies, requires a minimum adjustment of 30 basis points.

I then show on line 7 B an increase of 15 basis points for protection due to vagaries of the weather. In other words, assuming that there was no protection, no weather normalization adjustment clause, no -- in other words, the current status quo were to remain an upward adjustment of 15 basis points should be in effect, and that then aggregated 11.76. And I said the recommendation would be 11.75 percent.

I then acknowledged, in the context of

surrebuttal testimony, that if a WNA were put in place, the 15 basis points would then necessarily have to go away, as they say, which would then reduce the recommendation to 11.60 percent. So that would then give the full value of 25 basis points impact to a WNA protection.

I then said, well, if the WNA goes away, but a straight fixed variable comes into place, in effect, there's not only that 25 but an additional ten basis points which would then reduce the recommendation from 11.6 down to 11.50 percent. So that's how I get there.

And then on schedule 3, I just want the record to be clear also of -- I'm sorry. Page 3 of schedule FJH 26, I provided for informational purposes only, calculations based upon proxy groups of three and six gas distribution companies. And the reason I did that is to be consistent with more current information regarding the proxy companies.

In other words, due to acquisition and merger circumstances that did not -- not exist at the time of the preparation of my direct testimony, I made similar calculations for -- the group of four became three because I excluded Cascade from that group. And then out of the larger group of eight, it went down to six because I excluded Cascade and Peoples since they are in the process of being acquired by -- well, Cascade by MDU Resources and Peoples by WPS Resources, respectively. And so I didn't think they were appropriate proxies any longer.

But I arrived at essentially the same conclusion of -- of common equity cost rate prior to adjustment for either WNA or straight fixed variable rate design as discussed.

Q. And I think you said in response to a question from Commissioner Clayton that four of those companies in your proxy group have some sort of a straight fixed variable rate design?

A. Or a revenue decoupling mechanism, yes.

Q. Okay. And so from that standpoint, should the Commission award MGE in this case that type of a rate design, they would be comparable -- those companies would be comparable to what MGE would then be; is that a fair statement?

A. Yes. That's why I don't think it would be proper to deduct, you know, without first considering the fact that they have, in large measure -- by "they," I mean the proxy group, have similar type protections. So it wouldn't be appropriate to take the whole bite of the value since the marketplace for those companies really reflects the benefit of the rate design already in place.

Q. Now, back to Commissioner Clayton's question about did you separate out MGE from Southern Union Company on the capital structure side, did you look at the same proxy group of companies to determine an appropriate capital structure for MGE as a stand-alone entity?

A. I did, yes, and that they're virtually a capital structure that I recommended falls dead, smack right -- right on where they average out to be.

Q. Okay. And I think you said also in response to a question from Commissioner Clayton that the Southern Union bond rating should not be applied to MGE. Can you say why?

A. Well, yes -- well, for basically two reasons: One, Southern Union because it is now viewed as a midstream high business risk operation, its bond rating is at the bottom of investment grade, triple B minus.

And as I believe I did say, but if not, I'll clarify, that kind of a bond rating, if it were applicable to a stand-alone gas distribution utility, would be a very precipitous place to be because one additional downgrade would drop it out of the triple B category which is the bottom of investment grade, into the BB, that's two capital B's, and that's considered by analysts and investors generally to be in the junk bond, very high-risk, speculative type of investment.

That is not a good place for a gas distribution utility to be because when capital is needed to provide proper investment for quality service to customers, it needs the ability to raise that capital at all times, even in tight capital markets. And experience shows us that in tight capital markets, it sometimes is extraordinarily difficult, always costly and sometimes impossible to raise capital when you're in the BB bond rating category.

Q. In response to a question from Commissioner Clayton, you described Southern Union Company as a midstream company. Could you define that term or tell us what you meant by that? What is a midstream company?

A. Well, I won't make my own. I'll tell you what Standard & Poor's says about it. They say, "The midstream gas industry and the United States provides an essential link between upstream producers of natural gas and the delivery of natural gas products to end user markets.

"Being in the middle of the commodity chain, the sector is characterized by cyclical operations that are subject to volatile cash flow. Midstream players suffer volatility, not only because they're exposed to input and output prices that may not be closely correlated, but also because of competition, types of contracts with customers and volatility and throughput volumes due to cyclical demand.

"As a result, companies in this sector have business profile scores ranging from seven to nine which is very high risk." And it says, "Standard & Poor's Ratings Services views the midstream natural gas sector as having high business risk."

Q. You said that Standard & Poor's has given a triple B minus rating to Southern Union Company; is that correct?

A. Yes, sir.

Q. Is that what a -- what I would call a utility bond rating or is that -- how would you respond to that?

A. Well, in this sense, no, it isn't

because now that they're categorized midstream, the Standard & Poor's financial guidelines that they use, and that I have actually, just to keep the record clear, set forth in schedule FJH 2, page 14 of 15 of Exhibit No. 001, those guidelines are not any longer applicable to Southern Union. Their own Standard & Poor's analyst that had been in contact with Staff basically specified this, that those risk profiles no longer applied.

What that means to me is that when you attempt to account for risk difference, it's okay to do it between real utilities that still fall within these guidelines, but it's really misleading to attempt to make a bond rating adjustment such as 30 basis points or something, assuming that it's the difference between the triple B utility that fits under these financial guidelines of Standard & Poor's, versus Southern Union that no longer does.

Q. The Public Counsel asked you some questions about the companies that make up your proxy group, and I think he used the term a couple of times to describe them, deregulated entities. Do you recall that?

A. Yes.

Q. Is it accurate to suggest that those

companies in your proxy group are deregulated?

A. No.

Q. And why not?

A. Well, because they are very much regulated. They're still subject to review and approval of their mechanisms, they still have the opportunity, regardless of whether they have straight fixed variable or not, although I assume it will be a lot less frequently that they'll have to apply for rate increases which is a good thing. But they're still very much under the auspices and the regulatory commissions to which they are responsible.

Q. And is the commodity that they sell still regulated?

A. Yes.

Q. Just a couple more questions. I think Mr. Thompson asked you about your -- the recent Commission decisions involving cost of capital were a zone of reasonable -- reasonableness concept was discussed. Do you recall that? He asked you if you were familiar with that.

A. I believe I said, "Oh, yes, I am."

Q. And what is your understanding of that zone of reasonableness concept that the Commission has articulated?

A. Well, I think exactly as Mr. Thompson in his opening statement indicated. It's pretty much 100 basis points around the average of recent -- recent awards. But I would note, for example, that the 9.60 percent recent award of the third quarter of 2006 to a gas distribution operation was, by the New York Public Service Commission, it's not an average at all. It was one company, Central Hudson Gas and Electric Company, to its -- to its operations.

And what's interesting to note, however, is -- and has to seriously be taken into account by this Commission, I believe, when -- if they're going to continue to look at this range, Central Hudson is under a three-year rate plan. They use a forward-looking future rate year in setting -- in setting rates. They have a revenue -- I'm sorry -- an earnings sharing mechanism, and it's important to note that no sharing or --

MR. THOMPSON: Your Honor, I'm going to object. This goes far beyond the question that was asked.

JUDGE JONES: Well, I remember during those questions he was instructed to answer his questions specifically without elaborating and that I would allow his counsel to give him an opportunity to elaborate, so I'm gonna let him do that. Your objection is overruled.

THE WITNESS: It's important to note that while the 9.6 was the specified return, no sharing of the return on equity begins until 10.6 percent. And then there's an incremental sharing between 10.6 percent and 11.6 percent that is to be shared equally between ratepayers and shareholders. And then any earnings on equity between 11.6 percent and 14 percent would be shared 65 percent to ratepayers and 35 percent to shareholders.

So without any sharing at all under this incentive mechanism not beginning before 10.6 percent, and with a future rate year, a three-year rate plan, with an automatic increase in July of 2007 and again in July of 2008, I don't think focusing only on 9.6 percent is entirely appropriate at all. And if you're going to use a return benchmark, I think the place to start with is a minimum of 10.6 percent which is where sharing begins.

BY MR. SWEARENGEN:

Q. And given that, how would you characterize where your recommendation falls with regard to the zone of reasonableness concept?

A. Well, if we look in the context of being the eternal optimist of my recommendation of 11.5, assuming the straight fixed variable is approved, we go from -- 10.6 would put it at 9.6 to 11.6, and it falls within that band, albeit, on the high side, but still within the band of reason.

Q. One last question: With regard to that 25-basis-point adjustment that you indicated was appropriate, if the Commission were to adopt the straight fixed variable rate design, Commissioner Clayton asked you if it was possible to reduce it more than 25 basis points, and what was your answer?

A. Well, I said, in effect, I've really given a recognition of 35 basis points to the straight fixed variable, and so it is more than 25. It was done incrementally, but it's important to keep in mind that it doesn't necessarily appear that way at first blush because a number of the proxy companies have such mechanism in place, and I'm really taking the difference, and so that in the aggregate we're really allowing for 35 basis points.

MR. SWEARENGEN: That's all I have. Thank you.

JUDGE JONES: Okay. And if there are no more questions for Mr. Hanley, you may step down.

THE WITNESS: Thank you, your Honor.

JUDGE JONES: At this time we're going to take a lunch break for an hour. That will put us back here at 1:40. After that, I see -- I believe Mr. Jackson has arrived. We'll take his testimony right after lunch.

MR. SWEARENGEN: And may Mr. Hanley be excused?

JUDGE JONES: Yes, he may. And also I want to bring this up. The Chairman has questions for Mr. Hack. He's not here today -- the Chairman isn't. I'm assuming Mr. Hack is here today, though?

MR. SWEARENGEN: Mr. Hack is here.

JUDGE JONES: Did he intend on leaving after today or is he going to be around?

MR. SWEARENGEN: Mr. Hack will not go anywhere without my consent.

JUDGE JONES: Well, we'll keep him around until the Commission has an opportunity to ask questions. With that we are at intermission.

(THE LUNCH RECESS WAS TAKEN.)

(EXHIBIT NO. 400 WAS MARKED FOR IDENTIFICATION BY THE COURT REPORTER.)

(EXHIBIT NOS. 200 THROUGH 206 WERE MARKED FOR IDENTIFICATION BY THE COURT REPORTER.)

JUDGE JONES: We're back on the record

with Case Number GR-2006-0422. At this time we're going to proceed with the City of Kansas City's witness, Mr. Jackson. Mr. Jackson, will you raise your right hand.

(THE WITNESS WAS SWORN.)

JUDGE JONES: Thank you. You may be seated. You may proceed, Mr. Comley.

DIRECT EXAMINATION BY MR. COMLEY:

Q. Mr. Jackson, one more time. Will you state your full name for the record, please?

A. Robert T. Jackson.

Q. Are you also the Robert T. Jackson that caused to be filed in this matter a piece of written rebuttal testimony which the reporter has marked for identification as Exhibit No. 400?

A. Yes.

Q. Mr. Jackson, if I were to ask you the questions that are contained in Exhibit 400, would your answers to the questions be the same today?

A. Yes, they would.

Q. Are there any questions -- are there any corrections to your testimony that you know of?

A. No.

MR. COMLEY: Your Honor, based upon those, I would like to admit into the record Exhibit

No. 400.

JUDGE JONES: Any objection?

(NO RESPONSE.)

JUDGE JONES: Seeing none, Exhibit 400 is admitted into the record.

(EXHIBIT NO. 400 WAS RECEIVED INTO EVIDENCE AND MADE A PART OF THE RECORD.)

MR. COMLEY: And tender the witness for cross-examination.

JUDGE JONES: All right. Missouri Gas Energy, any cross for Mr. Jackson?

MR. MITTEN: I just have a couple of questions, your Honor.

JUDGE JONES: Go right ahead.

CROSS-EXAMINATION BY MR. MITTEN:

Q. Mr. Jackson, good afternoon.

A. Good afternoon.

Q. Are you aware that the contribution that MGE currently makes to the city's weatherization program is collected from customers?

A. Yes, I am.

Q. If the Commission agrees with your recommendation and increases that amount by another quarter million dollars, would you be in favor of including that additional increment in rates as well?

A. Yes.
MR. MITTEN: Thank you. No further questions.
JUDGE JONES: Questions from the Staff of the Commission?
MR. FRANSON: Yes, sir.
CROSS-EXAMINATION BY MR. FRANSON:
Q. Mr. Jackson, my name is Robert Franson. I'm an attorney for the Staff of the Commission. Couple questions. You -- there were some questions during -- earlier in the hearing about what exactly your agency does. Besides servicing low-income folks with the weatherization program, do you have any purview over energy efficiency programs?
A. Yes.
Q. Could you elaborate on that, please?
A. Yes, I'd be glad to. The various affordable housing programs and housing strategies with regard to energy comes under the purview of the weatherization staff and the department.
There are also some other initiatives that the city has just undertaken with regard to the -- it's called the Climate Protection Plan for which the city's a signatory to the National League of Cities' Climate Protection Plan that is addressing

global warming.

And the city has just undertaken a very wide-ranging process to look at some of the things that can be done both in city buildings, residential and all other forms of energy use that can impact the climate. And I happen to chair one of four work groups which is the energy work group.

And so we're meeting to provide some direction, and it is outside the city. It includes the community at large. So we're in the process of doing those things.

Q. Okay. Have you reviewed the proposals of Mr. Hendershot in this case?

A. No, I have not.

Q. Okay. So you wouldn't be familiar with his water -- well, you aren't familiar with anything -- any energy efficiency programs proposed by MGE in this case?

A. I am aware of the residential and primarily the low income. I have not seen the other -- with regard to water, I will say that we are working with the city's water services department to look at water efficiency, and certainly with the funds from the weatherization program, certainly there is some positive impact on the program with regard to the replacement of hot water tanks and dealing with the water leaks in the residential structures.

Q. Okay. Let's say that the Commission approves the programs proposed by MGE. And I know your understanding is just general, but would you be willing to participate in a collaborative with Staff and MGE and maybe the Office of Public Counsel to develop the details of a program that the Commission might approve for energy efficiency?

A. Yes.

MR. FRANSON: I don't believe I have any further questions, your Honor.

JUDGE JONES: Thank you. Any questions from the Office of Public Counsel?

MR. POSTON: No, thank you.

JUDGE JONES: Midwest Gas Users Association?

MR. CONRAD: No.

JUDGE JONES: Does anyone else have any questions for cross?

(NO RESPONSE.)

JUDGE JONES: Do you have any questions for Mr. Jackson?

COMMISSIONER CLAYTON: I do.

JUDGE JONES: It's your turn.
COMMISSIONER CLAYTON: Glad I got here now.
QUESTIONS BY COMMISSIONER CLAYTON:
Q. Mr. Jackson, he would have cut you loose if I hadn't walked in that door.
A. Yes, sir.
Q. Nice to see you again.
A. Same here. Thank you.
Q. Mr. Jackson, I apologize for being repetitive and I apologize for walking in late here. Could you just summarize your position or your interest in the case for me?
A. I represent the City of Kansas City with regard to residential energy efficiency activities.
Q. Is it just energy efficiency issues? Does it relate to conservation issues, weatherization, anything like that?
A. Yes. Some of this has just evolved over the last three months. We -- the city has just undertaken a global climate change protection plan of which I chair one of the work groups. We're looking at some wide-ranging impacts of which energy efficiency is a proponent part of that process.
Q. This is the mayor's appointed task

force; is that correct?
A. That's correct.
Q. And the task force includes how many people, would you estimate?
A. It's -- it's approximately 80 people and it is not, you know, just city officials but includes the city council and many -- much of the private sector.
Q. So it includes government and private sector. Who else is on it? I think it's got a pretty broad assortment of members, the group?
A. That's correct, Commissioner.
Q. Okay. And the focus is on -- is it everything relating to energy?
A. No. It goes significantly beyond that. Energy is just a small part of it, but anything that can have any impact on the -- on the concept of global -- global warming, water conservation, dealing with water run-off, you know, using, you know, rain.
You know, just -- I guess -- I wasn't prepared for this, but it is quite wide-ranging. And really, what has occurred recently, there is an ambitious schedule to have a report out in April even though we just started in November. So it's kind of pushing everyone to do -- to digest quite a bit of

information to come up with some recommendations.

I also say that we're also participating in the mayor's Million Lights Program, and one of the unique aspects of it is that weatherization program has now mandated the change-out of incandescents to compact fluorescents and requiring the contractors to report the number of bulbs or wattages saved and provide a report that we'll be providing to the task force in the city from this point forward. That was started two weeks ago.

Q. That's part of the weatherization program?

A. That is part of the weatherization program, sir.

Q. But that has nothing to do with weatherization?

A. Yes, it does have to do with weatherization. It has to do with the amount of energy that's being used, it has to do with cooling. So we have just made that an integral part of the program, and it is an eligible Federal Department of Energy measure.

Q. And that's the Million Lights Program that you're referencing?

A. We are tapping into it. We don't run

the million lights but we're actually using the weatherization program to help support that.

Q. Well, how many programs are there? Because I keep -- I ask one question and I get -- it ends up being connected with something else. So just to be organized, we have the governor's -- the mayor's task force; what is the name of that?

A. That is the climate protection work group, and I probably don't have the exact name.

Q. That's okay. You've also referenced the Million Lights Program?

A. Which is an integral part of that process. In other words, they've just pulled them in under an umbrella and used the Climate Protection Plan as an umbrella for all of those initiatives.

Q. Okay. And these are, I suppose, in addition to your duties that existed prior to the creation of the climate protection work group; is that correct?

A. That's correct, Commissioner.

Q. Now, your day job, which was before the appointment of this task force, is what?

A. It is being responsible for the weatherization program and making recommendations on the energy efficiency component of the affordable housing programs in Kansas City.

Q. Do you also participate in the distribution or oversight of LIHEAP funds or Utilicare or any other government funds associated with energy affordability?

A. No, I don't. We would like to and we'd like to coordinate that vis-a-vis the recommendations of the governor's energy task force but we haven't seen any, you know, results -- any action on that effort.

Q. Okay. Okay. Today, in current rates, tell me what MGE is doing with regard to weatherization, energy efficiency, any low-income programs that are ongoing right now.

A. With regard to the city, MGE provides the city with $367,000 of ratepayer funds to weatherize the MGE customer base that is eligible. We've been administering those funds for quite a few years.

That program is operated pursuant to the Federal Department of Energy weatherization criteria which provide -- gives us the opportunity to network those funds with other programs that we have weatherization funds for so that we don't walk away from the very large homes that have significant needs.

Q. Is -- does that DOE program have any money that goes with it?

A. Yes, it does, but a number of the funding sources we have, have varying income eligibility guidelines, and so sometimes they coalesce to where the -- one property could benefit from multiple funds, other times they do not.

Q. Now, those programs just relate to weatherization; is that correct?

A. That's correct.

Q. All right. And the $367,000, is that -- how many years would you say that amount -- that program has been funded at that level?

A. Well, MGE was probably the first utility in the state to make permanent -- I mean, to initiate a wealth-funded weatherization program back in the early '90s. That has grown as everyone has been satisfied with the program operation.

So I would say the $367,000 figure is probably a couple of years old. It went up, I think, 117,000 from the 250 we were getting a couple of years ago. So that's been somewhat the progression of it.

Q. Okay. Are you asking for any additional

funds --
A. Yes.
Q. -- for weatherization, weatherization only?
A. Yes.
Q. And what is that funding amount?
A. $250,000.
Q. An additional 250?
A. That's correct.
Q. Is there anything magical about that 250,000? Is it attached to a federal program or a matching program, anything like that?
A. No, Commissioner, it isn't. It is really the result of demand for the program. And our experience, as we progressed, we spend the funds down a little earlier each year. So we're just trying to -- in our capacity we're trying to match all of those factors.
Q. Okay. Are you asking for additional money beyond the 367 plus the 250?
A. No, we're not.
Q. Okay. I read through some of the testimony. I think -- is it MGE has suggested an additional amount to do an evaluation of weatherization programs? Are you familiar with that?

A. Yes, I am.
Q. Are you supportive of that program?
A. Yes, I am.
Q. What is your understanding of how those funds would be spent and how the evaluation would be conducted?
A. If it's the -- my recollection is that I believe that MGE would be coordinating that with Kansas City Power & Light to -- for a joint weather, you know, evaluation process since they just had their rate case approved.
And beyond that, I know that a portion of the funds that -- that it was recommended for the increase would be based on the same percentages that the funds are distributed to the weatherization network for MGE's customer base.
Q. Okay. How many customers per year do you serve under current funding?
A. Presently between 200 and 300.
Q. And is there a range of how much money would be spent per customer?
A. That range is evolving because we locked in a range many years ago, and that range has yet to keep up with the changes in technology and the increasing energy conservation measures that we

provide. And we're talking with MGE staff on seeing how that can be adjusted.

But the -- the tariff somewhat limits the range to an average of $1,700 which is significantly below what it really takes if we have only a single fund source to do the work. In essence, we have a choice of not doing all the work or eliminating some homes from the program, and that's kind of the dilemma we're facing.

Q. So it's an average of 1,700 per person?

A. That's correct.

Q. And those funds are only spent on weatherization, not spent on energy efficiency or other conservation programs; is that correct?

A. Well, weatherization and energy efficiency is an interchangeable term.

Q. Well, see, I keep -- I keep saying weatherization and you come back and say energy efficiency. You said that -- starting off, that you're director of energy efficiency programs which is different than what I thought you were originally.

A. Okay.

Q. So explain to me what is going on today in terms of how you spend the money. I mean, is it just putting up -- putting in windows that are --

that will save heating costs, or is it also putting in furnaces that are Energy Star-rated? Explain to me how you spend these funds.

A. Right. The program will only install cost-effective measures. And what happens is, you go out and make an assessment of each property. And from there, we use a computer simulation that has been provided by the Department of Energy that will tell us whether the measures that are being proposed are cost-effective or not.

If they're not cost-effective, we remove them from the specifications or for consideration. So any measure that we install from any fund source has to have a savings-to-investment ratio that exceeds a figure of one, meaning that at a minimum it pays for itself once. And most often, it pays for itself significantly above the minimum of one.

The measures can include anything from replacing furnaces, hot water tanks, putting in insulation. We do very few window replacements. The wholesale changing of windows on low-income properties do not have a good savings-to-investment ratio as such. So it is very seldom that we will put in a whole window. We will repair windows and tighten those windows up as opposed to replacing them.

Q. It's just cost-prohibitive to start changing out windows; is that what you're saying?

A. Well, they don't pay for themselves within a reasonable period of time for the cost of installing them in existing homes. Now, certainly, that's something that could be done differently in new construction if it were to be considered.

Q. Is that because windows cost so much more, or is it because the impact is less than what insulation or what a water heater would be?

A. Well, the impact -- well, it's both.

Q. Okay.

A. It is both the impact and the cost.

Q. Okay. What type of education, if any, do you provide beyond adding a new appliance or doing the labor? What else do you do?

A. Well, the process on an energy audit is to sit down with the applicant and ask them what their experiences are, where they find most of the problems, how they're feeling, you know. They can just anecdotally tell us some things or point out specific needs.

After we make the assessment, the energy auditor will then give them some insight as to what we're going to do, then the installers are obligated to explain how to take care of most of their measures and so forth.

As we go through the home with the applicant, we point out things that they personally can do to have a positive impact on the measures that we're proposing. Sometimes we even walk away from the property based on structural conditions that don't permit us to do any work, but we -- at a minimum, we tell them things that they can still do to save some energy.

Often, we find, let's say, furniture blocking a return air vent or a supply vent because that's simply the way they placed the furniture and it's not getting heat. We often have to tell them to take care of the -- or change the proverbial filter that is probably thicker than an overcoat with dirt and so forth, that it causes the systems to overheat and we end up replacing motors and so forth. So it is a site-specific educational process as we interact with the public and the client there.

Q. Is it possible for you-all to quantify the savings and -- or efficiencies that come out of both communication, education as well as the actual installation of new hardware?

A. It's a challenge. We ran a program with -- that was funded by the Department of Natural Resources about 15 years ago called the CUBS program. It was called cutting utility bills. And we embarked upon a real ambitious process of engaging the applicant through the form of a real simplistic contract to provide a -- to raise their consciousness of things that they could do to save energy.

The problem was -- and it was structured that we would show them a video on the front end just to show them some things that they could do and gain their interest, and then approximately nine months after the weatherization measures installed -- were installed, we were to go back and make an assessment and see whether they had kept their part of the contract.

To be -- to put it mildly, it was a nightmare. One is, low income-people particularly are simply trying to survive, and when they have to stop, they cannot earn income. They don't know if they have to leave the job and they're in a very vulnerable position, you know. They have little incentive to keep coming back to listen to us.

And between that exercise and demands on them, and I hate to be a little sarcastic and say trying to get them to turn Jerry Springer off while we're talking to them, we weren't very successful. I mean, it was unbelievably difficult when we really tried to implore them to let us come and see what they'd done, how we could work with them.

So I don't want to label Missouri, but our experience with that -- and that was a very ambitious program of $100,000 invested to do that. I have read a lot of studies elsewhere that show that indeed energy education has an average of 4 to 5 percent savings -- additional savings besides the passive measures the program installs.

Q. But you weren't able to quantify that in your follow-up program?

A. No. We actually wasted a lot of staff time trying to convince, you know, them to let us come out and let us visit with them. We even tried doing telephone follow-up and it just wasn't working.

Q. This was -- so this is the only program that would provide some follow-up to both evaluate whether the customer was following through with energy efficiency programs or conservation or improved operation of equipment, or simply reviewing bills. This is the only time you-all would do that type of follow-up?

A. Well, no, we sometimes have a unique request. Sometimes a real -- you know, a customer that really has an interest and just has some sense of what's going on will call and we'll do some follow-up and provide them feedback and coordinate with the utility company so they can get a good weather-normalized analysis of their consumption.

Q. Was the -- the problem with the DNR program, the problem was that the parties weren't willing to cooperate in the follow-up or was it that they weren't following through with the commitments that they supposedly made, or was it just a complete lack of interest?

A. I think it was a little of both. Primarily, you can't even determine what it is they didn't do if you can't even get them to agree to sit down with you or give you the time of day. Most people, when they get what they need, that's it for them.

They're gone on to trying to figure out how they're going to take care of their next financial challenge or health challenge or something. And you know, not to disparage them, but they're just trying to survive and that was really my sense of it.

Q. Is the DNR program -- was that a

one-time program, the CUBS program, or is that something that is ongoing?

A. It was a one-time program just to determine whether we could do precisely, you know, quantify, qualify and determine the best strategies and methods. I can say that many persons -- many of my peers in the network still have a form of education because we all discuss it when we get together. The quantification of it is definitely lacking.

Q. Okay. If -- what happens if a customer calls your office that doesn't meet -- maybe I should ask the question this way: Do you have income guidelines on the people that can receive assistance from your office?

A. Yes, we do.

Q. If someone who is outside of those guidelines called up seeking information for energy efficiency or conservation or weatherization, do you-all have a plan or a program in place to assist them or are they turned away?

A. We have a program to assist them to the extent that they want to take advantage of it. We call it the fee-for-service program. If you're interested, I'll quickly explain that.

Q. Sure, please do.
A. The fee-for-service program, the applicant can simply pay the city its cost without profit for us to go out and use the skills we've honed over the years of the Low-Income Weatherization Program, pay our cost. We will use our same network and technical staff to provide them the same information.
They will pay -- we will put it out for bid as we do under the low-income program to protect their interest. We would do the pre and the post energy analysis with the diagnostic equipment to ensure that the outcomes that were expected are achieved.
And from there, the applicant will pay the contractor directly. And they will pay us on the front end and we'll collect that, we'll go out and do what we normally do, and then we'll do the post inspection and the contractors in our program agree to provide the same warranty that they do under the -- with the low-income program.
Q. I'd kind of like to just walk through that real quick. If a customer is outside the income guidelines, they call up and ask for help on, let's say, a broad array of issues. You-all, for a fee,

will provide the energy audit?

A. Yes.

Q. And then you-all will provide some sort of plan that would reduce their consumption?

A. It is the identical program we would use for the Low-Income Weatherization Program, the same computer analysis, same bid, competitive bid process, review the product with the owner.

The distinction here is that some owners may choose not to take our recommendations and we have them recognize that they're risking the interactive relationship with the measures we recommend and that they may not have the outcomes that they desire. Under the weather -- the low-income program, the customer doesn't have a choice; they're gonna either get the best product we can give or nothing.

Q. Okay. So a person who's paying their own way can choose the contractor, they can choose where they buy an appliance, they can choose who does particular work for them?

A. They can. We recommend they use the contractors that we have certified and trained in the program, but they're certainly free to use someone else.

Q. All right. Once they take that action, then -- then you-all will do follow-up after the fact?

A. We will do the same thing we do under the low-income program, whereas, we will go back with another set of diagnostic equipment and make a contrast between the pre and the post and make sure that the objectives are achieved, and at that point we advise them to pay the contractor.

Q. Does the -- does the price or the fee vary from customer to customer if you're paying -- paying as you go?

A. Not really. You know, what can drive it is, you know, most people paying their own way have a little bit more say-so and a little more vocal, and a smart businessman will look at the surroundings, you know, determine whether it's worth it to them to push it up a little maybe. But one of the -- the best part of it is the competitive process has always tended to keep costs down. We bid 100 percent of all the jobs, period. So anything --

Q. Okay. How much -- how much would a -- would a fee-for-service customer pay for the whole spectrum of service?

A. On average between 2,500 and $3,500.

Q. Is that including the amounts that they're gonna pay to the contractor or does that just go into the City of Kansas City?
A. That's everything including the city's fee and the contractor's cost.
Q. How much does the city out of that range actually take?
A. For the fee-for-service, from the pre, the post and a certification if they want an Energy Star rating, the cost would be $525.
Q. So that would -- the 525 going to the city would include the prework, the audit, all the way out to the post follow-up --
A. That's correct.
Q. -- effort and that would cost $525?
A. That's correct.
Q. The additional monies of between two and $3,000 would go to pay a contractor or the actual hardware going into a house or...
A. We just simply call that material and labor.
Q. Material and labor?
A. Yes.
Q. That's obviously much better than the way I'm saying it. Okay. How many people per year

do you get that are fee-for-service program customers?

A. Very few where -- we don't promote it mainly because our mainstay is the low-income program obviously. We probably get anywhere between eight and 12.

Q. Eight and 12; that's it?

A. That's all. That's it.

Q. How many employees do you have in your division?

A. I have four energy auditors, one field supervisor and myself.

Q. Now, in developing this program -- and I say the program regardless of a customer's income. In developing this program, did you write it? Did a task force write it? How much study went into developing it? Would you say it's one of a kind in the region? Describe to me how it came about and how you think it ranks in comparison to other programs.

A. First of all, the program evolved based on the 1977 oil embargo. I mean, that is the genesis of weatherization in general. Weatherization evolved from a prescriptive cookbook approach that just assumed everything was the same with some artificial limits. And those artificial limits at one point said that you couldn't spend more than $50 on a house. Well, that's the way it started. I'm just...

Obviously, we've come a long way since then. It also makes some assumptions that you could take people off the street under the CETA program, Concentrated Employment Training Act, which is one of the work programs that took people off the street. It was horrible.

From there, technology began to direct what was done. You had to use -- have some justification for what you did. And a number of studies showed what was -- what were cost-effective measures and what weren't. Obviously, the ones that weren't were tossed.

And the program continued to evolve, and presently the department -- the State Department of Natural Resources who is funded primarily by the U.S. Department of Energy, has a prescriptive process that's based on diagnostic tools that say these are good measures under specific circumstances and that's what guides what we do.

From there, we simply, you know, enhanced what we do in Kansas City with at one point significant city funds that allowed us to experiment on a number of processes that worked and so forth.

Having a good trained contracting force of which Kansas City has about 20 contractors.

Our capacity to do the work to satisfy the public and assure ourselves of savings has been enhanced, and when you asked -- I think in the latter part of your question to me, as to how it compares, the program has been recognized on a number of fronts including by the National DOE Weatherization Directors out of DC. We've gotten a number of awards and recognitions and so forth and continue to do that.

And we find that most of the customers we assist are more than pleased and we get -- we actually run an evaluation on every customer that evaluates the staff, the auditor, the contractor and the inspector and ask for comments. We categorize those, and we certainly can provide that kind of feedback from them. That's their feedback.

Sometimes you have a complaint. And anyone that says they have construction-related work without a complaint is not constructing anything. So by and large on a percentage basis, we're more than pleased with the public's acceptance of what we deliver.

Q. Would you agree that a lot of things

have changed since 1977 as it relates to energy efficiency and conservation?

A. Well, I can only say now I can hold my head up because what I saw back then I wouldn't want anyone to know that I was a part of it.

Q. Do you believe if you had additional funding, could you -- would you-all be providing different services aside from more people that you serve? Is there more that you could do in the overall efficiency/conservation/weatherization arena for a customer or can you do everything that they would need in this area?

A. It would be a little foolish to say you have all you need in a public setting like this. I will say that we are really giving some consideration to going a little more globally and looking in some other areas.

We want to work closer with the building trades, and we're also talking about having some greater modifications to the building codes because I think now that people have become educated and can understand the relationship to not on what we do in the comfort but what one spends their money for.

But we know that this has a significant impact on climate change. So on that basis, we are continuing to expand what we do. There's a lot of training and required certifications that the state is now requiring, and we simply want to make sure that at least in Kansas City every avenue to have a positive, measurable impact is being considered as we go forward.

Q. Do you -- do you study what other cities are doing?

A. Yes.

Q. Is there any other city that you would look to and say I wish we could do what they're doing?

A. Oh, I'd go better than that. I would go for any state and any -- and most of the states, including the seven that touch any portions of Missouri, are significantly ahead of Missouri when it comes to responsible use of public money, particularly to help low-income customers.

You know, everyone's heard it before, but I'm gonna continue to say it until there's a change in this state: Missouri is one of four states in this nation that doesn't use some of its public money to pay a few bills to use that same money to prevent a few bills.

And for some odd reason, every task

force, every study has supported what is called a transfer of the use of those public funds to prevent the need, and we still won't do it and we have no public policy that requires an in-depth coordination between the use of money to pay bills and a program to prevent those bills in the first place. I don't know of any state that is as far behind as this state.

Q. That wasn't the answer I was anticipating.

A. I'm sorry.

Q. I was impressed -- I was impressed with what you-all are doing in Kansas City getting this full evaluation, and then you turn around and say but even still, we're still near the bottom in what needs to be done.

A. Well, I tell the truth even if it impacts me. I would go so far, Commissioner, to say that if what I did is proven not to be of value, I'd be the first to say we shouldn't do it.

Q. You said we're one of four states that spends money to, what, pay for bills rather than prevent the bills; is that what you said?

A. I said we're one of four states that don't use a portion of the bill payment funds to prevent the bill or to minimize the need for assistance. It's kind of like long-term or systemic welfare. In other words, if you don't pay a bill under certain circumstances, you can get help; if your bill is current, you're not eligible for help.

Q. Can I summarize that by saying we're not doing enough to make the bills affordable in the first place as opposed to just going back and paying back -- paying off bad debt; is that you're saying?

A. Yes, and if you could erase what I said, I'll take that instead.

Q. Okay. Okay. So would your office have the tools, if you had the money, to -- at least with regard to Kansas City, take the -- take steps necessary -- do you-all have the resources, skills, education, training, to make a significant dent in Missouri's being at the bottom of the list? I mean, is there -- is -- do we just need to devote more money and if so, does it go to you or does it go to someone else, does it go to DNR?

A. Well, what I'm advocating is a change in public policy so that the full net worth across this state can do that. No, Kansas City will really not do any more than the three county areas that we're targeted. We're not looking to go elsewhere. We're simply looking to have a public policy that provides the Missourians the best outcome of resources as possible.

Q. I understand what you're saying in terms of changing public policy, and for today's purposes I'm limited in, you know, what we -- what I can do, what this Commission could do in regard to these subjects. So I'm focusing on Kansas City MGE service territory and the work that you do in your office.

Tell me what would need to happen in the -- in the world of Kansas City that would -- that needs to move us to where you think it needs to be.

A. Well, the $250,000 in additional funds we asked for, as I said earlier, are based on what our present capacity is and what impact we can have on the people that are trying to afford their bills.

Certainly, a year from now, two years from now, five years from now, that figure would change, but I don't believe in asking for where we -- you know, asking for what we can't digest and make sure it's a maximum benefit to the customer.

And so our thought is to say that we can continue this process. There's -- there will always be new customers that can't pay and probably those that are near poor that as the cost of energy goes up, they fall into a category that we can assist.

At the same time, we're looking on, you know, doing the things that we do in Kansas City to minimize that consumption, both with utility funds and nonutility funds and to hopefully impact building practices that in the long run will result in lower consumption. Hopefully, that will result in customers that can't afford the energy being able to afford it and pay for it on time. So that's our go-forward process.

So we think that we've made -- used all the tools that are out there within a reasonable sense. The city, from time to time, contributes general fund money to support this effort outside of any rate case or anything, so I think the city's commitment speaks volumes for where it is in the fact it's supported this program for over 20-some odd years.

Q. Okay. What state or city would you look to as that shining example that I asked earlier?

A. The state would be Ohio.

Q. For conservation, weatherization, energy efficiency --

A. That's correct.

Q. -- the programs that they do? And when you -- when you use Ohio as an example, does that include programs for -- for people outside of the low-income guidelines?

A. Yes.

Q. Do you know what they do with regard to people who are -- who earn more than the low-income guidelines who seek out assistance for energy efficiency?

A. They have a number of rating programs, the Energy Star program and various things to rate residential property. They have a good network of dedicated funds, by the way, both from the public sector and the private sector, and it is well coordinated on a -- on a broad-scale basis so that there is, you know, a good understanding of the technology transfer to a single source. I do know that some of the utilities in Ohio are deregulated, so we may not be, you know, comparing 100 percent apples to apples.

Q. Is there a way to quantify in terms of dollar the level of investment necessary to make a positive impact on both the low-income side and the non-low-income side?

A. Just at this point that's somewhat beyond me, Commissioner.

Q. Okay. Okay. Mr. Jackson, lastly, what do you think -- are there -- what else do you believe this Commission should be doing or reviewing with regard to energy efficiency and conservation matters? I know you've suggested this -- the $250,000. Is there anything else in terms of policy that this Commission should be considering, whether it be a rulemaking, whether it's in this case or general policy within our jurisdiction and our authority?

A. Commissioner, what I would like to see is a coordination and a capacity for the utilities to share more ratepayer -- low-income ratepayer information outside of the companies so that we can have an assured coordination of the utility customer that can mostly benefit from these programs. Right now it's pretty much ad hoc and all you can do is suggest.

I would like to see long term which, I believe there are some states that may do this, but I don't want you to hold me to that, because I haven't done my homework, but I think that a customer that owes a utility money, that consistently owes them money and is simply being directed to go get another pot of money rather than to be mandated to take advantage of a program that's going to give them ultimate benefit, that is a radical change but I think it is a responsible change.

I think if we continue to say let's go over here and get some of that free money but not do anything to, you know, stop the hemorrhage of the free money, it's just irresponsible. And I'd like to see that type of a consideration.

So, for instance, Kansas City -- and let me just first of all preface what I'm saying, that the utilities in Kansas City are most cooperative. I don't want to suggest that there is no cooperation. But sometimes I think that we need a capacity to coordinate the people that can't pay to resources that will reduce the frequency of can't pay, and we don't have that.

So I know there's a confidentiality-of-information barrier. I do know that there are memorandums of understanding and other instruments that can be used to provide those relationships for people that have the same objectives for the customer, and I think the long-term benefit would be more public money to go around and ultimately less public money needed to do the same thing year in and year out.

Q. Mr. Jackson, do you take a position at all in this case regarding the proposed rate design that would go to a fixed rate without volumetric rates? Do you have any position or knowledge of that?

A. No, sir, I don't take a position on that at all.

Q. Do you -- does it -- do you believe that if we were to do that, that you would get more assistance from the utility since their revenues wouldn't be based on usage?

A. I don't have a definite understanding of that so I wouldn't be able to comment on it.

Q. Okay. Okay. How many more customers would you be able to serve with that $250,000 in additional funds?

A. I would say around between 100 and 150.

Q. And how many customers per year do you think your office identifies that would be eligible for assistance in total? If you're currently serving between 200, 300 people, you'd be able to serve another 100 to 150, and since you probably can't overnight identify folks, they need to contact you and go through the process, how many per year do you think you could identify that need assistance?

A. Well, if -- if we coordinated all the resources, I am more than comfortable that we'd be looking at 800 to 1,000 that we would talk to. Now, let me just make sure it's clear that you have people that apply that just walk away, they won't follow through. You have a few homes that have such a state of deferred maintenance that it's not wise to spend money, and we do walk away from those as a matter of defined policy.

So to the extent that some of these folks, you get in their homes and you give them information even if you don't weatherize them or you direct them to some resources they weren't aware of, that gives us some degree of comfort. We may not weatherize 1,000 households, but we could easily be in 1,000 households.

As far as the additional homes that we could weatherize with additional funds, again, it depends on whether that is a one-time injection of funds or whether we can project it as long-term, then you'd make the resources available, assuming that -- assuring that the measures installed are still cost-effective because that is the driver for whatever we do on any of the homes.

Q. Without -- without naming any names or specifics, I don't -- I'm not asking for that, but for the people who have completed your program in that group, could you identify, not specifically here today, this is a yes or no question, are you able to identify folks that -- that were in the category of having large, unpaid bills or going in arrears year after year, that you've been able to assist where now the bills are affordable and they're able to make better progress in making those payments, have the impact that you mentioned earlier?

A. We have some. We even have some that when we have various forms of awards or publicity, they do give us permission and they will -- some of them are actually willing to go on camera, they are very enthused.

And I say that the utility and their staff would probably be a good resource to do some tracking on that. I don't know to what extent they could do it, but I think that would be a good resource. And all you do is look at, you know, just what you said, what was the problem in the past and where are they now.

And I'll also call your attention to an informal analysis that the Department of Natural Resources did as a part of the governor's energy task force where they took a couple of years of data on clients that had received LIHEAP which is the fuel bill payment and tracked them to see what their future use was, and they saw an over 60 percent reduction or elimination in need. So I believe that's more than, you know, just a thought, but a fact that the program does have that type of a positive impact.

Q. Which -- was that Governor Blunt's energy task force?

A. That's correct.

Q. Okay. And that would have been the report that would have been issued, I guess, in the last year?

A. It would have been, I believe, in August of 2006.

COMMISSIONER CLAYTON: August of 2006. Mr. Jackson, thank you very much. Been very informative.

JUDGE JONES: Commissioner Murray?

COMMISSIONER MURRAY: I don't have any questions, thank you.

QUESTIONS BY JUDGE JONES:

Q. I just have a couple of questions. You're proposing that MGE modify its internal referring procedures so that those eligible customers are referred directly to the city?

A. Well, not exactly. I was really proposing that there be a better coordination and kind of a little pressure put on them. If you're gonna work out an agreement, you might as well work out an agreement that not only delays what they pay but pretty much requires them to take advantage of something that's going to reduce that same problem in the future.

So you know, the mechanics of it, I think is doable. I know it's somewhat of a radical enforcement concept, but I think it is a responsible concept and I think the net effect would be positive.

So I don't have the mechanics worked out, but if that was something that made good sense and MGE was willing to consider it, even if we did it on a pilot basis, I think it's worthy of review.

JUDGE JONES: Okay. Do we have any recross? Staff? MGE?

MR. FRANSON: Actually I do, Judge.

JUDGE JONES: Let me start with MGE, first. MGE, do you have any recross?

MR. MITTEN: No, your Honor.

JUDGE JONES: Okay. Staff?

MR. FRANSON: Thank you, your Honor.

RECROSS-EXAMINATION BY MR. FRANSON:

Q. Mr. Jackson, you've used the term public funds. What public funds does -- specifically maybe LIHEAP comes to mind. Is there -- what are you referring to when you talk about public funds?

A. Precisely the LIHEAP funds, those are public funds, right.

Q. Anything else that you have available that is -- whether it's for weatherization or any of your other programs which might have --

A. Yes, Commissioner Clayton mentioned which is a consideration we hope to see it fund would be the Utilicare funds.

Q. And Utilicare and LIHEAP, is that pretty much it?

A. That's it.

MR. FRANSON: Thank you.

JUDGE JONES: Any questions from Office of Public Counsel?

MR. POSTON: No, thank you.

JUDGE JONES: Midwest Gas Users Association?

MR. CONRAD: No, sir.

JUDGE JONES: Does anyone else have any questions?

(NO RESPONSE.)

JUDGE JONES: Any redirect?

REDIRECT EXAMINATION BY MR. COMLEY:

Q. To clarify the public funds idea, it's true, isn't it, that the city also teams up with Department of Energy through the Missouri Department of Natural Resources for some sort of funding in terms of low energy -- low-income weatherization; is that correct?

A. That is correct.

Q. Would that be part of the public funds you're referring to as well or not?

A. No.

Q. Okay.

A. No. Precisely the fuel assistance payment funds which the Utilicare and LIHEAP appears.

MR. COMLEY: I was confused. I have no other questions.

JUDGE JONES: Okay. With that, then, you are excused, Mr. Jackson. Thank you for your testimony. Now we'll move on to MGE's next witness.

MR. COMLEY: Before that, I want to thank the parties again for allowing Mr. Jackson to appear and testify today. Thank you very much. And the Commission too.

MR. SWEARENGEN: We would call Mr. Noack at this time.

JUDGE JONES: Mr. Noack, will you approach the witness stand?

(THE WITNESS WAS SWORN.)

JUDGE JONES: Thank you, sir. Your witness, Counsel.

MR. SWEARENGEN: Thank you, your Honor. And I will just state for the Commission that Mr. Noack has several pieces of testimony, but he touches on the cost of capital at issue in his surrebuttal testimony which is Exhibit No. 7, and that's the purpose we're putting him on the witness stand this afternoon, in connection with that.

DIRECT EXAMINATION BY MR. SWEARENGEN:

Q. So would you state your name for the record, please?

A. It's Michael Noack, N-o-a-c-k.

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

A. I'm employed by Missouri Gas Energy as a director of pricing and regulatory affairs.

Q. Did you cause to be prepared for purposes of this case certain surrebuttal testimony in question and answer form?

A. I did.
Q. And is it your understanding that that surrebuttal testimony has been marked for identification as Exhibit 7?
A. Yes, it is.
Q. And do you have that testimony with you this afternoon?
A. I do.
Q. Are there any changes that you need to make with regard to that testimony? And I'm talking about the entire exhibit at this point.
A. No, I do not believe so.
Q. Now, it's your understanding that the issue you're on the stand for this afternoon is cost of capital; is that right?
A. Yes.
Q. And where in your surrebuttal testimony do you discuss that issue?
A. At the bottom of page 2 beginning at line 15 and stretching over to the bottom of page 4.
Q. Thank you. If I asked you the questions that are contained in Exhibit 7 in its entirety, would your answers this afternoon under oath be the same?
A. Yes, they would.
Q. And would those answers be true and

correct to the best of your knowledge, information and belief?

A. Yes, they would.

MR. SWEARENGEN: Thank you. I will offer the exhibit at this time just for the record, understanding that he'll have to retake the stand later in the proceeding to undergo cross on the other issues that are covered. So I wouldn't anticipate that you would rule on that now necessarily, but I would offer into evidence Exhibit 7 and tender the witness for cross-examination.

JUDGE JONES: Any objection?

MR. THOMPSON: No objection.

JUDGE JONES: Exhibit 7 is admitted into the record.

(EXHIBIT NO. 7 WAS RECEIVED INTO EVIDENCE AND MADE A PART OF THE RECORD.)

JUDGE JONES: We now have cross-examination from Staff.

MR. THOMPSON: Thank you, your Honor.

CROSS-EXAMINATION BY MR. THOMPSON:

Q. You also caused to be prepared and filed true-up testimony; isn't that correct?

A. That's correct.

Q. And do you recall how that testimony has been designated? In other words, what exhibit number it has been assigned?

A. No, I don't know what exhibit number it is.

Q. You don't know?

A. It's probably Exhibit 8 would be the next number in line if we're consecutive.

Q. Do you have that testimony with you?

A. No, I do not.

MR. THOMPSON: May I approach, your Honor?

JUDGE JONES: Yes, you may.

BY MR. THOMPSON:

Q. I'm gonna show you page 5 of your true-up testimony, sir, and direct your attention to the bottom of the page. It's correct, is it not, that in that paragraph you suggest that if the Commission does not use the hypothetical capital structure sponsored by Mr. Hanley, that they should, instead, use the actual capital structure of Southern Union Company as of October 31st, 2006; isn't that correct?

A. That's correct.

Q. In fact, that capital structure is described in the true-up testimony Mr. David Murray,

is it not?
A. I believe it is, yes.
Q. Thank you. Now, Mr. Noack, you produced a figure, did you not, as to the revenue shortfall experienced by Missouri Gas Energy for the true-up year -- excuse me -- the test year?
A. Well, I've got probably three. I've got the initial filing, an updated filing which went through known and measurable changes through June 30 and then finally the true-up.
Q. And do you recall what the true-up figure was?
A. I believe it was 40 million 102, I think.
Q. And if you are able to, sir, I wonder if you could tell me how much of that deficiency would be erased if Staff's proposed rate design were in effect?
A. How much of that deficiency would be erased?
Q. That's correct.
A. The only part there that I mentioned in the testimony would be approximately $1 million, taking into consideration a reduction of 25 basis points in Mr. Hanley's recommended return on equity.
Q. So it is your testimony that the only

value to Missouri Gas Energy of Staff's proposed rate design is $1 million?
A. It is on -- to the effect of Mr. Hanley's return on equity recommendation, that is $1 million, yes.
Q. What about revenue shortfall?
A. Well, there would be -- we wouldn't suffer the revenue shortfall for the residential class like we have in the past.
Q. And what has that shortfall been?
A. For the first few months of 2006 it was $15 million.
Q. Would you expect it to be similar for the last six months of 2006?
A. I think it would -- maybe not the same because we have summer months in there, so it wouldn't be as bad. But December was -- was quite warm, November, I believe, was pretty mild also. So I would expect to see some significant shortfalls also there.
Q. So in a ball park for the year, then, of 20 to $25 million?
A. Possibly.
Q. Now, that shortfall would be erased, would it not, if Staff's proposed rate design were

adopted?

A. A good portion of that shortfall would be erased. Not all of it, because we're only asking for the straight fixed variable on the residential class. So as it relates to weather risk, it would be there for the small commercial class, it would be there for all the other customers except for the residential customers.

MR. THOMPSON: Thank you. No further questions.

JUDGE JONES: Any cross-examination from the Office of Public Counsel?

MR. POSTON: No, thank you.

JUDGE JONES: I see City of Kansas City has left. Any cross from Midwest Gas Users Association?

MR. CONRAD: No, your Honor.

JUDGE JONES: Anyone else have any cross?

MR. FINNEGAN: No, your Honor.

JUDGE JONES: Commissioner Murray, do you have questions?

COMMISSIONER MURRAY: I have no questions, thank you.

JUDGE JONES: Commissioner Clayton?

QUESTIONS BY COMMISSIONER CLAYTON:

Q. Good afternoon, Mr. Noack. Can you help me understand how your testimony fits in with Mr. Hanley's testimony?

A. Well, my testimony is surrebuttal testimony primarily to OPC witness Russ Trippensee, and -- as it relates to his comments about getting rid of the risk by this rate design.

Q. Okay. I assume you agreed with Mr. Trippensee?

A. No.

Q. Oh, I misunderstood. You disagreed with Mr. Trippensee?

A. Yes. Yes.

Q. Okay. So you believe that MGE would still be facing some risk even with the straight fixed variable, the flat rate that was mentioned earlier? With that type of rate design you believe MGE would still be facing some risk in the marketplace?

A. Absolutely.

Q. Okay. Can you tell me where the risk comes from?

A. Sure. The risk, again, as I mentioned to Staff attorney, the straight fixed variable only relates to the residential class, so as weather can affect the other classes of customer, that risk is still there. If it's not cold we're not gonna sell any gas to the small commercial, large commercial and to a certain extent the transportation customers. We won't deliver gas to the transportation customers.

Q. Okay. So weather is the risk and it's in the other class categories, correct?

A. That's correct.

Q. Okay.

A. We have expenses such as bad debt expense that, you know, that is -- depending on the cost of gas, which we strictly pass through, you know, if that is higher than normal --

Q. Does bad debt go up the colder the weather gets?

A. It goes up -- if the bills go up, the bad debts go up, yes.

Q. Okay. That's probably a better way because prices could go up.

A. Yes.

Q. So the higher prices go, the higher the bad debts go. Does that -- how does that compare to increase in company revenue or profit? Because if prices or revenues go up, also they go up for the company as well. Is there any correlation between bad debt and increased revenues? Do they offset one another or are they close or any connection?

A. Well, bad debts are gonna go up more than -- than the revenue because 75 percent of our, quote, revenue is PGA revenue which we don't get to keep. We're passing that directly through to the pipeline and the suppliers of our gas. So while -- if it's very cold now and we realize an earnings windfall or a revenue windfall, the bad debt is gonna be more than that because of the cost of gas being such a big chunk.

Q. Is MGE asking for any weather normalization as it relates to the other class, the other classes --

A. No.

Q. -- customers?

A. Now, if we have the straight fixed variable rate design, we haven't asked for weather normalization of the other classes, no.

Q. Okay. What percentage of the -- of the company revenues come from the residential category?

A. Approximately $100 million out of a $160 million margin is residential, so five-eighths, 62 and a half percent, something like that.

Q. I'm impressed.
A. Thank you.
Q. Worked that a lot faster than I did. Do you know -- and if you don't know off the top of your head, that's fine. What percent is made up of industrial customers? Is that a large service? If you don't know, that's fine.
A. No. It's -- I think our transportation revenue, which is primarily the industrial, is between ten and $12 million, so, what, that's 16, something like that.
Q. 16 percent, yeah, yeah.
A. And the small commercial is gonna be probably the next biggest class. That's gonna be a -- probably 35 to $40 million.
COMMISSIONER CLAYTON: Okay. About 20 percent, maybe, something like that? I'm making these numbers up. Okay. I won't ask you any other questions. Thank you, Mr. Noack.
JUDGE JONES: Any recross from Staff?
MR. THOMPSON: No, your Honor.
JUDGE JONES: Any direct -- redirect from MGE?
MR. SWEARENGEN: No redirect, thank you.
JUDGE JONES: Thank you, Mr. Noack. You

may step down. I believe next we're to hear from Staff's witness. I was intending to take a break at three o'clock. How about we take a bathroom break. And I do mean that literally. Well, not for me but anyone that needs to go. So it's just like five minutes and we're gonna start back up in five minutes. It's just the court reporter and I and the witness and we'll go. With that, we're off the record.

(A RECESS WAS TAKEN.)

(EXHIBIT NOS. 101, 102, 103 AND 103A WERE MARKED FOR IDENTIFICATION BY THE COURT REPORTER.)

JUDGE JONES: Okay. Let's go back on the record again.

MR. THOMPSON: Staff calls David Murray.

(THE WITNESS WAS SWORN.)

JUDGE JONES: Thank you. You may be seated.

DIRECT EXAMINATION BY MR. THOMPSON:

Q. State your name, please.

A. David Murray.

Q. How are you employed, sir?

A. I'm employed as a utility auditor IV in the financial analysis department.

Q. Is that with the Missouri Public Service Commission?
A. Yes, it is.
Q. And are you the same David Murray that caused to be prepared and filed direct testimony marked as Exhibit 101, rebuttal testimony marked as Exhibit 102, surrebuttal testimony marked as Exhibit 103 and true-up testimony marked as Exhibit 103A?
A. Yes.
Q. Do you have any corrections to any of those four exhibits at this time?
A. No. I made my corrections in my true-up testimony.
Q. If I were to ask you the same questions today as are asked in those pieces of testimony, would your answers today be the same?
A. Yes.
Q. And as far as you know, were those answers true and correct to the best of your knowledge and belief?
A. Yes.
MR. THOMPSON: At this time I would offer Exhibits 101, 102, 103 and 103A.
JUDGE JONES: Any objections to Exhibits

101, 102, 103 and 103A?

MR. SWEARENGEN: No, we have none.

JUDGE JONES: Seeing no objections, the exhibits are admitted into the record.

(EXHIBIT NOS. 101, 102, 103 AND 103A WERE RECEIVED INTO EVIDENCE AND MADE A PART OF THE RECORD.)

MR. THOMPSON: Thank you, your Honor. I tender the witness for cross.

JUDGE JONES: MGE, cross-examination?

MR. SWEARENGEN: Thank you, Judge.

CROSS-EXAMINATION BY MR. SWEARENGEN:

Q. Good afternoon, Mr. Murray.

A. Good afternoon, Mr. Swearengen.

Q. How are you today?

A. Pretty good. How are you doing?

Q. Fine, thanks. At the outset, I just want to ask you a few questions, if I could, about what I believe are the four most recent Missouri Public Service Commission cases in which cost of capital/rate of return has been litigated, and I think you're probably familiar with those.

Let me start with the last -- what I call the last Missouri Gas Energy rate case which I think was decided by the Commission back in September

of 2004, a little over two years ago. Do you recall that case?
A. Yes, I do.
Q. And were you the cost of capital witness for the Staff in that case?
A. Yes.
Q. Do you remember at that time that the company asked for a return on common equity of 12 percent?
A. Yes.
Q. And the midpoint of the Staff's recommended return on equity in that case according to your testimony was 9.02 percent; does that sound right?
A. Yes.
Q. And do you recall that the Public Counsel filed testimony in that proceeding --
A. Yes.
Q. -- do you remember that? And the Public Counsel supported a return on equity between 9.01 and 9.43 percent; is that true? Do you recall that?
A. I don't recall those specific numbers, but that sounds like it's in the area that I recall.
Q. And ultimately in that case, the Commission found that the company, that MGE should be

awarded a return on equity of 10 and a half percent; is that right?

A. Yes.

Q. Okay. And you read the Commission's decision in that case, I take it?

A. Yes.

Q. Okay. Would you -- Southern Union Company has been called in this case the parent of Missouri Gas Energy. Is it your understanding that MGE is an operating division of Southern Union Company?

A. Yes.

Q. Now, the next case I want to ask you about which was decided in March of 2005 involved the Empire District Electric Company. Do you recall that case?

A. Yes.

Q. And did you provide cost of capital testimony in that case for the Staff?

A. Yes.

Q. And if I said you supported a return on equity range for Empire in that case of 8.29 percent to 9.29 percent, would that be correct?

A. Yes.

Q. And do you recall that the Public

Counsel also filed testimony in that case?
A. Yes.
Q. And the Public Counsel had a somewhat higher range than you did, 8.96 to 9.41 percent; do you recall that?
A. Once again, I don't recall the specific numbers but that sounds in the ball park.
Q. And you do remember the Public Counsel was a little higher than the Staff in that case?
A. They tend to be at times.
Q. And I take it you read the Commission's decision in that case?
A. Yes.
Q. And the Commission found that an 11 percent return on equity was justified for Empire in that case; is that right?
A. Yes.
Q. And that 11 percent return on equity was applied to Empire's capital structure which at that time consisted of approximately 49 percent common equity; is that true?
A. It was right around the 50 percent range. I don't recall the specific numbers.
Q. Okay. Thank you. Empire then filed another rate case which was just recently decided by

the Commission; is that true?
A. Yes.
Q. And that's the third case I want to ask you about. I take it you're familiar with the Commission's decision in that proceeding?
A. Yes.
Q. And you were the cost of capital witness for the Staff in that case?
A. Yes.
Q. And then in that second Empire case you supported a return on equity ranging from 9.2 percent to 9.5 percent; would that be correct?
A. No.
Q. What was it?
A. It was revised. That was my initial recommendation in my direct testimony.
Q. Okay.
A. After looking at some other calculations I looked at with the dividend yield, I found out that there was some numbers that I needed to look at for future years. I think I accidently included 2005 which was the actual dividend as of that year, and I wanted to get a better idea as to what the dividend yield was for the expected dividend for the next year. So when I revised that, my recommendation was,

I believe, 9 -- was the 9.5 to 9.6.
Q. Okay. So you think your recommendation in that case was 9.5 to 9.6?
A. Yes.
Q. And so that would have been just roughly 30 basis points above the high end of your recommendation in the first Empire case; is that right?
A. Yes.
Q. Okay. And in that second Empire case, the Public Counsel again came in with a little higher recommendation than you did at 9.65 percent; is that true?
A. Slightly higher. That's about as close as we've been.
Q. Okay. Thanks. And ultimately in that second Empire case which was just decided by the Commission, the Commission awarded the company a 9 -- excuse me, a 10.9 percent ROE; is that true?
A. Yes.
Q. And once again, that was on a capital structure for Empire at about -- of about 50 percent common equity, right?
A. Yes.
Q. And on the same day the Commission

decided the Empire case it also decided a rate case involving the Kansas City Power & Light Company; is that true?

A. Yes.

Q. Were you the Staff cost of capital witness in the Kansas City case?

A. No.

Q. Who testified on behalf of the Staff in that case, do you recall?

A. Staff witness, Matt Barnes.

Q. Would I be correct if I said that Mr. Barnes recommended an ROE for KCPL in a range of 9.32 to 9.42?

A. That sounds correct, yes.

Q. And Public Counsel filed cost of capital testimony in the KCPL case and recommended an ROE of about 9.9 percent, a little higher than the Staff; is that correct?

A. Yes.

Q. And have you read that decision in the KCPL case?

A. Not the entire decision. The part of the decision that dealt with rate of return, yes.

Q. Is it your understanding that the Commission ultimately awarded KCPL an ROE of

11.25 percent?
A. Yes.
Q. And that would have been applied to the KCPL capital structure which is, at that time was about 54 percent common equity; is that true?
A. I'd have to review that. I believe, once again, it was in the 50 percent range but I don't recall the specifics.
Q. Is it fair to say that in these four cases that we've just discussed, the KCPL case, the two Empire cases and the earlier MGE case, that the Staff's approach to recommending and to determining and recommending a return on equity has been consistent?
A. Yes, it's been consistent, but there has been some variation within those recommendations, some that has to do with capital structure. Other aspects just have to do with whether to go in the -- I would say the high 8's to low 9's or mid 9 range.
Q. Is that essentially the same approach that you're using in this case, in the current MGE case, the approach that the Staff used in those four earlier cases we just discussed?
A. Let me explain what I do think is a key difference because this is something that was

emphasized in the 2004 Empire case. The Commission believed that a company-specific DCF analysis was not consistent with Hope and Bluefield.

As a result, even though I still believe that -- that a company-specific analysis can arrive at a reliable cost of equity if the proper analysis is done, because the Commission felt that a company-specific cost of equity analysis was not consistent with Hope and Bluefield, and I decided that in order to be considered and not discarded, it was probably best for me to go ahead and do a comparable company analysis and maybe just show the company-specific analysis.

As far as the approach with the cost of capital models, there has been some changes with the models that I used for tests of reasonableness and the inputs that I used for those models.

Now, the DCF which is the model that Staff, myself, has relied upon for, you know, since I've been here, you know, the way I've gone about doing the DCF model has not changed dramatically.

There has been some -- some movement towards maybe relying a little bit more on projected growth rates, especially for the electric utility industry, because of the historical growth rates at times have been somewhat volatile. And since the DCF is -- is -- one of the main assumptions of the DCF is the constant growth of the share price, it's important to -- it's important to use a growth rate that you can expect to occur in the future on a constant basis. So while the recommendations are fairly close, there has -- there has been changes in the methodologies.

Well, another example is the risk premium methodology that Staff had used in the Missouri Gas Energy/Empire rate case in 2004. I decided to eliminate that. I just -- with some of the decisions of the Commission, I didn't think that that was providing an informative analysis that would help them understand what the -- you know, what more -- what the, you know, the popular and, I guess, prominent finance minds in the industry were indicating about risk premium.

Q. Okay.

A. And I wanted to try to educate the Commission as to what some of the most well-known individuals in the field of finance were communicating about their estimates on the equity risk premium. So I made some changes for those reasons.

Q. So would it be fair to say that since that first Empire rate decision, that you looked at what the Commission has said and what the Commission has accepted and what the Commission has rejected, and tried to take that into account in your subsequent testimonies in the following cases?
A. Take it into account but at the same time still communicate to the Commission what I think the cost of equity is. I don't think that -- that I should just go ahead and tell them what they want to hear.
Q. Okay. Let me ask you, does the Staff -- who else does cost of capital testimony within the Commission Staff now?
A. The only other person that's been doing cost of capital testimony for Staff or internal Staff is Matt Barnes. John Kiebel, who is no longer with the Commission, he helped out in our department for, I'd say, a year and a half, and it was in the Laclede rate case which -- testimony was not filed but he did perform an analysis.
Q. Does someone in your department coordinate the cost of capital testimony that the Staff ultimately files or supervises the work that you do?

A. Yes, but that's been changing a lot. There's been quite a bit of -- quite a bit of a revolving door, I guess, with my manager in the department.

Q. Who's your manager now?

A. My manager now is Ron Bible.

Q. And you say there's been changes. Was someone else your manager at some other time?

A. When Ron Bible was mobilized in the military for two years, Bob Schallenberg was acting manager for a period of time. At the end of those two years, I was promoted to interim manager for a month, and then Ron Bible returned and took over his position.

Q. When did he return?

A. He returned -- was that -- I want to say May 1st of this last year, 2006.

Q. So since May 1st of 2006, he would be your supervisor; is that a fair --

A. Yes.

Q. And for some period of time prior to that, you were your own manager maybe for a month or so; is that right?

A. Yes.

Q. And then prior to that, Mr. Schallenberg

for some period of time?
A. Yes.
Q. Okay. So I guess you report to Ron Bible now, would that be a fair statement?
A. Yes. However, I should clarify that due to medical reasons Ron Bible was out of the office for about two and a half months recently, and I reported to Bob Schallenberg during that time period as well.
Q. Okay. And I think you may have touched on this earlier but let me just ask you, after the Empire rate case -- excuse me, after the Missouri Gas Energy rate case, the last one, the first Empire rate case that we talked about, did you have any discussions with anyone in the department, or anyone for that matter, about whether you should do things differently in terms of your cost of capital analysis and recommendations?
A. I don't think there was much, say, discussion with anybody above me because at that time there was -- there really wasn't anybody above me that did a lot of cost of capital work.
I did -- I have had occasions to talk to Dave Parcell and discuss various issues with him at -- I guess that was shortly after Ron Bible was

immobilized. And we just talked about the various approaches to cost of capital analysis. And I communicated to him that the DCF model is still the model that Staff at the Public Service Commission believes is the most reliable just from the mere standpoint that you use company-specific inputs. It looks at the valuation level of stock prices.

So -- but we did just briefly discuss some of the various approaches out there. I believe he uses the CAPM as well. But just like any other cost of capital witness and obviously, people are familiar with the wide ranges of recommendations you can see with return on equity and rate of return, there's judgments on the inputs that go into those models.

One of the key things that we discussed, and I'd say this was more discussed with Bob Schallenberg, was the Commission's -- Commission's desire, I guess, to use allowed ROE's as a benchmark, and I think the MGE case in 2004 was the first case where that was really made known through its Report and Order that that's something that the -- that they want to look at because I believe the way they termed it in their Report and Order, that is the capital in which they compete for capital.

Q. Would it be fair to say that since the first MGE case and the first Empire case, you've made some changes in the way that you're doing things or the Staff has made some changes in the way it's been doing things as far as cost of capital is concerned, but the ultimate result isn't much different? For example, the high side of your range in this case for MGE, 9.2, is just about 20 basis points above where you were in the last case; would that be correct?

MR. THOMPSON: I'm gonna object, your Honor. I don't see the relevance of this entire line of questioning. His recommendation is what it is, and I don't think it matters if his mom told him how to do it, that's --

JUDGE JONES: Well, you've been talking about what he's been doing in the past cases, Mr. Swearengen. I assume it's compared to do what? What are you trying to do?

MR. SWEARENGEN: Well, I'm trying to establish what -- he has changed in response to some things that the Commission has indicated and not others, and I'm just trying to find out the rationale and reason behind his recommendations, I think.

JUDGE JONES: You mean the recommendation in this case?

MR. SWEARENGEN: In this case, exactly.
MR. THOMPSON: Well, your Honor, I think there's extensive written testimony that explains the rationale behind his recommendation in this case.
JUDGE JONES: Are you satisfied with that, Mr. Swearengen?
MR. SWEARENGEN: Well, I think I'm entitled to inquire about that.
JUDGE JONES: About his testimony?
MR. SWEARENGEN: That's what I'm doing.
JUDGE JONES: Does his testimony cover what he's done in other cases?
MR. SWEARENGEN: His testimony is -- right now his recommendation is 9.2 percent which is about 20 basis points above, I think, where he was in the last case.
JUDGE JONES: The last MGE case?
MR. SWEARENGEN: The last MGE case.
JUDGE JONES: What difference does it make?
MR. SWEARENGEN: I think it makes a significant difference.
JUDGE JONES: I'm gonna sustain the objection. I don't think it matters what he did in the last case. Maybe the methodology he might have

used in the last case if there is some contradiction between what he did then and now, but the end result I don't think matters.

BY MR. SWEARENGEN:

Q. Let me ask this question then: You indicated the changes that you had made since the first Empire case and the first MGE case and you've explained those, correct?

A. Yes.

Q. And would it be fair to say that your results -- your result in this MGE case does not differ significantly from the -- your recommendation in the last MGE case?

A. Actually, if you look at the mipoint, it's about exactly the same.

Q. Okay. Let me ask you this, sir: Do you have your surrebuttal testimony?

A. Yes.

Q. If you turn to page 7, there's a question at line 3 of page 7 of your surrebuttal. It says, "Considering the testimony you sponsored in the last rate case in support of including all Panhandle Energy debt issuances and the overall cost of debt recommendation, why didn't you do the same in this case?"

And then your answer follows; is that right?
A. Yes.
Q. Is it fair for me to say that you followed the Commission's lead or suggestion concerning the cost of the Panhandle debt?
A. Yes. I didn't -- I didn't believe that the facts and circumstances have changed significantly since the last Report and Order, so I decided to -- because that's a mechanical calculation, I decided to accept what the Commission had done or at least directed in this Report and Order.
Q. But it would also be fair to say that your ROE recommendation in this case may not be consistent with what the Commission decided in the last case?
A. That's correct.
Q. Would you agree that one of the goals of the Commission in this case should be to provide a fair and reasonable rate of return on the equity capital that has been invested in MGE's natural gas distribution operations?
A. Yes.
Q. Would you agree that Missouri Gas Energy

must compete in the same capital markets as does the Empire District Electric Company and Kansas City Power & Light company?

A. Southern Union has to compete in the same capital markets and MGE relies on Southern Union for its capital, so if you look at it through that indirect type of approach, then, yes.

Q. So if I asked you would Southern Union have to compete in the same capital markets as KCPL and Empire, your answer would be yes?

A. You -- if -- you would need to clarify the capital markets because KCPL, they compete in the debt capital markets, they do not compete in the equity market. Great Plains Energy competes in the equity market. So I mean, there are some distinctions there that would have to be cleared up.

Q. What is your definition of capital market?

A. Capital market is the debt and equity market, and each one of those, just like MGE because they're not a separate legal corporation, they don't issue their own debt, they rely on Southern Union for their debt capital; therefore, they don't go out to either the debt or the equity markets.

Where Kansas City Power & Light, they

are their own subsidiary, they issue their own debt, they can go to the debt capital markets and compete against whoever else may be seeking debt financing where they rely on their parent company, Great Plains Energy, for equity capital.

Q. Has the Missouri Public Service Commission ever indicated a preference for a larger proxy group when determining an appropriate ROE for a utility, do you know?

A. In the last two orders, yes.

Q. What last two orders?

A. The Empire and the KCPL order.

Q. They indicated that in those -- in their testimony -- in those decisions?

A. Yes.

Q. And when they were talking about a larger proxy group, do you have any idea what they were talking about?

A. No. Actually, unfortunately, it doesn't say that they would ever say that that -- you know, that that is too small of a group in the future. They don't want to set any specific, you know, limitation as to what they would think is too small. But in that instance they decided it was too small for liking in the Empire and KCPL rate cases.

Q. And they decided what was too small?
A. The comparable group.
Q. Whose comparable group?
A. Staff's.
Q. And how big was the comparable group that the Staff used in those two cases?
A. In the Kansas City Power & Light case, I believe it was -- one was five and one was six, and I don't recall specifically, but one was five and one was six.
Q. Would you agree with me that the business risk of an entity, a utility, for example, is a collective term encompassing all of the risks of a business entity, except financial risk?
A. Yes.
Q. And financial risk is debt; is that a fair statement?
A. Well, I think you -- some people want to simplify it as just being debt, but it's the fixed charges that are created by debt because you can have -- one company can have $1 million of debt on its books, a computer company can -- another company can have $1 million of debt on its books, but if one has, say, a 5 percent interest rate and another one has a 6 percent interest rate, obviously, there's

more financial risk for the one that has the higher cost debt.

Q. Would you agree with me that the business risk of an entity is driven by the dominant operations of the company?

A. Not necessarily.

MR. SWEARENGEN: Could I approach the witness, your Honor?

JUDGE JONES: Yes, you may.

BY MR. SWEARENGEN:

Q. Mr. Murray, I'm gonna hand you a copy of the surrebuttal testimony of David Murray that was filed in the Empire District Electric Company, Case Number ER-2006-0315, dated August 2006, and ask you to read into the record, if you would, the question beginning on line 8 and the answer that follows on line 10, please.

A. Just -- just from line 10 through 12? The highlighted portion?

Q. Read the -- read the question on line 8 and then --

A. The entire answer?

Q. Yes, please.

A. Sure.

Q. Thanks.

A. "Question: What is the best way to ensure that a comparable company's group's risks are similar to that of the subject company?

"Answer: There are two main types of risk in corporate finance: Business risk and financial risk. The financial risk of an entity is driven by the amount of fixed obligations created by issuing debt. Some analysts will attempt to screen comparable companies" -- excuse me -- "for this type of risk by only selecting companies with certain common equity percentage in the book value capital structure.

"I control for this type of risk by selecting companies that have at least investment grade credit rating. The business risk of an entity is driven by the dominant operations of the company. The purest way to select companies that face similar business risk is to select companies that are predominantly in the same business as the operations being evaluated. In common finance textbooks, this approach is commonly referred to as the pure play method."

Q. Thank you.

MR. THOMPSON: What page was that?

MR. SWEARENGEN: Page 13.

MR. THOMPSON: Thank you.
BY MR. SWEARENGEN:
Q. Would you agree that size has a bearing on business risk?
A. I believe it depends on what industry you're looking at.
Q. Explain what you mean by that.
A. Actually -- well, here, I'll just go ahead and refer to my testimony. It's in my rebuttal testimony on page 30. It starts on line 13 and it runs through page 31, line 15. If you want me to, I can read that.
Q. No, that's fine. Would you agree that in this case before the Commission today, that we're concerned with the gas distribution operations of Missouri Gas Energy?
A. Yes.
Q. And I think you earlier said that MGE is an operating division of Southern Union Company; is that correct?
A. Yes.
Q. And at a couple of points in your surrebuttal testimony, I believe at pages 9 and perhaps 10 and 11, you cite statements made by Roger Morin; is that correct?

A. I believe that's on 9 and 10, that's correct, but not -- not 11.

Q. Well, I'm looking at line 16 of your surrebuttal testimony on page 11.

A. Line 16 on page 11? Oh, I'm sorry. You're right. On page 9 it was separated over to the side as, you know, indented in that case. It's in quotes, so yes, you're correct, I apologize.

Q. And who is Roger Morin?

A. Dr. Roger Morin is an individual that's written a couple of textbooks on utility regulatory finance.

Q. And do you regard him as an authority on regulatory finance matters?

A. Yes.

Q. And would this include cost of capital for regulated utilities?

A. Yes.

Q. And is that the same Roger Morin who testified in MGE's last rate case?

A. Yes.

Q. And I assume you're familiar with his testimony in that case; is that right?

A. It's been a little while, but yes.

Q. If you'd turn to your direct testimony,

please, page 21.
A. Yes.
Q. Is it there on page 21 where you start to discuss how you estimated the cost of common equity for MGE in this case?
A. Yes.
Q. And then over on page 22 you made this statement at line 7 through 11, "However, because Southern Union is transforming itself from a natural gas distribution utility company to a diversified natural gas company, Southern Union's cost of common equity no longer reflects the lower risks associated with natural gas distribution operations. Consequently, my cost of common equity analysis on Southern Union is for informational purposes only." Is that still your testimony?
A. Yes.
Q. Okay. Then over on page 24, lines 10 through 14, you say, "I chose to analyze Southern Union's cost of common equity for informational purposes only. I don't believe that any weight should be given to my Southern Union cost of common equity estimations. Because Southern Union is now a diversified gas company, its cost of common equity may not be consistent with that of the lower risk

natural gas distribution industry." Is that still your testimony?
A.   Yes.
Q.   And would you agree that since MGE's last rate case back in 2004, the facts and circumstances surrounding Southern Union have changed?
A.   It depends on what time period you're looking at. If you could tell me what time period you're referring to.
Q.   Well, since, say, for example, the test year in the 2004 rate case.
A.   Are you referring to the test year from the 2004 test year of this case --
Q.   Yes.
A.   -- versus the test year of this case?
Q.   Yeah, have the facts and circumstances involving Southern Union Company changed?
A.   I'd say through the test year of this case, no.
Q.   Okay. And what about through the true-up period of this case?
A.   Through the true-up period, yes, they have.
Q.   Okay. And how have they changed through

the true-up period?

A. They've acquired the Sid Richardson Energy properties which entails gathering and processing operations.

Q. Have they -- has Southern Union disposed of any gas -- natural gas distribution operations recently?

A. Yes, they have. Let me back up a little bit on the Sid Richardson properties. I just want to make sure -- I know I have something in here that indicates the specific closing date on that, and I'd just like to clarify that for the record.

Q. Sure.

A. Yes, I just wanted to make sure for the record, they did close on the Sid Richardson acquisition on March 1st of 2006.

Q. Okay. And what about the sale of the gas distribution properties out east, do you know when those -- when that took place?

A. That occurred in August, August of 2006.

Q. So those would be changes that have taken place in Southern Union since the last rate case; would that be fair?

A. Yes.

Q. I'm looking at your schedule 20 to your

direct testimony. Do you have that in front of you?
A. Yes.
Q. And if I look, you have your one, two, three, four, five, six, comparable companies set out in that schedule; is that true?
A. Yes.
Q. And you show that the common equity ratio -- the 2005 common equity ratio for those six companies and -- indicate that the average is 55.23 percent common equity; is that true?
A. Yes.
Q. Now, you've used these six companies as a proxy for determining the cost of equity for Missouri Gas Energy in this case; is that true?
A. Yes.
Q. But you're not using the capital structures of these same six companies with regard to your capital structure recommendation; is that fair to say?
A. That's correct, yes.
Q. And then instead, you're looking at the actual capital structure of Southern Union?
A. Yes.
Q. And the Southern Union equity ratio is approximately 36 percent; is that true?

A. Yes. And I'd like to make sure for the record as well, in the corrected true-up testimony I filed, the revised common equity ratio was in the low 40 percent range. That's in my true-up direct testimony in this case.
Q. Now, say that again.
A. In my true-up direct testimony --
Q. Yes.
A. -- I made some corrections to my direct testimony.
Q. Uh-huh.
A. And the common equity ratio is the schedule DM 22 attached to my true-up direct testimony. Common equity ratio is 41.36 percent.
Q. And what caused that change? Is that for the same period of time?
A. Yes, it's for the same period of time. What caused that change was in response to -- I don't remember -- well, here, it's probably referenced in the bottom of one of -- excuse me -- one of these schedules as far as the DR response. In response to DR -- I'll go to the direct testimony just to make sure I have this right.
In response to DR 65.1, there was -- that was a -- that was a response that showed a

schedule of all the long-term debt of Southern Union. And after I was doing the true-up testimony, I discovered in that schedule of long-term debt, there was included 400 million -- at least 400 million of short-term debt. And so I caught that and took it out because we needed to get this, you know, done accurately.

Q. And how did that change the common equity ratios for your proxy companies that are shown on schedule 20 of your direct testimony?

A. It had no effect on my proxy companies.

Q. Okay. So the common equity ratio for your proxy companies is 55.23 percent, that number's not changed?

A. No, it hasn't changed.

Q. Okay. All right. I misunderstood what you said. Thank you. Would it be fair to say that when compared to your proxy group, Southern Union is more thinly capitalized from an equity standpoint?

A. Without a doubt.

Q. And less equity or thin equity would suggest greater risk; is that not true?

A. It suggests greater financial risk, assuming, like I said, once you review the fixed-charge coverages, the coverage ratios such as FFO interest and then look at that in conjunction with your leverage ratios.

Q. And if you have more risk, you need a higher return to attract capital; isn't that a fair statement?

A. Yes.

Q. Do you recall that when Dr. Morin testified in the last MGE rate case on the cost of capital issue, in response to questions from the Commission, he said that from a ratemaking standpoint, there are two ways to deal with a utility that has an equity-thin capital structure. Do you remember his testimony on that?

A. I don't recall the specifics on that.

Q. Well, let me ask you, would you agree with that one way to deal with an equity-thin capital structure would be to recognize that risk by adding a premium to the awarded return on equity?

A. To the recommended ROE, yes, and actually, I did that in this case.

Q. Okay. And would another way to do the same thing would be to use a more balanced or more representative or more conservative capital structure?

A. Obviously, Mr. Hanley proposed that in

this case.
Q. Do you recall whether or not Dr. Morin proposed that in the last Southern Union/MGE case?
A. I don't recall specifically.
Q. If you used that latter approach, and used a more balanced conservative capital structure, you would not have to add to the rate of return; is that true?
A. Can you clarify rate of return? Are you --
Q. Return on equity.
A. Return on equity, okay.
Q. Right.
A. You would not have -- assuming that the credit ratings -- and you have to understand my methodology to put this in context. Assuming that the overall risk level, even if the capital structures are the same, you could have business risk that -- and this has been discussed extensively in this proceeding -- you could have business risk that differs. So even if the capital structures are the same, that doesn't necessarily mean that an adjustment should be made.
Q. I understand that. You had indicated earlier that you would agree that MGE/Southern Union

is thinly capitalized from an equity standpoint, right?

A. Yes.

Q. And one way to fix that for ratemaking purposes, would you not agree, would be to use a capital structure that imputes more equity?

A. As I indicated before, some analysts would propose that.

Q. So you could deal with the risk by increasing the equity cushion; wouldn't that be a fair way to look at it? I know you don't agree with that, but isn't that a way that one could do it?

A. Yes, that's an approach that some people use, yes.

Q. But in this case you don't want to do that. You're using the capital structure of Southern Union Company; is that correct?

A. Yes. The cost of the debt to MGE has been based on the aggressive leverage of Southern Union since -- since the time that Southern Union bought MGE. I believe I showed a schedule in my -- I believe it was my rebuttal testimony that showed the average equity ratio for Southern Union of 30 percent. That has directly affected the cost of debt, the historical cost of debt that's on the books for Southern Union, and that was a debt capital that MGE relies upon for -- for its capital expenditures.

Q. So for ratemaking purposes in Missouri for Missouri Gas Energy, you would use the financial risk of Southern Union Company; is that right?

A. That's what I proposed, yes.

Q. And then, I think you indicated this earlier in response to a question. If you'd look at page 37 of your direct testimony, please.

A. Yes.

Q. And if I read that, can I conclude that you recognize the risk of Missouri Gas Energy's thin equity by adding a 30-basis-point premium to the return on equity?

A. Yes.

Q. And that 30-basis-point upward adjustment is based on the average spread between A-rated utility bonds and triple-B-rated utility bonds; is that correct?

A. Yes.

Q. And that's a spread that would relate to traditional utilities; is that true?

A. Can you please define traditional?

Q. Well, what would your definition be?

A. Traditional utilities is one that's

been in prominently regulated operations, but unfortunately, I -- with the Moody's version bond record, their average public utility bond yields can include some companies that have some diversified operations, but you have to deal with the information that you have, and I believe that that's appropriate to use for -- for a regulated utility.

Q. Would you agree that Southern Union could be characterized as a midstream company?

A. It is currently, yes, it is.

Q. And what is a midstream company according to your understanding?

A. A midstream company is a company that's -- you know, it's not all the way, you know, up the stream. It takes gas, gathers gas, processes the gas and transports the gas.

Q. Is a midstream company more risky than a utility?

A. The gathering and the processing operations which is part of the midstream business is considered to have more risk. The transportation -- pipeline transportation is not necessarily considered to have more risk. It depends on, you know, obviously, what pipelines you're looking at.

Q. Can you turn back to your surrebuttal

testimony, please? And I'm looking at page 9.
A. Yes.
Q. Do you have that in front of you?
A. Yes, I do.
Q. And there, starting at line 16, you quote from Dr. Morin's book; is that true?
A. Yes, I do.
Q. And that's his book "Regulatory Finance Utilities' Cost of Capital," 1994.
A. Yes.
MR. SWEARENGEN: Can I approach the witness, please?
JUDGE JONES: Yes, you may.
MR. SWEARENGEN: Just about finished.
BY MR. SWEARENGEN:
Q. Mr. Murray, I'm gonna hand you excerpts from Roger Morin's 1994 publication "Regulatory Finance Utilities Cost of Capital." I'm gonna show you page 123 from that text and ask you if the last full paragraph on that page is the paragraph that you have quoted in your surrebuttal testimony at page 9?
A. Yes, it is.
Q. Okay. And just ahead of that paragraph also on page 123 is another full paragraph, one, two, three, four, five, six, seven, eight, nine, ten, 11

lines long. Could you read just the first and last sentence of that paragraph into the record, please?

A. Sure. "Another application of the nonconstant growth DCF model is when stock price and dividends cannot grow at the same rate by virtue of realistic circumstances in the capital markets." That's the first sentence.

The last sentence, "The standard DCF model suppresses such capital gains or losses by assuming an infinite investment horizon."

Q. Thank you. And then if you would look at page 236 from that same text, the second full paragraph on that page, would you read that into the record, please?

A. The entire paragraph?

Q. The entire paragraph, yes.

A. "The third reason for caution and skepticism is that application of DCF model produces estimates of common equity costs that are consistent with investors' expected return only when stock price and book value are reasonably similar. That is when market-to-book is close to unity.

"As shown below, application of standard DCF model to utility stocks understates the investors' expected return when the market-to-book ratio of a given stock exceeds unity. This is particularly relevant in the capital market environment of the 1990's where utility stocks were trading at market-to-book ratios well above unity.

"The converse is also true, that the -- that is, the DCF model overstates the investors' return when the stock's market-to-book ratio is less than unity. The reason for distortion is that the DCF market return is applied to a book-value rate base by the regulator. That is, a utility's earnings are limited to earnings on a book-value rate base."

Q. Okay. Thank you. Now, I'm gonna hand you excerpts from Mr. Morin's publication, "New Regulatory Finance" dated 2006. Are you familiar with that text?

A. Yes. Yes, I am.

Q. And if you would look at page 434 of that text and read the -- just look at the second from the last paragraph on that page and tell me if that's the same paragraph that you just read into the record from the earlier version?

A. There are some minor wording changes. And we've -- we've done this before and you wanted me to point out the minor -- the minor wording changes.

Q. Go ahead.

A. Okay. In the new textbook by Dr. Roger Morin, it indicates the third reason for caution and skepticism is that application of the DCF model produces -- I'm sorry. Am I on the right...

Q. You're right.

A. No, I'm sorry. No, I'm wrong. I was reading from the 1994 one again. In the 2006 book, it says, "The third and perhaps most important reason for caution and skepticism is the application of the DCF model produces estimates of common equity costs that are consistent with investors' expected return only when stock price and book value are reasonably similar."

Let me look through the rest of this to see if it's all the same. In the new book it indicates, "This was particularly relevant in the capital market -- capital market environment of the 1990's and 2000" -- which it was not in the old book, obviously. And of course, now he has, "for nearly two decades." Rest of this is basically the same.

Q. So would it be fair to say that the thrust of that paragraph in his new 2006 publication is essentially the same as what he said in the earlier one, the 2004 version?

A. Yes, just for some -- other than some

updating --
Q. Excuse me. I said 2004, I meant 1994.
A. I do the same thing now, I'm getting older. Yes, that's correct.
Q. Now, turning back to the 1994 text on page 123 that you cite in your testimony, and you read into the record the first and last sentence of the paragraph that immediately preceding -- preceded the text that you cited, I'm gonna hand you the 2006 publication and ask you to read into the record the first and last sentence of the full paragraph -- the last full paragraph on page 267.
A. Okay. The first sentence, "Another application of the nonconstant growth DCF model is when stock price and dividends could not grow at the same rate by virtue of realistic circumstances in the capital markets."
And the last sentence reads, "The standard DCF model suppresses such capital gains or losses by assuming an incident investment horizon."
Q. Now, that's the same paragraph that immediately precedes the paragraph that you have cited in your testimony; is that right?
A. Yes, and I don't know why the next paragraph's not in the new book.

Q. Now, what paragraph is not in the new book?
A. Well, the paragraph right after that same paragraph in this book is not following this paragraph in the new book.
Q. So you're saying that in the 2006 publication, Dr. Morin does not include the paragraph that you have cited in your testimony from the 1994 publication; is that true?
A. Not -- not after that paragraph in the new book.
Q. Okay. Thank you. Are you aware whether or not that paragraph appears anywhere else in the new text?
A. I don't recall. I think he's changed. Instead of looking at market-to-book issues, I think he's looking more at price-to-earnings. I think he looks more at the market valuation. Instead of looking at market-to-book, he looks at PDU ratios.
Q. One last question. You're familiar with the Panhandle Eastern Pipeline Company debt; is that not true?
A. Yes, more so in the 2004 case than this case, yes.
Q. Have you included that in your capital

structure ratios for purposes of this case?
A. Yes.
Q. But the cost of that debt is excluded; is that true?
A. That's correct.
Q. In this case?
A. Yes.
Q. Would you agree that that debt has not been used to finance MGE's operations?
A. The debt that was refinanced, I believe I can say that with some certainty, I have not studied if there's been any new debt issued. And if there's been any new debt issued, obviously, there's distributions up to the parent company. And where those distributions come from, I can't say with certainty that it didn't come from any new debt issuances they may have had at that subsidiary level.
Q. But as far as you know, that debt has not been used to finance any MGE operations?
A. I can't say yes or no on any new issuances. I can't say.
Q. And when you say new issuances, that would include what you are now including in the capital structure for the company?
A. Yes.

MR. SWEARENGEN: Okay. That's all I have. Thanks.

JUDGE JONES: Is there any cross-examination from the Office of Public Counsel?

MR. POSTON: Yes, thank you.

CROSS-EXAMINATION BY MR. POSTON:

Q. Good afternoon.

A. Good afternoon.

Q. On page 22 you explain how you determine which companies to include in your comparable proxy group of LDC, and you present a criteria list that you use to determine whether an LDC in your proxy group is truly comparable to MGE; is that correct?

A. I'm sorry. Can you refer me to what --

Q. I think it was page 22.

A. What lines? Lines -- beginning on line 12?

Q. Starting, I guess the Q and A that starts on line 14, and then you have a -- you have a list that starts on line 17 and goes through onto page 23.

A. Yes, okay.

Q. Is the type of rate design used by the LDC specifically listed as one of your criteria?

A. No.

Q. And you chose to list the companies monitored by Edward Jones; is that correct?

A. Well, it was a subset of the list monitored by Edward Jones. I didn't select the entire list.

Q. And that entire list was how many companies?

A. I can go to schedule -- I believe the schedule on my -- attached to my direct testimony will show exactly the number of companies.

Q. I believe schedule 13.

A. I have 15 on schedule 13.

Q. Okay. And so that's -- that's all of the companies that Edward Jones monitors?

A. Well, that they classify as natural gas distribution companies, yes.

Q. And can you tell me why you chose to use companies monitored by Edward Jones?

A. It's a recognized publication. One of the things that I appreciate about their publication is they have a percent of revenues that they look at to try to classify their -- the companies that they follow as distribution, diversified or a combination.

But they -- they don't hold fast to that rule. I talked to one of their analysts. They look at how the stock trades and if it seems to be trading as a distribution company and, you know, meaning that the distribution company tends to have a little less volatility, then they still keep it classified as a distribution company. And I believe that that's what we're trying to do here is to estimate the cost of equity for -- for a distribution company.

Q. Did you look at any list of companies monitored by any other financial services company?

A. That -- well, I looked at some other companies. I think especially when this rate design issue became a little more prominent, I looked at -- Standard & Poor's had some reports on some distribution companies.

I also may have looked at some Value Line information on distribution companies, but as far as starting with a list for the criteria, I used Edward Jones.

Q. And on your schedule 14 you list the six comparable LDCs that you chose to use, correct?

A. That's correct.

Q. And do you know the rate designs employed by your six companies?

A. Yes. I mean, that's something that I

explained in my surrebuttal testimony.

Q. And when did you first look to see what type of rate design is used by each of these six companies?

A. The specifics of the rate design was after Mr. Trippensee filed rebuttal testimony.

Q. And did you study the orders from the various state commissions to determine whether they factored a reduction in business risk into their ROE calculation?

A. I didn't study the orders, I studied the annual reports. And it's mainly the annual reports because that's what's communicated to investors and that's what I considered to be the most relevant information.

Q. And when were you first made aware of the Staff's intention to impose a revenue decoupling rate design for MGE?

A. I was aware that there was going to be a rate design that was somewhat similar to maybe what Laclede received, if not maybe a little more favorable. It was during a case coordination meeting. I never discussed the specifics of that rate design. So that was when I first became aware of that and I don't recall when that was. I think it was early on in the -- probably the discovery process.

Q. Have you read the rate design testimony?

A. Yes, I -- I did.

Q. And when did you read that?

A. I read it -- most of the testimony I read was after Mr. Trippensee filed rebuttal testimony.

Q. Would you agree that weather variability is a business risk?

A. Yes.

Q. And do different LDCs have different business risk or is the business risk for all LDCs identical?

A. Nothing's completely identical. It varies.

Q. And do you agree that if weather variability is limited for a gas utility that the reduction in business risk should be reflected in the ROE approved by the Commission?

A. It depends on if there's something that offsets that risk. I -- I don't know that I could just look at a company and say, okay, there's gonna be a new rate design proposed that goes into effect. Therefore, I need to make a specific adjustment downward. There are other things that could come into play.

Obviously, Southern Union has an aggressive capital structure that, in my opinion, is one of the reasons why they were a triple-B-rated company, even when they were a natural gas distribution company before they got into some of these midstream businesses.

So there are other factors that can come into play, you know, say, a year or two down the road, especially if things don't, you know, do not, I guess, evolve as people think they will under these new types of rate designs.

Q. Well, if all else is equal, then would you agree that there should be that reduction?

A. If all else is equal -- excuse me. If all else is equal, yes, there is a reduction of business risk.

Q. And you testified that if the Commission determines that it should lower ROE to reflect the reduction in risk, that you believe the Commission should authorize an ROE in the lower part of your recommended range; is that correct?

A. Yes.

Q. And what do you mean by lower part of your range?

A. Just if the Commission so desires, there's a range of reasonableness and I provided it, and the low end is 865. If they wanted to go that low -- that's 30 basis points from my midpoint -- I think that that would, you know, be appropriate to stay -- you know, to go down to that level.

MR. POSTON: That's all I have. Thank you.

JUDGE JONES: Thank you. Any questions from Midwest Gas Users Association?

MR. CONRAD: No, Judge.

JUDGE JONES: Jackson County doesn't appear to be here. How about CMSU --

MR. FINNEGAN: Jackson County is here.

JUDGE JONES: Oh, I'm sorry. Jackson County, UMKC, CMSU any questions?

MR. FINNEGAN: I have no questions.

JUDGE JONES: Commissioner Murray, do you have any questions?

COMMISSIONER MURRAY: I have a couple.

THE WITNESS: Hi, Commissioner.

QUESTIONS BY COMMISSIONER MURRAY:

Q. Good afternoon.

A. How you doing?

Q. Fine, thank you. How are you?
A. Pretty good.
Q. Your recommended ROE, it sounds as if you're recommending more toward 8.65 than even your midpoint.
A. No. Well, what I -- what I -- what I tried to, you know, communicate in that response was if the Commission is inclined to want to specifically consider this -- this -- if the straight fixed variable rate design goes into effect, if they want to consider that, then the low end of the range would, you know, would be appropriate.

I just think there are a few uncertainties with these various rate designs. From what I've looked at in some of these annual reports I looked at of my comparable companies, there are, you know, with these all -- and there are, there's a ton -- there's a different -- a lot of different types of proposals out there.

And it seems like a lot of these states are doing pilot programs to see how things go. And I've seen mention of maybe the ROE's not going to be specifically reduced in -- in the case that the rate design's proposed in, but it will be something that's specifically looked at in future rate cases. They may have some earnings types of issues where there will be earnings reviews once that rate design is put into place.

Actually, I think we also have a company in the state of Missouri that has a weather mitigation rate design, and I believe in the stipulation and agreement in that case it was indicated that ROE would be looked at in future cases.

So I just think this is a learning curve for -- you know, for everybody. And one of the things that -- that I think other states are being mindful of is that -- is that this is -- this is uncertain. As Mr. Hanley was indicating earlier, he recommends a 25 -- gross reduction would be 35 basis points. Well, that's based on his judgment. And even after, you know, many years of, you know, of doing this work, it's still a judgment call.

Q. So it sounds like you're saying that even if we adopted your recommended ROE with the rate design that Staff and the company are proposing, that in a future rate case it might even result in a lower ROE based on the fact that there was this new rate design; is that --

A. Well, that --

Q. Am I interpreting what you're saying correctly or not?

A. Well, it would definitely be reflected in my recommendations in the future. Actually, I think these -- these weather mitigation -- their rate designs clauses, revenue normalization adjustments, straight fixed variable, they all have customer utilization tracker. They all have their, you know, different names to them.

But the whole idea is to decouple the recovery of the -- what is called fixed cost. I don't like to call it fixed cost because I think that the revenue requirement can change. And so I think there still is risk there. There's no guarantee that the pension expense and the maintenance expenses and everything will stay the same or the rate base will stay the same.

But from -- as this is more prevalent and obviously it's prevalent because all six of my companies have, you know, some type of -- some type of weather mitigation design clause, et cetera, that as that becomes more prevalent, if you abide by the DCF, if you believe in the DCF, which I do, if you apply a reasonable growth rate, say, 3 percent -- some of these companies are quite mature -- if you apply a regional growth rate at 3 percent, the expected dividend yield -- the valuation of the stock is gonna reflect that.

So I would not -- I mean, I would not be driving my recommendation down. It would be the capital market that's driving the cost of equity down. It would just be my analysis of what the capital market is telling us.

Q. Okay. Let me ask you a question about your direct testimony. On page 35, you're speaking there on that page about average ROE's, average authorized ROE's --

A. Yes.

Q. -- for various time periods, including the first three quarters of 2006 --

A. Yes.

Q. -- is that correct? And you indicate there at lines 10 and following, that, "The average authorized ROE for the first three quarters of 2006 was 10.49 percent based on nine decisions." Is that your testimony?

A. Yes, that's directly from Regulatory Research Associates.

Q. Yes. And then going back to the last MGE rate case, the Report and Order there where the

Commission talked about a variation of 100 basis points above or below the national average being appropriate; do you recall that?

A. I recall that.

Q. Now, relating that to -- to your testimony and your recommendation and the averages that were shown through Regulatory Research Associates for the first three quarters of 2006, it appears to me that Staff's -- even Staff's midpoint is about 60 basis points below what would be the floor of the zone of reasonableness.

A. According to what the Commission had indicated they, you know, they believed was a zone of reasonableness, yes. I believe -- I believe Mr. Dunn in the last case recommended, was it 12 -- it was 12 percent, so they recommended -- so he went 100 basis points over the average of 11, and I think he'd indicated that she'd (sic) be willing to accept ten.

I mean, so they started with -- with Mr. Dunn. I'm not -- I mean, I guess the Commission can probably tell me why he didn't -- maybe why he didn't start with me instead, but Mr. Dunn -- that's what you started with was Mr. Dunn's recommendation. And as far as --

Q. What we did was look at a national

average and take 100 basis points either below or above it and considered it in that range of reasonableness. And that's what I'm asking you about, that range of reasonableness. Do you not think that that is a consideration that you should be looking at?

A. Well, and this is -- you know, this is my -- where I feel like my integrity comes into play. I feel like I need to report what I -- what I believe -- what I see from the stock prices using the DCF model, which with natural gas distribution companies, it gets -- this is about -- in my opinion, this is about as easy as it gets because a lot of these natural gas distribution companies are pretty mature.

Since I'm -- since I'm tasked with reporting what I believe the cost of equity to be, which I believe is the ultimate goal of rate of return analysis, is to -- is to recommend to the Commission what you believe the cost of capital is, I -- I view my -- my task as trying to provide you that information.

If -- you know, if the Commission wants me to look at average authorized ROE's and go, you know, plus or minus 100 basis points, then, I mean, I guess I would need to be instructed to do so because right now I use the DCF as my -- as the methodology -- because I believe it's the appropriate methodology.

Q. Okay. Let's get back to my question. My question is, do you think it's appropriate that you consider that range of reasonableness or did you consider it at all anywhere in your analysis?

A. I didn't -- I didn't mention that 100-basis- point variance. I will point out -- the reason why I pointed out -- or provided all this average authorized ROE and rate of return information was being mindful of what the Commission had put in its previous orders. So, no, I did not relate my specific ROE recommendation to -- to that zone of reasonableness.

Q. And it apparently does not concern you that you are so far below that, what would be considered that zone of reasonableness based on reasoning that was stated in the last Report and Order?

A. Well, I wouldn't say it doesn't concern me. I would -- you know, my explanation would be that, I guess, if at any time I'm below the -- say, the 100 basis points below the average authorized

ROE, does that mean that I should just automatically go up to that -- to what the Commission's logic was in the MGE case? I'm not sure that that, I mean, is going to provide information to you as to what I think the cost of equity is.

Now -- and obviously, the capital markets change over time. Now, what you -- what you probably can surmise from -- from my recommendation in this case and recommendation in the gas distribution cases, is that at least right now I don't believe the cost of capital is that much different from the 2004 case.

So if the Commission believed that 10.5 was reasonable at that time, and I guess maybe had the same makeup of the Commission, I don't recall for sure, then -- of course, we do have some changes with the rate design issue, then, you know, I would say that that would be within reason if that's what you believe -- if you believe that I am too low.

Q. Okay. And I'm -- and I'm not trying to indicate whether -- whether you're right or wrong, whether I think you're right or wrong, I'm just trying to determine whether you think there is any validity to looking at a national average. And it appears from what you're saying that you don't personally think there's any validity to that.

A. The biggest problem I have personally with looking at the national average is each Commission receives, obviously, quite a bit of evidence in every case, and I mean, this is -- this is the rate of return testimony I have in this case and it's usually that big in every case.

And sometimes the company witness -- or company's hiring two witnesses, sometimes the OPC has a witness, AmerenUE you're gonna have, I think, six rate of return witnesses.

So my point is that if -- you know, in these other states I know there are staffs that also recommend below what the allowed ROE is. I don't think it means that, you know, necessarily the Staff is wrong in its -- in its opinion or the OPC is wrong in its opinion or the company is wrong in its opinion.

I just believe that the Commission looked at all the recommendations and decided, okay, ten and a half is -- is what we think is reasonable considering all the evidence of the rate of return witnesses. We don't think that one rate of return witness is necessarily better than the other, we just -- each one of them has -- has a good point on certain -- on certain arguments.

COMMISSIONER MURRAY: I don't think I have any other questions, thank you.

THE WITNESS: Thank you.

JUDGE JONES: Commissioner Clayton, do you have questions of Mr. Murray?

QUESTIONS BY COMMISSIONER CLAYTON:

Q. I'm wearing down, Mr. Murray.

A. Me too.

Q. I do have a -- you just started, brother, what are you talking about?

A. Well, I got here early.

Q. I have a handful of questions. I hope that we won't take too long, and I apologize in advance if any of it is repetitious.

My first question is, in using the discounted cash flow model, is there any way in that formula that would acknowledge any change in risk like in the rate design discussion we've had here today?

A. That's -- I mean, that is what I feel the most strongly about. I think the DCF model picks up exactly the reduced risk from all these rate designs that these comparable companies have, whether --

Q. Explain to me how the DCF picks up a change in risk on any given rate design.

A. Okay. If -- obviously, each of these companies has their stocks traded in the equity markets. Most of them -- I think all of them are in the New York Stock Exchange.

If investors perceive reduced risk for this company because -- or any one of these companies because they have a weather mitigation rate design or clause or et cetera, then the discount rate which is the cost of equity comes down. And when that happens, the stock price goes up.

And assuming that you still use a reasonable growth rate, when that stock price goes up and that -- because that discount rate came down, you should have a lower dividend yield along with the same growth rate. So it would be directly reflected in the cost of equity from that model. The other models, unfortunately, they don't look at the specifics of the stock price and the expected growth of that stock price.

Q. Can you -- what is the formula for the discounted cash flow model?

A. For the standard DCF it's D sub 1 which is expected dividends over the next 12 months divided by P sub 0 which is the price -- technically, it's supposed to be today's price but because of volatility, most analysts average it over at least six weeks, if not six months.

And then it's plus the growth factor which, under the original traditional dividend growth model, which is what it's called in finance textbooks, that's based on the expected growth in dividends.

Now, we've -- we've gone from expected growth in dividends to expected growth, for the most part, in earnings per share. It doesn't mean that dividends should be just completely discounted. Earnings per share has been used in many cases because the payout ratios of some utilities has declined.

Q. Okay. So is that all the -- is that all the variables?

A. Yes.

Q. D sub 1 divided by P sub 0 plus G?

A. Yes.

Q. That's it. Now, which of these variables have forward-looking numbers that would -- that would pick up a change in rate design?

A. All of them. I mean, the --

Q. Well, the price is today's price so that one's not forward-looking. The dividend is in the past and the growth is past earnings per share. So how do you pick up -- how do you pick up change in risk moving forward with a new rate design to be reflected in those? That's what I'm not understanding.

A. Well, if I could explain. The market price today, the price that shares are trading at today reflect investors' expectations of the future. They don't reflect the past, they reflect what they think the possibility of the growth in the cash flow for that company is going forward.

Q. So you think investors are anticipating that we are going to adopt a certain rate design and the stock reflects -- the stock price reflects that decision?

A. No, I'm not saying that at all because I don't use the -- I don't use MGE as a proxy. I can't -- well, as we've talked about, I'm not even using Southern Union as a proxy for the cost of equity. What I'm -- what I'm -- what I'm trying to explain is that these comparable companies that I use, they have these mechanisms in place now.

And therefore, the investors that invest in the shares of these companies are aware of that reduced risk. And if there is risk reduction, the required return on equity that they perceive -- or the risk reduction that they perceive, the required return on equity will be reduced which could cause -- which should cause a share price to increase.

Q. Okay. So in your comparable company -- you picked comparable companies that have a rate design and overall profile that would reflect a similar risk in your opinion?

A. In my opinion, yes.

Q. Yes, okay. Now, when you say that you don't use Southern Union as a proxy, does that mean that you never put into this formula that you just gave me, Southern Union or MGE numbers?

A. No, that's not correct. I did run a DCF and a CAPM on Southern Union for informational purposes.

Q. Okay. So on -- on the DCF analysis for MGE, you inputted your numbers and you came out with 8.65 to 9.25, correct?

A. For the comparable companies that I used as a proxy for MGE. As far as for Southern Union, I'll have to look at my schedules and I can tell you specifically what I --

Q. Sure, sure. Yeah, what did you come out with, I guess? If you...

JUDGE JONES: While he's looking for that, do you-all object to working through till 6:00? I don't want to get off on a bad start, basically. If you do, say so. It's an open question. I don't have a --

MR. THOMPSON: I need to make a phone call.

JUDGE JONES: Okay.

MR. SWEARENGEN: I think we've gotten off to a great start.

JUDGE JONES: Well, we're not gonna finish with all the witnesses for today by 5:00.

MR. THOMPSON: Or by 6:00.

JUDGE JONES: Well, okay. He needs to make a phone call. Do you care if we stay past 6:00 -- or up till 6:00?

MR. SWEARENGEN: I'll do whatever you want.

JUDGE JONES: My point being is, I'd like to get through Schallenberg's testimony, and he's supposed to go today, isn't he? If we could finish it by 6:00. If not, then at least try to up until 6:00.

MR. THOMPSON: Sir, the next scheduled witness is Mr. Trippensee.

JUDGE JONES: Right.

MR. THOMPSON: And then there's three witnesses on policy, the last of whom I believe is Mr. Schallenberg.

JUDGE JONES: Exactly. All of which were supposed to go today.

MR. THOMPSON: And you're saying that you think if we go until 6:00 you'll get four more witnesses in?

JUDGE JONES: No. I'm saying let's try until 6:00 to see if we can.

MR. THOMPSON: Whatever you want, Judge.

JUDGE JONES: Well, in that case, let's stay until 7:00 and finish.

MR. CONRAD: Do I hear eight?

JUDGE JONES: Are you ready?

THE WITNESS: Yes.

JUDGE JONES: Very good.

THE WITNESS: On schedule 18, I show my proxy companies, and then I also show three companies below that, the companies that have Missouri operations.

BY COMMISSIONER CLAYTON:

Q. I just want to focus on MGE. I don't want to talk about any proxy companies for a moment.
A. And just to clarify, we have to focus on Southern Union because MGE doesn't have publicly traded stock. It's actually not even a separate legal corporation. But Southern Union -- if you look at --
Q. Just tell me the percentage, that's all I want. What return on equity just running the discounted cash flow variables in the formula that you gave me, that's all -- I want a number.
A. I'll just give you the range, 10.83 to 13.43.
Q. 13.83 to?
A. Excuse me, 10.83 --
Q. Yeah.
A. -- to 13.43.
Q. Okay. All right. Now, go ahead and talk to me about your proxies or your comparable companies. Whatever you did at this point.
A. And I'm sorry. I forgot what I did before. Weren't we just talking about the proxies as far as the stock price?
Q. I just wanted the -- what the discounted cash flow model would show for Southern Union using

the D 1 P sub O plus G.
A. Yes, and that's what I --
Q. And you just gave me that number?
A. Yes.
Q. Okay. Okay. Now, in your analysis, you take these figures and you do what?
A. Well, I didn't -- I didn't use the Southern Union DCF estimates.
Q. Okay. Then -- all right. Well, then, talk to me about what you did from there with your comparables.
A. What I did with my comparables is, I looked at -- let me turn back to schedule 16. I looked at my six comparable companies and looked at a variety of growth rates. The projected growth rates ranged anywhere from 4.5 to 5.08.
The historical growth was actually higher which is not usually the case, 5.1. And the average historical and projected is 4.93. I decided because of the growth rates -- because they were so tightly correlated, there was a small range, I went ahead and just used -- you know, gave way to basically all the projected and the historical by going with the low end of 4.5 to the high end of 5.1 which was the highest growth rate based on historical

and projected. That usually doesn't -- it usually doesn't happen that neatly.

And then I looked at the stock prices for the comparable companies from May through August 2006, and so I averaged that to come up with an average stock price. And then I looked at -- on schedule 18. I looked at what I believe to be the expected dividend. And this is where the D sub 1 is a future figure. D sub 0 would be the number that's based on a dividend that's already paid.

D sub 1 is expected dividend, so that's where it is forward-looking, so I just wanted to clarify that as well. So it's use the expected annual dividend and divide that into the stock price because if stock price is -- should reflect what investors expect the dividend to be the next year, and then, of course, the growth and the stock price into the indefinite future.

So as a result of that, I just came up with an average dividend yield of 3.85 and looked at the -- used the same growth rates of four and a half to 5.1. I guess, once again, that's based on projected growth rates. At one time projected growth rates would have easily got you into the 11 and 12 percent range, but that has changed a lot within the last two to three years. That's why you see these low single-digit numbers.

Q. What has changed? And that is --

A. What has -- what has changed is that the projected growth rates have come down somewhat, and the stock price has not reacted to that. The valuation levels of the -- of natural gas distribution companies in particular has increased. There's more value placed on the earnings. And that's -- you know, that's when you have a lower cost of equity.

And so after I looked at the dividend yield and the growth rates, that's where I estimated the proxy cost of common equity of 835 to 895, and -- but I decided that because I was looking at Southern Union's capital structure because that is how MGE is -- you know, that's how they procure their capital. And they've always been -- procured their capital with an aggressive financial leverage, aggressive capital structure.

I went ahead and made a 30-basis-point adjustment to that proxy group cost of equity, and that 30 basis points was based on more or less the average spread between a triple-B-rated company and a single-A-rated company that's based on the debt cost.

And I believe it's appropriate to use the spread based on the debt cost because -- because of the fact that utility companies trade much like debt. They are a yield type of investment. That's your widow and orphan stock if you're selecting regulated companies.

Q. Okay. How many were in your -- in our proxy group? How many companies?

A. Six.

Q. And how did you choose the six companies?

A. I started with the --

Q. What was your most important criteria when selecting, I guess I'll ask the question?

A. Well, most form of criteria was selecting a natural gas distribution company that didn't have, you know, nonregulated operations that materially detracted from what I believe would be appropriate. And that's -- Edward Jones is helpful because they look at how the stock is traded, and don't look at just percent of revenues.

And then I just -- from there I just had to make sure that there was information available and --

Q. Size, did you look at the size or

overall revenues of the company?
A. I looked at -- I looked at total -- total capitalization, but your natural gas distribution companies, I don't -- I don't think there's one in my comparable group that has a market cap over three billion, which is actually pretty small when you look -- compared to electric utility companies. I think some of them go as low as below one billion.
Q. What is the market cap of, I guess Southern Union? It wouldn't be MGE.
A. Southern Union, I think their -- I want to say it was -- I can look that up here for you.
Q. But your proxy group was three billion?
A. No, that was the highest in my proxy group.
Q. That was the highest.
A. According to Southern Union's 2005 annual report, the market cap is 2.7 billion. Now, it's probably gone up since then.
Q. Now, the six companies that you used, did you also study their rate design for each one?
A. Yes.
Q. Okay. And was there a range of different types of rate design or...

A. Yes, they vary quite a bit. But from my understanding of what I looked at in the annual reports is, the end result is the same. What they're trying to do is trying to decouple the usage. And when I say usage, I include conservation and weather from -- you know, from the volume of gas used. And some use clauses where there may be, after two months, they'll true it up and they --

Q. So each one has some sort of weather normalization?

A. Each -- each company has at least one division that has some type of weather normalization.

Q. Did any of them go to the straight fixed variable rate design?

A. Only -- only one that I'm aware of and that's Atlanta Gas Light.

Q. And did you study how long they had been operating under that type of rate design?

A. I can probably tell you here.

Q. Well, it's not so much that I'm interested in how long they've been doing it, but did you study what the impact was on rates, on volatility, on earnings after the rate design was implemented?

A. Well, I did not study the specific, you know, earnings volatility before and after the rate design. That's -- once again, that's where I -- you know, that's the beauty of the DCF. If you're using the publicly traded market prices, that reflects investors' expectations and their view is, you know, what the risk level of those -- of those companies are.

Q. So you're saying the risk -- the evaluation of risk is picked up in the stock prices, is what you're saying?

A. Yes. Now, let me clarify. I'm not saying that investors always get it right. I mean, that's why -- that's why there's -- sometimes there's dispute as to whether or not, you know, a stock is over or undervalued. But it's not for me to determine that; it's for me to report on what I think the cost of equity is.

Q. Commissioner Murray asked you some questions about some averages around the country. Did you review -- did you review what the average return on equity was being awarded for comparable natural gas companies around the country?

A. I just -- I used the RRA information which was natural gas distribution.

Q. So that's a yes?

A. Yes.

Q. Okay. So you did look at them. And was it stated what the average was or did you identify what the average was for natural gas utilities?

A. Yes, that's in my direct testimony. It's on page 35 of my direct testimony. And there was some discussion on the third quarter on the 9.6 percent. There's some -- I guess, there's some specific nuances to that. I mean, there's one decision and I would never recommend that the Commission -- if it is going to use allowed ROE's --

Q. That's just for the third quarter though, right?

A. That's just for the third quarter.

Q. How about second quarter?

A. For the second quarter it was 10.5 but once again, it's based on two decisions.

Q. First quarter?

A. 10.63 based on six decisions. So you're getting into, you know, a little larger volume of decisions.

Q. Was there an average -- did you have an average for all of 2006?

A. Yes, it was 10.49. Well, what's interesting is from 2004 through 2006 it looks like just right about ten and a half.

COMMISSIONER CLAYTON: Okay. I don't have any other questions, thank you.

JUDGE JONES: Recross, Missouri Gas Energy?

MR. SWEARENGEN: Just a couple.

RECROSS-EXAMINATION BY MR. SWEARENGEN:

Q. And Mr. Murray, I think you said in response to a question from Commissioner Murray that the cost of capital for MGE is not much different now than it was in the 2004 case?

A. Yes.

Q. And the Commission found at that time the 10.5 was the cost of common equity for MGE/Southern Union in that case?

A. Yes.

Q. And then also I think in response to a question from Commissioner Murray, you were talking about making a downward adjustment to your ROE to account for the straight fixed variable rate design concept, should that be approved by the Commission for MGE in this case. Do you recall that?

A. Yes.

Q. And I think you were working off your recommended range for MGE in this case which is -- at

the midpoint is 8.95 percent; is that right?
A. Yes.
Q. And I think you said that you could see -- if the Commission decided to go with the straight fixed variable rate design, that you could see reducing that ROE to your low end which would be 8.65; do you recall that?
A. Yes.
Q. And that's about a 30-basis-point adjustment; is that right?
A. Yes.
Q. And the company's witness this morning was talking about a 25-basis-point adjustment for reduced risk given that rate design; is that right?
A. Yes.
Q. So the magnitude of the adjustment that we're talking about, at least that you're talking about and the company's cost of capital witness is talking about, is essentially the same?
A. Yes.
Q. It's just a question of where you start to make that adjustment; isn't that right?
A. That's the big question.
MR. SWEARENGEN: Thank you very much. That's all I have.

JUDGE JONES: Thank you. Any recross from the Office of Public Counsel?

MR. POSTON: No, thank you.

JUDGE JONES: Recross of anyone else?

(NO RESPONSE.)

JUDGE JONES: Any redirect from Staff?

MR. THOMPSON: Why, yes, thank you, Judge.

REDIRECT EXAMINATION BY MR. THOMPSON:

Q. Do you have your true-up direct with you, sir?

A. Yes.

Q. Could you read the answer that starts at line 1 of page 3?

A. "As of October 31st, 2006, Southern Union's capital structure was as follows: 36.06 percent common equity, 4.71 percent preferred stock, 55.92 percent long-term debt and 3.3 percent short-term debt."

Q. As far as you know, are the numbers the numbers you stand by at this time?

A. Yes.

Q. And are you confident in the recommended range for ROE that you've offered in this case, 8.65 to 9.25?

A. Yes.

MR. THOMPSON: Thank you. No further questions.

JUDGE JONES: At this time, Mr. Murray, you may step down.

THE WITNESS: Thank you.

JUDGE JONES: At this time let's take a moment to make phone calls and arrangements to stay until 6:00.

(A RECESS WAS TAKEN.)

JUDGE JONES: Let's go ahead and go back on the record. Mr. Trippensee, will you raise your right hand?

(THE WITNESS WAS SWORN.)

JUDGE JONES: Thank you. You may be seated. Your witness, Mr. Poston.

MR. POSTON: Thank you.

DIRECT EXAMINATION BY MR. POSTON:

Q. Would you please state your name for the record?

A. Russell Trippensee.

Q. And who are -- by who are you employed and in what capacity?

A. I'm the chief utility accountant for the Missouri Office of Public Counsel.

Q. Are you the same Russell Trippensee that filed testimony that has been marked as Exhibit 200?
A. Yes, I am.
Q. Do you have any corrections to your testimony?
A. Not to my knowledge.
Q. If I asked you the questions that appear in your testimony today, would your answers be the same?
A. Yes, they would.
MR. POSTON: I offer Exhibit 200 and I tender Mr. Trippensee for cross-exam.
MR. SWEARENGEN: Your Honor, before you rule on Mr. Trippensee's testimony, I would just like for the record to renew the objection that we raised earlier in the motion to exclude the testimony and opinions of Russell Trippensee and ask that that motion be incorporated by reference at this point in time and that it should be a continuing objection as to all opinion testimony that may be offered by Mr. Trippensee on the cost of capital issue today.
JUDGE JONES: Is that a yes or no question? The answer is yes, if it is a yes or no question. It is incorporated, and I believe as we discussed -- it was actually discussed earlier on the

record, so it's in the record, if that's what your concern is.

MR. SWEARENGEN: Yeah. I just wanted to note that it's a continuing objection.

JUDGE JONES: Okay. All righty. With that, then, we'll begin with cross-examination from Missouri Gas Energy.

MR. SWEARENGEN: Thank you, Judge.

CROSS-EXAMINATION BY MR. SWEARENGEN:

Q. Just a couple of questions, Mr. Trippensee. I'm looking at page 12 of your rebuttal testimony, lines 3 through 6 or 4 through 6, I guess. And am I correct in understanding that you're recommending that the appropriate return on equity for MGE in this case be set somewhere between the 7.7 percent and the low end of the Staff's rate of return recommendation of 8.65 percent?

A. In the event that the Commission would approve the -- what's been referred to as straight fixed variable rate design --

Q. Yes.

A. -- that would be correct.

Q. And the 8.65 percent is the Staff -- is the low end of Mr. Murray's range that he's recommended for the Staff; is that right?

A. I believe that is correct, yes.
Q. And you heard him testify earlier this afternoon that he got there by making a 30-basis-point adjustment from his midpoint down to the 8.65 percent, do you recall that?
A. Could you repeat that, Mr. Swearengen?
Q. Yeah. I asked Mr. Murray if he was working from the midpoint of his recommended range which was 8.95, and he was making a 30-basis-point adjustment to that to get to the 8.65 in the event the straight fixed variable rate design is adopted by the Commission, and he said that's what he was doing. Do you recall that?
A. Mr. Murray's direct testimony proposed a range of 8.65 to something slightly over 9 percent.
Q. 9.25, but that wasn't my question. On cross-examination I asked Mr. Murray about his adjustment that he was proposing might be appropriate in the event the Commission went to a straight fixed variable rate design, and he said he would move from his 8.95 midpoint to his 8.65 low end; do you recall that?
A. I recall that line of questioning, yes.
Q. And do you recall that answer that he made?

A. That answer -- yes, I recall that answer. I do not believe it is consistent with his direct testimony where he proposed the entire range.

Q. No, I understand that. Would you agree with me that he was proposing a 30-basis-point downward adjustment for the less risk that might result if the straight fixed variable rate design is adopted?

A. A 30-basis-point adjustment, yes, that's what he discussed.

Q. And that gets him to 8.65?

A. If you start in his midpoint.

Q. Right.

A. If you started at his top end, it gets to 8.95.

Q. And you said in your testimony that the 8.65 would be acceptable from your standpoint if the straight fixed variable rate design is adopted; is that right?

A. No, I did not say that. I think the word between is in there.

Q. Would you not accept 8.65? It has to be below that; is that what you're saying?

A. Staff's direct testimony did not make -- to my knowledge, did not make a specific recommendation within its range. The comparable companies that Staff utilized, as has been discussed today, have -- some of the comparable companies have some sort of weather mitigation clauses, other clauses that address revenue variability.

However, none of those companies have a complete straight fixed variable for all divisions as would be the case with the Staff rate design testimony. So that would be the starting point off of which that 30 basis point, if we accept Mr. Murray's -- or the 35 basis points as Mr. Hanley talked about this morning, or this afternoon, would be taken off of if you accept their opinion as the appropriate 30 or 35 basis points is the proper recognition.

Q. Well, let me go back to your rebuttal testimony on page 12, and I'm reading from lines 4 through 6. Let's see, "The Public Counsel would -- therefore would recommend that the appropriate return on equity be set at an appropriate point between the cost of debt for MGE, 7.7 percent and the low end of the Staff's rate of return recommendation of 8.65 percent."

And my question to you is, are you saying that the 8.65 percent would be an appropriate number or does it have to be something less than that?

A. I believe my answer states it would be less than that. It's between. I didn't say at 8.65.

Q. So 8.65 would be appropriate, then, in your mind?

A. If -- if the Commission found that one basis point risk was the value of the risk reduction related to the rate design, then that would be the Commission's finding. I think Mr. Murray and Mr. Hanley have testified that 30 or 35 basis points is appropriate. I did not take a position on the specific amount.

Q. Well, what my question is, though, and if you just listen to my question and try to answer that, I'm trying to find out if the Commission said we're going to establish the company's ROE at 8.64 percent, would that be consistent with your recommendation as set out on page 12 of your rebuttal testimony?

A. Yes.

Q. Okay. Now, also on page 12 you characterized the straight fixed variable rate design as radical; is that right?

A. On page 12? Can you refer me to a line, sir?

Q. Have you characterized it as radical anywhere in your testimony?

A. Excuse me. I'm getting my testimony and my deposition confused up here. I use that term --

Q. Would you characterize the straight fixed variable rate design as radical, can you answer that?

A. Yes, I would in this state.

Q. On page 11 it's suggested that you might think that if the Commission adopts the straight fixed variable rate design it would be stepping off into unchartered regulatory practices; would that be your testimony?

A. Yes, it is.

Q. And would you think if the Commission adopts this rate design it would be abandoning proven rate design principles?

A. I believe Ms. Meisenheimer will be testifying on that for our office later in the week.

Q. But I mean, what's your opinion on that?

A. Could you repeat the question, please?

Q. Would it be your testimony that if the Commission adopts the straight fixed variable rate design, it would be abandoning proven rate design

principles?
A. I think by definition it would be abandoning the existing principles which I believe personally have served Missouri well for 75 to 80 years.
Q. Do you think the Commission would be abandoning proven rate design principles?
A. Proven? I think they've proven themselves well over the last 75 years.
Q. Is it not true that the straight fixed variable rate design approach has been used by the Federal Energy Regulatory Commission in the interstate gas pipeline industry for many years?
A. I have not participated in interstate pipeline cases, so I'm not intimately familiar enough to answer that question.
Q. So you don't know the answer to that question?
A. As I sit here today, no, I do not.
Q. Do you know whether or not other local gas distribution companies in other state jurisdictions have similar rate designs?
A. As a straight fixed variable?
Q. Yes.
A. I believe as has been testified today

to, Atlanta Gas has a straight fixed variable that was recently implemented.

Q. Is that the only one you're aware of?

A. I believe there's also similar, although I think the mechanics are slightly different, Northern States Power.

Q. So --

A. Two companies.

Q. So there would only be two that you're aware of that have similar rate designs?

A. That is correct, that are completely the same or 100 percent of the revenue requirement is built into the rates that the companies are allowed to charge.

Q. And how many companies are you aware of in other jurisdictions that have rate designs that have many of the characteristics of the straight fixed variable proposal?

A. The characteristics?

Q. Yes.

A. What do you mean by characteristics?

Q. You can define the term.

A. Well, I hate to be argumentative but I didn't ask the question. I think -- so --

JUDGE JONES: What was your question

again, Mr. Swearengen?

MR. SWEARENGEN: If he's aware of any other -- companies in other jurisdictions that operate under rate designs that have similar characteristics to the straight fixed variable rate design proposal.

JUDGE JONES: I think that's a pretty straightforward question.

THE WITNESS: The answer would be from the standpoint that the characteristics of the straight fixed variable are significantly different than a weather mitigation clause or a conservation clause. So I don't think -- as I just mentioned, there's two companies that have a straight fixed variable as Mr. Finnegan referred to it earlier, a flat rate, which is probably closer to be more accurate, so there's only two companies that have similar that are basically the same.

BY MR. SWEARENGEN:

Q. Have you done a study or undertaken any analysis to determine whether or not these two companies that you are familiar with that operate under this type of rate design no longer need to seek rate increases?

A. I believe both of those companies, the rate design is fairly current within the last year and a half, so I don't believe that would give you any measurable assurance. So therefore, no study was necessary.

Q. Have you read the company's direct testimony in this case?

A. Portions of it, yes.

Q. With regard to Missouri Gas Energy, have you done a study or an analysis that shows that the company has not experienced a consistent inability to achieve its Commission-authorized rate of return?

A. I believe there was a study in Mr. Noack's direct testimony that addressed some of that -- those concerns.

Q. Have you done a study or analysis that shows the company has not experienced a consistent inability to achieve its Commission-Authorized rate of return?

A. Did I personally go -- I reviewed the numbers Mr. Noack provided in his testimony. I did not independently go out and look at those.

Q. And you have not disputed this claim by the company in your prepared testimony; is that true?

A. The company -- no, I have not disputed that they haven't earned their, quote, authorized rate of return.

MR. SWEARENGEN: Thank you. That's all I have of the witness.

JUDGE JONES: Any cross-examination from the Staff of the Commission?

MR. THOMPSON: Thank you, your Honor.

CROSS-EXAMINATION BY MR. THOMPSON:

Q. Mr. Trippensee, you were present during the testimony given by Dave Murray?

A. For about virtually all of it. I think I stepped out for just a minute.

Q. Okay. Did you hear Southern Union Company characterized as being aggressively leveraged?

A. Yes, I did.

Q. There were also some questions about an equity-thin capital structure that I seem to recall; did you hear that?

A. Yes, I did.

Q. Would you agree that Southern Union has an equity-thin capital structure?

A. Relative to most LDCs, that would be correct.

Q. In your opinion, is that the result of management decision-making?

A. The level of equity and the level of debt that a company maintains is a result of decisions made by the management of the company, of how to finance their operations. In a industry where it has both regulated and nonregulated, they can also use that to maximize the earnings of the entire company, as I believe is the case in this case.

Q. So it is the result of management decisions?

A. Yes.

Q. And there was -- were questions directed to David Murray having to do with two alternatives proposed by Mr. Morin; do you recall those questions?

A. Two alternatives by Mr. Morin? Yes, I believe I do.

Q. One of those was to add a premium to ROE and the other was to use a more conservative capital structure. Do you recall that?

A. Yes, I do.

Q. Now, isn't it true that either one of those alternatives would result in ratepayers paying more?

A. Yes, there -- but there's a significant difference between the two alternatives that has not been addressed in this case.

Q. What is that difference?
A. With the premium you're looking at strictly dollars related to some risk of having a higher leverage. With a conservative capital structure or what has been referred to as a hypothetical capital structure, it creates the appearance of equity earnings in the rate case, which then, in the revenue requirement, federal income tax and state income tax has to be built on that of what's called the tax multiplier.
So for every dollar of additional equity required due to a hypothetical capital structure, the ratepayer has to pay $1.62, when, in fact, when the rate -- if, in fact, it's adopted and the ratepayer pays that, that 62 cents flows directly into the company as income and profit because there's no actual federal tax related to it because the company is leveraged and has debt expense to offset those earnings.
Q. So from your point of view, the second alternative would be worse for the ratepayer than the first?
A. Much worse.
Q. But both of these alternatives require ratepayers to underwrite management decisions, do

they not?

A. To underwrite management decisions, that would be correct.

MR. THOMPSON: No further questions.

JUDGE JONES: Any cross-examination from Midwest Gas Users Association?

MR. CONRAD: No, Judge.

JUDGE JONES: Mr. Finnegan, any questions?

MR. FINNEGAN: No, your Honor.

JUDGE JONES: And then, I don't have any questions, and we'll move on to -- well, redirect.

MR. POSTON: Thank you.

REDIRECT EXAMINATION BY MR. POSTON:

Q. Is it your understanding that Mr. Murray's 8.65 low end that he identified in his direct was achieved as a result of an adjustment to account for a straight fixed variable rate design?

A. I believe his direct testimony made no mention of rate design. I believe Mr. Murray testified today that he only read the rate design testimony after Public Counsel and myself, particularly, had filed rebuttal testimony. His direct testimony included a recommended range of 8.65 to nine and a quarter with not -- without any specific recommendation within that range.

Q. You were asked a question about the interstate pipeline. Has that industry been deregulated?

A. Portions of the interstate pipeline as far as price of gas have been deregulated. The actual transportation charges associated with it, I believe, is still under FERC regulation, F-E-R-C.

MR. POSTON: That's all I have. Thank you.

JUDGE JONES: Okay. With that, then, Mr. Trippensee, you may step down.

THE WITNESS: Thank you.

JUDGE JONES: Let's move into our next issue of policy. MGE, call your first witness.

MR. BOUDREAU: I just have a short -- a few short opening comments.

JUDGE JONES: Before I forget, I do want to admit Mr. Trippensee's testimony into the record. I don't believe I did that.

(EXHIBIT NO. 200 WAS RECEIVED INTO EVIDENCE AND MADE A PART OF THE RECORD.)

MR. FRANSON: Judge, before Mr. Boudreau comes up, how are we doing this? Are we doing all of the many openings here or are we going to do them --

JUDGE JONES: Why don't we let him do his and present his witness. Before you present your witness, do your opening. Call your witness, then do your opening.

MR. FRANSON: Okay.

MR. BOUDREAU: May it please the Commission?

JUDGE JONES: Go right ahead.

MR. BOUDREAU: MGE's business emphasis is on providing quality customer service at affordable rates. And as such, MGE places a great deal of importance on safety and customer satisfaction. Its success can be measured in the fact that there really were no complaints lodged by the company's customers concerning customer service or billing problems at the local public hearings held in October, even though specifically asked those questions, the public witnesses were specifically asked those questions by Commissioner Clayton, as I -- as I recall.

Also, the written comments filed by Public Counsel asked Friday contained no complaints about quality of service.

MGE is also committed to being a low-cost provider. And in this regard, its O&M costs are the lowest of all comparable Missouri LDCs. Its margin rates, which are the sum of fixed monthly rate element plus the volumetric delivery rates, shows that MGE -- MGE's are the lowest of comparable companies.

At the same time, MGE's rates have not been set in such a way that it has been able to earn its authorized rate of return. There are a number of reasons for this, but the two principal drivers are its inability to obtain an authorized return at a level to compensate shareholders for their investment risks.

And the second reason is the desperate need for a ratemaking solution to remedy material and chronic volumetric shortfalls associated with declining customer use and actual weather being warmer than the normal weather assumed in the rate-setting process.

It is time the Commission shows the value it places on service quality by providing MGE with a meaningful opportunity to realize its authorized return because maintaining its high level of customer service is not sustainable if earnings continue to remain in inadequate levels.

If this revenue problem is not

adequately addressed, MGE's only recourse will be to file yet another rate increase request, an outcome that MGE does not believe is in the best interest of its customers or the shareholders.

And with respect to this topic, I will offer the testimony of MGE's chief operating officer, Robert Hack, whose testimony elaborates on these themes. And with that, I'll, for the record, call Mr. Hack to the stand.

JUDGE JONES: Okay. Mr. Hack, would you raise your right hand?

(THE WITNESS WAS SWORN.)

JUDGE JONES: Thank you.

(EXHIBIT NOS. 9 AND 10 WERE MARKED FOR IDENTIFICATION BY THE COURT REPORTER.)

DIRECT EXAMINATION BY MR. BOUDREAU:

Q. Would you state your name for the record, sir?

A. Robert Hack, H-a-c-k.

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

A. I am the chief operating officer for Missouri Gas Energy which is an operating division of Southern Union Company.

Q. Are you the same Robert Hack that has caused to be filed prepared direct and surrebuttal testimony which has been marked as Exhibits 009 and 010, respectively?

A. Yes.

Q. Was that testimony prepared by you or under your direct supervision?

A. Yes.

Q. Do you have any corrections you'd like to make to your testimony at this time?

A. Just a few to the direct, which is Exhibit 9. The first one is on page 7, line 21. There is a parenthetical which says, "See media advisory attached hereto as schedule RH 1." Strike that parenthetical because there is no such attachment to the testimony.

Q. Which page was that again, sir?

A. Page 7, line 21.

Q. Thank you. Do you have any other corrections to make, sir?

A. The second is on page 19, also of the direct, line 16. At the end of that line there is the word "including" and I inadvertently dropped some words. The words which should be included there or added after the word "including" are, "plant in service and miscellaneous expense items," semi-colon.

MR. FRANSON: I'm sorry. Could you tell us -- Mr. Boudreau, where was that?

MR. BOUDREAU: Page 19, line 16.

BY MR. BOUDREAU:

Q. And if I could ask the witness to once again indicate the language that should be added?

A. Yes. After the word "including" at the end of that line, insert the following: "Plant in service and miscellaneous expense items," semi-colon.

Q. Do you have any other corrections to your direct testimony?

A. The final -- final change or correction, page 20, line 10, also direct testimony, towards the end of that line, between -- after the word "only," add the word "recourse" so that it would read, "The unfortunate fact is that the company's only recourse will be..."

Q. Okay. Did you have any corrections you wanted to make to your surrebuttal testimony?

A. No.

Q. If I were to ask you the same questions today, taking into consideration the corrections that you just made, would your answers be substantially the same?

A. Yes.
Q. And are your answer -- or your testimony true and correct to the best of your information, knowledge and belief?
A. Yes.
MR. BOUDREAU: With that, I would offer Mr. Hack's direct and surrebuttal testimony and offer -- or tender him for cross-examination.
JUDGE JONES: Any objections?
(NO RESPONSE.)
JUDGE JONES: Seeing none, Exhibits 9 and 10 are admitted into the record.
(EXHIBIT NOS. 9 AND 10 WERE RECEIVED INTO EVIDENCE AND MADE A PART OF THE RECORD.)
JUDGE JONES: And we'll move right into cross-examination for the Staff of the Commission.
MR. FRANSON: Thank you.
CROSS-EXAMINATION BY MR. FRANSON:
Q. Mr. Hack, if you could -- I believe it's Exhibit 9, if you could turn to page 18, lines 12 through 13. Please tell me when you're there.
A. Yes.
Q. Okay. You say, "Which is based on a 10.5 return on equity, ROE, in a capital structure

comprised of 29.99 percent common equity fails this test." Is that, in fact, a reference to the return on equity and the ratio of common equity set by the Commission in Case Number GR-2004-0209?

A. That is correct.

Q. Okay. You aren't here saying today, though, that the actual common equity percentage for Southern Union Company at the time that the Commission set the rates in the GR 2004-0209 case was anything different than 29.99 percent, are you?

A. No.

Q. Okay. You just are saying, for ratemaking purposes, you want something different?

A. I'm saying that a ten and a half percent ROE in conjunction with an exceedingly low common equity ratio, which at the time was sub 30 percent, does not meet, in my opinion, the Hope and Bluefield requirements that require a return on -- an authorized return to be commensurate with risks of enterprises with similar risks.

JUDGE JONES: Mr. Franson, is your microphone on?

MR. FRANSON: It is now, your Honor, thank you.

BY MR. FRANSON:

Q. Now, the 29.99 percent common equity, was that caused by the actual capital -- let me just ask it this way: The actual capital structure of Southern Union Company is a product of management and their management decisions; isn't that correct?

A. It's a product of many factors, including adequacy of earnings as well as management decisions.

Q. Okay. Would you agree that management decisions are a very important driver in the -- what turns out to be the actual capital structure of a company Southern Union included?

A. Certainly.

Q. And, in fact, ultimately, the 10.5 return on equity and capital structure comprised of 29.99 percent was upheld by the Western District Court of Appeals; isn't that correct?

A. I don't believe the Western District of Missouri Court of Appeals reviewed the decision.

Q. So you don't think they passed -- never mind. You answered my question. Thank you. You talked in your testimony that you want a new look at things in the ratemaking process for Missouri Gas Energy; is that true?

A. Yes, sir.

Q. Okay. You want -- are you telling the Commissioners they've just simply blown it in past MGE cases and you want them to get it right this time?

A. I think the record is clear that rates set in the past for MGE have proven to be inadequate, and it didn't take very long for that inadequacy to become clear.

Is any specific entity primarily responsible for that inadequacy? No. We all play a part in the process. But I think it's incumbent upon all of the parties to bring forward the facts that bear on setting rates for the future, and those -- those historical inadequate earnings are clear, undeniable evidence that something needs to change.

Q. And you think the way that needs to change is to, across the board, grant everything that MGE's asked for in this case today, including your -- well, go ahead. I'll leave my question the way it is.

A. I don't harbor any delusion that we will come away with, you know, a complete and utter shut-out in this case. I believe all of the positions we've taken are principal positions, and I think the Commission could very well adopt our position on each of those issues.

There are clearly some issues that are far more critical to going-forward earnings for this company than others, and we really need the Commission to take a look at those as explained by Mr. Swearengen and Mr. Boudreau in their opening statements. In particular, rate design, in particular, if the rate design goes other than straight fixed variable, the weather normal measure is absolutely critical.

Q. What is retroactive ratemaking?

A. Retroactive ratemaking would be the setting of -- of future rates so as to recover either past losses or past benefits.

Q. Is it fair to say that as the COO of MGE, you are familiar with the various issues in this case and the positions of MGE on those issues?

A. Sure.

Q. Okay. Would you agree with Mr. Noack's testimony, and I believe it's stated in your 81-page prehearing brief, that your issue of unrecovered cost of service amortization -- and this is a yes or no question, by the way, Mr. Hack -- constitutes retroactive ratemaking?

A. Yes, as explained in that testimony.

Q. With that -- and you understand -- or well, let me ask you this: Would you agree that retroactive ratemaking in this state is considered to be inappropriate?

MR. BOUDREAU: I'd object on the grounds that it's calling for a legal conclusion.

MR. FRANSON: Your Honor, first of all, witnesses can certainly respond to their understanding of the law; and second of all, we've got a legal expert here. I don't think anyone in this room is going to question this man's legal expertise. So I think it's an appropriate question.

JUDGE JONES: Well, Mr. Boudreau, in all frankness, it doesn't matter what he thinks is legal or illegal, so his answer is irrelevant even. It doesn't matter whether he thinks it's illegal; it's what the Commission thinks is legal or illegal. So it doesn't matter what Mr. Hack thinks.

So I'm gonna sustain the objection for different reasons, put it that way.

MR. FRANSON: Okay. With that, Judge, I have no further questions.

JUDGE JONES: Okay. We'll move on to cross from the Office of Public Counsel.

MR. POSTON: Thank you.

CROSS-EXAMINATION BY MR. POSTON:

Q. Good evening, Mr. Hack.

A. Hello.

Q. If the Commission issued a final order in this case favorable to Southern Union, for example, if the Commission approved your straight fixed variable rate design proposal or approved the environmental response fund, could that make MGE more attractive to a company looking to purchase MGE?

A. I don't know.

MR. POSTON: I'd like to approach the witness, if I could?

JUDGE JONES: You may.

BY MR. POSTON:

Q. Would you please identify what I just handed to you?

A. This appears to be Southern Union Company's 2005 annual report.

Q. And have you seen Southern Union's 2005 annual report before?

A. Yes.

Q. Does that look to be an accurate, complete copy of that report?

A. I'll trust you on that, Marc.

Q. Thank you. And I've tabbed -- the first tab in there has a timeline. Can you please turn to that?

A. Yes.

Q. And looking at this timeline, Southern Union acquired its Missouri operations, LDC operations in 1994, correct?

A. That is correct.

Q. And in 1999 acquired the Pennsylvania operations, that's also an LDC, correct?

A. That is correct.

Q. And then in 2000, New England operations, also an LDC, correct?

A. Correct.

Q. And then in the seven years since MGE was acquired in '94, in 2003, Southern Union sold the Texas operations; was that also an LDC?

A. That is correct.

Q. And in the same year they acquired Panhandle, correct?

A. That is correct.

Q. And Panhandle is a pipeline?

A. An interstate pipeline, two actually.

Q. And then in '04 acquired Cross Country Energy?

A. That is correct.
Q. Is that a pipeline?
A. That is several pipelines.
Q. And then just last year in '06 acquired Sid Richardson. And is that a pipeline?
A. No. That is a -- it's a gathering and processing system.
Q. Okay. And then also last year, Southern Union announced the sale of the Pennsylvania and Rhode Island operations, both LDCs, correct?
A. Yes.
Q. So is MGE the last remaining LDC owned by Southern Union?
A. No.
Q. What other LDCs does Southern Union own?
A. There's a Massachusetts operation.
Q. Is there any intention to sell that to your knowledge?
A. Not that I'm aware.
Q. And to your knowledge, is one of the reasons Southern Union filed this rate case to make MGE more attractive to potential buyers?
A. Not that I'm aware of.
Q. Did MGE perform well financially in 2005?

A. Did MGE?

Q. Yes.

A. Thanks to property tax refunds that we fought for, yes. Absent those property tax refunds, no.

Q. Is Mr. George Lindemann the chairman, president and CEO of Southern Union?

A. Yes.

Q. Could you please turn to the second tabbed page?

A. Yes.

Q. And would you please read the last sentence of that first full paragraph?

A. "Our Missouri Gas Energy distribution company performed exceptionally well and was the major contributor to the success of the company's distribution segment in 2005."

Q. And whose signature appears at the bottom of that statement?

A. Mr. Lindemann's.

Q. And when is that dated?

A. March of this -- March 14, 2006.

Q. And MGE filed this request for a rate increase in May of 2006, correct?

A. That's correct.

MR. POSTON: Thank you. That's all I have.

JUDGE JONES: Commissioner Murray?

COMMISSIONER MURRAY: I have no questions, thank you.

JUDGE JONES: Mr. Finnegan, did you have a question?

MR. FINNEGAN: Yes, I do.

JUDGE JONES: Go right ahead.

CROSS-EXAMINATION BY MR. FINNEGAN:

Q. Mr. Hack, if you'd turn to page 3 of Exhibit 9, your direct testimony.

A. I'm there.

Q. Okay. Beginning on page 6 in that paragraph there, you discussed the major reasons the company decided to file a general rate case at this time?

A. Yes.

Q. And No. 1 was, "the inability to achieve your Commission-authorized rate of return driven primarily by chronic and material volumetric revenue shortfalls due to warm weather and declining average use per customer"; is that correct?

A. That is correct.

Q. Okay. Is the -- with respect to the

declining average use per customer, isn't that just a result of the warm weather?

A. It is -- it's actually -- you can measure declining average use per customer independent of the weather. Our normalized -- our weather-normalized consumption assumed through the rate setting process over every rate case for the past ten years has produced a lower residential normalized sale. So customers are using less gas irrespective of the weather.

When you -- when you layer warmer than normal weather on top of it, that just exacerbates an already difficult situation.

Q. The second reason you give is, "The need for MGE to obtain an authorized rate of return from the Commission that is competitive in the industry and commensurate with the risk borne by the shareholders who invest in MGE."

A. That is correct.

Q. Do shareholders invest in MGE?

A. Indirectly through Southern Union Company.

Q. So instead of MGE, it should be Southern Union; is that correct?

A. I stand by -- by the testimony. The --

the investment that is deployed in Missouri is MGE-specific investment. What -- one could view it as we have one shareholder and that shareholder is Southern Union, and then shareholder investors actually invest in Southern Union.

Q. So is the shareholders invested in Southern Union?

A. To invest in MGE, correct.

Q. And the third reason is, "The cost-of-service increase is attributable to other factors, including additional capital deployed by MGE's system and continued exceedingly high gas costs." Aren't those two factors covered by ISRS and the PGA clause?

A. ISRS recovers some investment. It certainly doesn't recover all. I believe of our 30 to $40 million capital budget each year, ISRS probably covers about half of it.

Gas costs are -- are recovered through the PGA, but bad debts associated with high gas costs are not recovered through the PGA. In addition, high gas costs contribute to the declining use per customer that we see. When gas costs and bills are high, people dial their thermostats back and our earnings suffer as a result.

Q. Okay. And that could be a result of gas

cost or the result of your rates too, could it not?
A. Certainly, the volumetric rate element in the wintertime contributes to high customer bills in the wintertime.
MR. FINNEGAN: That's all the questions.
JUDGE JONES: Any other cross-examination?
(NO RESPONSE.)
JUDGE JONES: Okay. We'll move on to redirect.
MR. BOUDREAU: I don't believe I have any questions on redirect, thank you.
JUDGE JONES: Okay. With that, then, Mr. Hack, you may step down but you are not excused.
THE WITNESS: Thank you.
JUDGE JONES: Let's move to MGE's next witness.
MR. BOUDREAU: I don't believe MGE has another witness on the issue of policy. Oh, yeah, I guess that's true, we do. I'm sorry. Yes, call Mr. Noack to the stand, please.
JUDGE JONES: And Mr. Noack, you just remain under oath.
THE WITNESS: Yes, sir.
MR. FRANSON: Your Honor, if I may,

before Mr. Noack begins, I'm looking at my list of exhibits and I show his Exhibit 7 is in. Will his testimony here bring us 5, 6 or 8? I would certainly have no objection to that, but I was just gonna ask because if that would bring in any of his other testimony --

JUDGE JONES: You're asking me? I have no idea.

MR. FRANSON: Okay. I was hoping Mr. Boudreau would address that.

DIRECT EXAMINATION BY MR. BOUDREAU:

Q. Would you state your name, please, sir?

A. Michael Noack.

Q. You've previously testified at least with respect to your surrebuttal testimony; is that correct?

A. That's correct.

Q. On the issue of cost of capital?

A. Yes.

Q. And in that regard, your surrebuttal testimony has already been identified as an exhibit and I believe offered into the record?

A. I believe so.

Q. Okay. Have you also caused to be filed with the Commission your prepared direct, rebuttal, updated test year of your direct testimony and true-up testimony in this case?

A. Yes. I think I have a total of five different testimonies.

Q. And your direct testimony, I believe, has been previously identified as Exhibit 004, your updated test-year direct testimony as 005, your rebuttal testimony as Exhibit 006 and your true-up testimony as 008; is that your understanding?

A. I believe so.

Q. Okay. Do you have any corrections that you would like to make to any of those items of prepared testimony at this time?

A. No.

Q. Were they prepared by you or under your direct supervision?

A. Yes, they were.

Q. And if I were to ask you the same questions as were asked in these pieces of testimony today, would your answers to them be substantially the same?

A. Yes, they would.

MR. BOUDREAU: With that, I'd like to offer company Exhibits 004, 005, 006 and 008.

JUDGE JONES: Any objections?

(NO RESPONSE.)

JUDGE JONES: Seeing none, those exhibits are admitted into the record.

(EXHIBIT NOS. 4, 5, 6 AND 8 WERE RECEIVED INTO EVIDENCE AND MADE A PART OF THE RECORD.)

MR. BOUDREAU: At this point I'll tender him for cross.

JUDGE JONES: Cross-examination from the Staff of the Commission?

MR. FRANSON: No questions, your Honor.

JUDGE JONES: Any questions from Office of the Public Counsel?

MR. POSTON: Just a few.

CROSS-EXAMINATION BY MR. POSTON:

Q. Could you please turn to your schedule G-4, page 1 of 2?

A. I have it.

Q. Okay. And were you in here during Mr. Swearengen's opening and he talked about one of the reasons that MGE was in here for this rate case was because the company did not earn its authorized rate of return?

A. Correct.

Q. And looking at the schedule, it's a

comparison of achieved rate of return versus authorized rate of return; is that correct?

A. That's correct.

Q. And so in the last column, is it correct that for -- I guess is the year ending -- what does -- what does that last column show? Is that a six-month time period?

A. No. It's a 12-month period ending 12/31/05.

Q. And so it shows an authorized rate of return of 8.36 percent; is that correct?

A. Correct.

Q. And then an achieved return of 7.49 percent?

A. Correct.

Q. And is that the return that MGE's referring to that they're not achieving and that's why they're back?

A. It's the authorized rate of return we're not achieving, yes.

Q. And those numbers, the 7.49 and the 8.36, was that calculated with a hypothetical or an actual capital structure?

A. It was using the capital structure from the case immediately preceding which would give rise to the authorized rate of return. So the capital structure associated with the 8.36 percent or the capital structure from GR-2004-0209.

Q. That was the authorized you're saying?

A. Yes.

Q. Okay. And do you have data on the equity returns for this same time period?

A. No, I did not break that out separately.

MR. POSTON: That's all I have. Thank you.

JUDGE JONES: Commissioner Murray, do you have any questions?

COMMISSIONER MURRAY: I don't have any questions.

JUDGE JONES: Any redirect?

MR. BOUDREAU: I have none, thank you.

JUDGE JONES: Thank you, Mr. Hack -- I'm sorry. Mr. Noack, you may step down. Staff witnesses do I see here? Anybody from Staff?

MR. FRANSON: Not in the room, but we will have him here in a moment.

MR. FINNEGAN: While we're -- while we're waiting, your Honor?

JUDGE JONES: Yes.

MR. FINNEGAN: I'm trying to clarify

what exhibits were admitted just then.

JUDGE JONES: Exhibits 4, 5, 6 and 8.

MR. FINNEGAN: Eight is the true-up testimony. Seven was already admitted?

MR. BOUDREAU: Seven was already admitted.

MR. FINNEGAN: Okay. That's what I was wondering.

MR. BOUDREAU: And 8 was the true-up.

(EXHIBIT NO. 104 WAS MARKED FOR IDENTIFICATION BY THE COURT REPORTER.)

MR. FRANSON: Your Honor, Mr. Schallenberg is here. He's going to adopt the testimony of Mr. Oligschlaeger, and at this time I guess Staff would call Robert Schallenberg.

JUDGE JONES: Mr. Schallenberg, will you raise your right hand?

(THE WITNESS WAS SWORN.)

JUDGE JONES: Thank you, sir. You may proceed.

MR. FRANSON: May I proceed?

JUDGE JONES: Yes, you may.

DIRECT EXAMINATION BY MR. FRANSON:

Q. Sir, please state your name.

A. Robert E. Schallenberg.

Q. Mr. Schallenberg, how are you employed?
A. I'm employed as the director of the utility services division for the Missouri Public Service Commission.
Q. And in the capacity of your job as the director of the utility services division, do you hold any professional certifications?
A. Yes.
Q. And what are those?
A. I am a certified public accountant.
Q. And how long have you been working for the Public Service Commission?
A. It would be over 30 years if you count -- it would be about 30 years for the Commission, for the Missouri Public Service Commission, and a little over 30 years if you count my eight-month stay with the Kansas Corporation Commission.
Q. Okay. Are you familiar with Mark Oligschlaeger?
A. Yes.
Q. Are you, in fact, adopting his testimony today?
A. Yes.
Q. Has that -- and I believe that's been

previously marked as Exhibit 104. Do you have any changes to the rebuttal testimony of Mark Oligschlaeger, changes, additions, corrections or deletions?

A. No.

Q. If you were asked these questions that -- and answers that -- if you were asked the questions that appear in Mr. Oligschlaeger's rebuttal testimony marked as Exhibit 104, would your answers today be substantially similar?

A. Substantially, yes.

MR. FRANSON: Okay. At this time, your Honor, I would offer into evidence Exhibit 104, the rebuttal testimony of Mark Oligschlaeger as adopted by Mr. Schallenberg, and then tender the witness for cross-examination.

JUDGE JONES: Any objections?

MR. BOUDREAU: None, thank you.

JUDGE JONES: Exhibit 104 is admitted into the record.

(EXHIBIT NO. 104 WAS RECEIVED INTO EVIDENCE AND MADE A PART OF THE RECORD.)

JUDGE JONES: Any cross from Missouri Gas Energy?

MR. BOUDREAU: Yes, thank you, just a

few questions. Is it acceptable to ask the questions from here?

JUDGE JONES: Yes, please. That's no problem.

CROSS-EXAMINATION BY MR. BOUDREAU:

Q. Good evening, Mr. Schallenberg. How are you?

A. Fine. How are you?

Q. I'm doing well. I just have a few questions for you. Would you agree with me, sir, that the purpose of using a test year in a rate case is to construct a reasonably expected level of expenses, rate base and revenues during the future period during which the rates determined will be in effect?

A. Could you repeat all of that?

Q. Let me rephrase that just slightly. Would you agree with me that the purpose of using a test year is to construct a reasonably expected level of expenses, rate base and revenues that will be representative of a future period during which the rates determined will be in effect?

A. I -- I would not agree that's the primary purpose for a test year but it can be used for that purpose.

Q. Okay. Well, let me ask you, then, what -- what is your view of the use -- I mean, what is the purpose of a test year in a rate case?

A. If in practice before the Missouri Commission --

Q. Yes, please.

A. Commission tries cases, rate cases on an issue-by-issue basis, and you need a common starting point in order to identify issues, and the use of a test year is the requirement that everybody starts, from that starting point. So you can trace what everybody has done to the test year to create their cost of service.

Q. Okay. Thank you. Would you agree with me, then, that the Commission looks to historical data and makes certain adjustments to account for future circumstances or events?

A. Yes, with the understanding that we also use a matching principle, controlling about how you adjust the test year for future events -- events.

Q. Okay. Thank you. In fact, I think at page 7 of your testimony, and again, I don't want to throw you. I'm gonna refer to it as your testimony since you've adopted it. Page 7 of your testimony, I believe you state that if there are methodological problems with how rates are set, the proper course of action is to propose prospective solutions; is that correct?

MR. FRANSON: Can you be more specific on where that is?

MR. BOUDREAU: Yes, it's lines 8 through 10 on page 7 of his testimony.

THE WITNESS: Okay. I see the portion. Now, what was your question again?

BY MR. BOUDREAU:

Q. Well, is that a correct -- is that a correct summary of your testimony there?

A. Well, what the testimony says is what it --

Q. Okay.

A. -- is what it says.

Q. Okay. Well, with the idea of keeping that -- well, with keeping the idea of working a prospective solution, even with that as a general objective, are there limits to what any -- I mean, there are limits to what any of us can do in that regard, aren't there?

A. Yes, I mean, there's statutes and there are rules and other factors that provide parameters that you have to operate within, yes.

Q. Okay. Let me ask you this: If the tools that we use in the rate setting process don't reasonably achieve the objectives for which they're designed, would you agree with me that the tools should be reexamined for an eye for -- with an eye towards improvement or refinement?

A. Is this a hypothetical?

Q. I suppose in a sense, yes.

A. I would say hypothetically, I would agree. In practice, I have yet to see a problem that has not -- that we haven't been able to find an alternative to address, in practice.

Q. Fair enough. Thank you. I want to direct your attention now to page 8 of your testimony, and specifically the question and answer that appear -- that start on line 9 and complete at line 14. Would you review that, please?

A. Yes.

Q. And that is something of a critique of Mr. Hack's testimony that -- that -- where he makes some claims about the relative rates of MGE compared to another group of Missouri LDCs; is that correct?

A. Yes, I believe there were three other LDCs in his comparison.

Q. Yeah. And one of those was the Laclede Gas Company; isn't that correct?

A. Yes, it is.

Q. Now, since the testimony -- since this testimony was filed, Laclede Gas Company has filed a rate case of its own, hasn't it?

A. Yes, it has.

Q. Have you done a comparison of the company's rates taking into account both rate increases?

A. No, I have not.

Q. Okay. So you wouldn't know if the relative relationship of the resulting rates would continue to support Mr. Hack's claim?

A. No, I do not.

Q. Okay. Finally, I want to direct your attention to page 14 of your testimony, if you could turn to that, please?

A. I'm there.

Q. There is a question and answer that appear between lines 9 and 19 and I'd ask you to take a moment just to review those, if you would, or that question and answer.

A. Yes.

Q. There's a statement starting on line 16 and it addresses Senate Bill 179 and it states that -- it gives LDCs such as MGE the ability to obtain single issue rate recovery of additional plant investment beyond that already allowed under the ISRS law; do you see that?

A. Yes.

Q. Now, Senate -- Senate Bill 179 only authorizes recovery of expenses associated with complying with environmental laws or to reflect nongas revenue effects of weather variations for conservation; isn't that true?

MR. FRANSON: Your Honor, I'm gonna have to object. That, quite frankly, is a -- calls for a legal conclusion about a statute that's now in effect. And based on earlier rulings, that would not be relevant. And also, this witness is not qualified to state an affirmative legal conclusion which is what this question asks for.

JUDGE JONES: Are you asking him to interpret Senate Bill 179?

MR. BOUDREAU: Well, the testimony contains a statement about what Senate Bill 179 does, and I'm just asking if his understanding -- if that general statement is correct. I mean, it seems to me that if he states what the bill does or doesn't do, I ought to be able to inquire about the degree of his understanding about what the bill actually does or doesn't do. If he doesn't know --

JUDGE JONES: It is in his testimony, Mr. Franson.

MR. FRANSON: I agree, your Honor, but the question was not about his testimony. The question was specifically, Mr. Boudreau asked, doesn't Senate Bill 179 include this whole litany of things, and that question as asked is not asking the witness anything about his testimony; it's asking the witness a very broad -- for a broad legal interpretation of Senate Bill 179. And my objection to that still remains the same.

The question as asked asks for a legal conclusion, and I would object on that basis, and also I would object on the relevance of this witness testifying about what Senate Bill 179, a legal conclusion about that.

JUDGE JONES: What's included in the testimony, Mr. Boudreau?

MR. BOUDREAU: I was pointing -- I was directing Mr. Schallenberg to his testimony at page 14, lines 9 through 19, and it contains this statement among other things. The testimony reads as follows: "In addition, the passage of Missouri Senate Bill, parens SB, end parens, 179 in 2005, may give the Missouri LDCs such as MGE the ability to obtain single issue rate recovery of additional plant investment beyond that already allowed under the ISRS law once the implementation of the rules for Senate Bill 179 are issued in final form." And I'm just asking the witness about --

JUDGE JONES: That specific statement?

MR. BOUDREAU: -- whether this -- whether this general statement is perhaps a little bit overbroad, and I'm just asking for some clarification.

JUDGE JONES: I'm gonna allow the question.

BY MR. BOUDREAU:

Q. Okay. Would you like me to restate that, Mr. Schallenberg?

A. No, I think I recall it.

Q. Okay. Please.

A. The statement is directed towards -- as I remember, in Senate Bill 179, there is an environmental recovery type of adjustment that can be allowed, and depending on the definition of environmental, that would be in implementation rules.

There has -- and there is not a prohibition for MGE, which is a gas company unlike an electric company, to recover CWIP in the interim. There is a possibility that those rules would allow for recovery of plant other -- over and above the plant costs that could be recovered under the ISRS.

Q. Okay. So your testimony is that there's a possibility for some recovery under the bill --

A. Well, I think the testimony says "may give" once implementation rules are issued.

Q. In that regard, what kind of plant are we talking about?

A. It would be environmental.

MR. BOUDREAU: I believe that's all the questions I have for this witness. Thank you.

JUDGE JONES: Any questions from the Office of Public Counsel?

MR. POSTON: No questions.

JUDGE JONES: Mr. Franson -- or I'm sorry. Commissioner Murray, do you have questions?

COMMISSIONER MURRAY: No questions.

JUDGE JONES: Mr. Finnegan?

MR. FINNEGAN: No questions.

JUDGE JONES: Mr. Franson?

MR. FRANSON: Thank you.

REDIRECT EXAMINATION BY MR. FRANSON:

Q. Mr. Schallenberg, on page 14 of your testimony, Mr. Boudreau just asked you some questions regarding Senate Bill 179. You use the term CWIP. Is that construction work in progress?

A. Yes, that's the term used for gas and electric companies.

Q. Okay. Generally what is CWIP?

A. It's plant cost for a part of the -- for a project that's not completed and in service. That's the construction phase for a plant project.

Q. Right now if MGE has CWIP, can they recover the cost of that in rates?

A. By right now, there is no prohibition for inclusion and cost of service --

Q. Okay.

A. -- into rate base. For example, costs for a plant that is under construction but not completed. I'm not aware of such a request is an issue in this case, but there's no prohibition against that methodology.

Q. And your understanding of Senate Bill 179, is it only environmental plants or is -- can it be other types of plants we're talking about?

A. Well, there were three pieces, as I

recall, in terms of a single issue or adjustment surcharges. And one is a -- what's commonly referred to as a fuel adjustment clause, but that's applicable to electrics.

There was one for -- there's a feature for environmental expenditures which would basically, I think, hit almost all of our industries that the statute would apply. And the other one was conservation and weather which would generally affect electric and gas.

MR. FRANSON: I don't believe I have any further questions, your Honor.

JUDGE JONES: Okay. With that, then, Mr. Schallenberg, you may step down. And it is six o'clock and we will adjourn.

(WHEREUPON, the hearing of this case was recessed until January 9, 2007, at 9:30 a.m.)

I N D E X

JANUARY 8, 2007

ISSUE: COST OF CAPITAL

MGE'S EVIDENCE (RESUMED)

STAFF'S EVIDENCE

OPC'S EVIDENCE

ISSUE: POLICY

MGE'S EVIDENCE

STAFF'S EVIDENCE

EXHIBITS INDEX

* Neither offered nor received into evidence in this volume.

CERTIFICATE OF REPORTER

STATE OF MISSOURI)
)ss.
COUNTY OF COLE)

I, PAMELA FICK, RMR, RPR, CSR, CCR #447, within and for the State of Missouri, do hereby certify that the witnesses whose testimony appear in the foregoing hearing was duly sworn by me; that the testimony of said witnesses were taken by me to the best of my ability and thereafter reduced to typewriting under my direction; that I am neither counsel for, related to, nor employed by any of the parties to the action to which this hearing was conducted, and further that I am not a relative or employee of any attorney or counsel employed by the parties thereto, nor financially or otherwise interested in the outcome of the action.

____
PAMELA FICK, RMR, RPR, CSR, CCR #447