ATTACHMENT A

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of Missouri Gas Energy's Tariffs to	)	
Implement a General Rate Increase for	)	**Case No. GR-2004-0209**
Natural Gas Service	)	Tariff No. YG-2004-0624

REPORT AND ORDER

Issue Date: September 21, 2004

Effective Date: October 2, 2004

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OF THE STATE OF MISSOURI

In the Matter of Missouri Gas Energy's Tariffs to Implement a General Rate Increase for Natural Gas Service	)))	**Case No. GR-2004-0209** Tariff No. YG-2004-0624

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REGULATORY LAW JUDGE: **Morris L. Woodruff**

REPORT AND ORDER

Table of Contents

Summary

In this report and order, the Commission finds that Missouri Gas Energy, a division of Southern Union Company, is entitled to a rate increase sufficient to generate a revenue increase of approximately $22.5 million.

FINDINGS OF FACT

The Missouri Public Service Commission, having considered all of the competent and substantial evidence upon the whole record, makes the following findings of fact. The

Commission in making this decision has considered the positions and arguments of all of the parties. Failure to specifically address a piece of evidence, position, or argument of any party does not indicate that the Commission has failed to consider relevant evidence, but indicates rather that the omitted material was not dispositive of this decision.

Procedural History

On November 4, 2003, Missouri Gas Energy, a division of Southern Union Company (MGE), filed tariff sheets designed to implement a general rate increase for natural gas service in the amount of $44,875,635. The tariff revisions carried an effective date of December 4.

On November 7, the Commission suspended MGE's tariff until October 2, 2004, the maximum amount of time allowed by the controlling statute.[1] In the same order, the Commission directed that notice of MGE's tariff filing be provided to interested parties and the public. The Commission also established November 26 as the deadline for submission of applications to intervene.

Timely applications to intervene were filed by the City of Kansas City, Missouri; the Midwest Gas Users' Association (Midwest Gas);[2] the University of Missouri-Kansas City (UMKC), Central Missouri State University (CMSU), and Jackson County, Missouri. Those applications to intervene were granted on December 4. Subsequently, the Federal

[1] Section 393.150, RSMo 2000.

[2] The Midwest Gas Users' Association is an unincorporated non-profit association consisting of and representing business concerns and corporations that are substantial users of natural gas.

Executive Agencies[3] were allowed to intervene on February 10, 2004, and the City of Joplin, Missouri, was allowed to intervene on May 3.

On December 9, the Commission established the test year for this case as the 12-month period ending June 30, 2003, updated for known and measurable changes through December 31, 2003. A further true-up period through April 30, 2004, for the purpose of updating certain cost components, was established by Commission order on June 21, 2004. On December 18, 2003, the Commission established a procedural schedule leading to a hearing beginning on June 21, 2004.

The Commission conducted four local public hearings at which the Commission heard comments from MGE's customers and the public regarding MGE's request for a rate increase. Public hearings were held in Joplin on April 27, Blue Springs and Kansas City on April 28, and St. Joseph on April 29.

The parties prefiled direct, rebuttal, and surrebuttal testimony. The evidentiary hearing began on June 21, and continued through July 2. Further true-up direct testimony was prefiled on July 19, and a true-up hearing was conducted on July 23.

The Partial Stipulation and Agreement

On June 29, during the course of the evidentiary hearing, MGE and Staff filed a Nonunanimous Partial Stipulation and Agreement that concerned the issues of Alternative Minimum Tax, Depreciation, Accounting for Net Cost of Removal, Accounting for Pension Expenses, Revenues, Bad Debts, and May 1, 2004 Union Wage Increase issues. This partial stipulation and agreement reflected the agreement of Staff and MGE regarding

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[3] The Federal Executive Agencies include the United States Department of Defense, the United States Department of Energy, and other Federal Executive Agencies, which have offices, facilities or installations in the service territory of MGE and which purchase utility service from MGE.

several issues that would otherwise have been the subject of testimony at the hearing. No party opposed the partial stipulation and agreement. As permitted by its regulations, the Commission treated the unopposed partial stipulation and agreement as a unanimous partial stipulation and agreement. On July 8, the Commission issued an order approving that partial stipulation and agreement as a resolution of the issues addressed in that agreement.

Overview

MGE is a division of Southern Union Company. As a division, MGE has no separate corporate existence apart from Southern Union. MGE's divisional headquarters is located in Kansas City, Missouri, and it provides natural gas service to customers in Kansas City, Joplin, St. Joseph, and other smaller cities in the western half of Missouri. MGE is a local distribution company, sometimes referred to by the acronym LDC. That means that MGE purchases natural gas from a supplier, pays to transport the gas to Missouri over one or more interstate pipelines, and then distributes the natural gas to its customers in this state.

Southern Union is headquartered in Wilkes-Barre, Pennsylvania, and in addition to MGE, has other divisions that operate as LDCs in Pennsylvania and in New England. In addition to its LDC divisions, Southern Union owns Panhandle Eastern Pipeline Company, which is an interstate pipeline company. Unlike its LDC operating divisions, Panhandle Eastern is a subsidiary of Southern Union, rather than a division. That means that Panhandle Eastern has a separate corporate existence, and issues and holds debt in its own name.

As previously indicated, as an LDC, MGE must purchase natural gas from supply sources, transport the gas over an interstate pipeline, and then distribute that gas to its customers. This Commission does not have any authority to regulate the price that MGE must pay to purchase and transport gas over the interstate pipeline. The purchase price of natural gas is set by the market and transportation rates are regulated by the Federal Energy Regulatory Commission (FERC). As a result, this rate case has nothing to do with those aspects of the cost of natural gas.

The price that MGE must pay to purchase and transport natural gas is passed through, dollar for dollar, to its customers through the PGA/ACA process. Therefore, if MGE is to recover its cost of distributing natural gas to its customers, and earn a profit, it must have another source of income. It is those costs, and that source of income, that are at issue in this rate case.

MGE began the rate case process when it filed its tariff on November 4, 2003. In doing so, MGE asserted that it was entitled to increase its rates enough to generate an additional $44,875,635 in general revenues per year. MGE set out its rationale for increasing its rates in the direct testimony that it filed along with its tariff on November 4. In addition to its filed testimony, MGE provided work papers and other detailed information and records to the Staff of the Commission, Public Counsel, and to the intervening parties. Those parties then had the opportunity to review MGE's testimony and records to determine whether the requested rate increase was justified.

Obviously, there are a multitude of matters about which the parties could disagree. Fortunately, there was no disagreement about many matters and, as a result, those potential issues were never brought before the Commission. Where the parties disagreed, they prefiled written testimony for the purpose of raising those issues to the attention of the Commission. All parties were given an opportunity to prefile three rounds of testimony –

direct, rebuttal, and surrebuttal. The process of filing testimony and responding to the testimony filed by other parties revealed areas of agreement that resolved some issues and areas of disagreement that revealed new issues. On June 4, the parties filed a Joint Statement of Issues that listed the issues that they asked the Commission to resolve.

As previously indicated, a number of the identified issues were resolved by the approved partial stipulation and agreement and will not be further addressed in this report and order. The remaining issues will be addressed in turn. The issue description for each issue is taken from the Joint Statement of Issues filed by the parties. Factual matters will be addressed in the Findings of Fact section. If an issue also contains a legal aspect, that portion of the issue will be addressed in the Conclusions of Law section.

The Issues

The rates that MGE will be allowed to charge its customers are based on a determination of the company's revenue requirement. MGE's revenue requirement is calculated by adding the company's operating expenses, its depreciation on plant in rate base, taxes, and its rate of return multiplied by its rate base. The revenue requirement can be expressed as the following formula:[4]

Revenue Requirement = E + D + T + R(V-AD+A)

Where:
- E = Operating expense requirement
- D = Depreciation on plant in rate base
- T = Taxes including income tax related to return
- R = Return requirement
- (V-AD+A) = Rate base

For the rate base calculation:
- V = Gross Plant
- AD = Accumulated depreciation
- A = Other rate base items

[4] Dunn Direct, Ex. 1, Page 11, Lines 5-26.

All parties accept the basic formula. Disagreements arise over the amounts that should be included in the formula.

Rate of Return Issues

The first group of issues concerns the rate of return that MGE will be authorized to earn on its rate base; in other words, the return requirement in the revenue requirement formula just mentioned. Rate base includes things like gas mains in the ground, gas meters, and the trucks driven by MGE's repair crews. In order to determine a rate of return, the Commission must determine MGE's cost of obtaining the capital that it needs. The first step toward doing that requires a determination of the appropriate mix of capital sources that MGE will use to obtain its needed capital. That is called a capital structure and that is the first issue.

1. Capital Structure

Issue Description: *What is the appropriate Capital Structure (i.e., the relative proportions of long-term debt, short-term debt, preferred equity and common equity) to use in calculating MGE's cost of capital?*

Determining an appropriate capital structure for MGE is complicated by the fact that MGE is a division of Southern Union and does not issue its own debt or equity. Therefore, MGE does not have its own capital structure.

As a substitute for its non-existent capital structure, MGE proposes to use the consolidated capital structure of Southern Union Company, as of April 30, 2004. However, MGE proposes to modify the actual consolidated capital structure to remove the impact of

Southern Union's subsidiary, Panhandle Eastern Pipeline Company. MGE's proposed structure is as follows:[5]

Common Equity.	41.10%
Preferred Equity	11.49%
Long-Term Debt	47.41%

Staff and Public Counsel also recommend that the Commission use the actual consolidated capital structure of Southern Union, as of the true-up date, April 30, 2004. But they would not adjust that structure to remove the equity and debt of Panhandle Eastern Pipeline. The specific recommendations of Staff and Public Counsel differ slightly because Public Counsel includes short-term debt in the calculated structure. Staff and MGE do not include short-term debt in their capital structures because Southern Union had no short-term debt as of April 30. Public Counsel includes a 13-month average of short-term debt because Southern Union has used short-term debt in the past and in Public Counsel's view is likely to continue to do so in the future. These are the capital structures recommended by Staff and Public Counsel:

	Public Counsel[6]	**Staff[7]**
Common Stock:	28.37%	29.99%
Preferred Stock	6.06%	6.40%
Long-Term Debt	59.77%	63.61%
Short-Term Debt	5.80%	0.00%

[5] Noack True-up, Ex. 49, Schedule F.

[6] Allen True-up , Ex. 233, Page 2, Lines 2-6.

[7] Murray True-up, Ex. 860, Schedule 1.

It is important to note that the capital structures recommended by Public Counsel and Staff contain a much smaller proportion of common stock than does the structure recommended by MGE. It costs a company more to issue equity than it does to incur debt. Therefore, a capital structure that uses a lot of debt with relatively low levels of equity is less expensive for the company. That means that, all else being equal, a capital structure that includes a low percentage of equity and a large percentage of debt will be less costly, resulting in a lower rate of return, and consequently a lower revenue requirement and lower rates to customers.

However, all else is not equal. Including a high percentage of debt in a capital structure has an effect on the cost of equity. The shareholders in a company – the holders of equity – are subordinate to holders of debt. Generally, the company must pay the interest on debt, such as bonds issued by the company, before it can pay dividends to its shareholders, or before it can invest profits in other ways that benefit shareholders. If a company's income goes down, the risk is borne by the shareholders. Furthermore, if something really goes wrong and the company has to be liquidated, the holders of debt get paid first. The shareholders get only whatever is left over. Therefore, a company with a capital structure that includes a high percentage of debt is more risky for shareholders. The shareholders will consequently demand a higher rate of return to compensate them for the increased risk caused by the high level of debt.

Southern Union's unadjusted consolidated capital structure contains a good deal more debt and less equity than the capital structure of the average LDC. MGE's witness John Dunn indicated that his group of 15 comparable LDCs had an average of 46.6%

equity in their capital structures.[8] Staff's witness David Murray's group of 8 comparable LDCs had an average capital structure containing 49.68%.[9] And Public Counsel witness Travis Allen reported that his group of 8 comparable companies had an average capital structure containing 49.75% equity.[10] That means that, all other things being equal, a shareholder's investment in Southern Union is more risky than an investment in an average LDC.

MGE contends that the use of the consolidated capital structure adjusted to remove the effects of the Panhandle Eastern Pipeline subsidiary is appropriate because that structure most closely approximates the capital structure of Southern Union's natural gas distribution operations, including its MGE division. It does this by removing the equity and debt of the Panhandle Eastern subsidiary from the consolidated capital structure in a manner that it contends is consistent with the requirements of Generally Accepted Accounting Principles (GAAP).

Although Southern Union describes its proposed capital structure as an adjusted actual consolidated capital structure, what it is proposing may more accurately be described as a hypothetical capital structure in that its proposed capital structure clearly does not exist in the real world. Rather, it is the unadjusted consolidated capital structure under which Southern Union actually operates in the marketplace. Southern Union is able to conduct business, finance its operations, and raise capital with an investment grade rating based on that capital structure. When a business analyst such as Moody's or

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[8] Dunn Direct, Ex. 1, Schedule JCD-2.

[9] Murray Direct, Ex. 825, Schedule 22.

[10] Ex. 32.

Standard & Poor's examines Southern Union to assess its credit worthiness, it looks to that unadjusted consolidated capital structure to make its determination.[11]

Furthermore, Southern Union's unadjusted consolidated capital structure, with its heavy reliance on debt, results directly from Southern Union's management decision to become highly leveraged to finance the purchase of Panhandle Eastern, as well as earlier acquisitions. Southern Union decided to take on that additional debt because it saw an opportunity to earn greater returns to the benefit of its shareholders. That decision is clearly within Southern Union's management prerogative and the Commission does not wish to criticize or punish Southern Union for that decision. However, Southern Union must operate with the results of its investment decisions and one result of those investment decisions is a capital structure that includes a large amount of debt and relatively low amounts of equity.

Southern Union argues that in a 1993 rate case, involving St. Joseph Light & Power Company, the Commission found that the use of a hypothetical capital structure was appropriate when the utility's actual capital structure fell outside of a "zone of reasonableness."[12] While that was the finding of the Commission in that case, an examination of the entire report and order reveals that St. Joseph Light & Power's actual capital structure was nearly a mirror image of Southern Union's consolidated capital structure. While Southern Union carries a large percentage of debt, St. Joseph Light & Power had an inordinate amount of equity in its capital structure.[13] That meant that

[11] Transcript Page 191, Lines 19-22, and Page 203, Lines 23-25.

[12] In Re: St. Joseph Light & Power, 2 Mo. P.S.C. 3d 248, 253 (1993)

[13] In Re: St Joseph Light & Power, 2 Mo. P.S.C. 3d 248, 250 (1993). SJL&P's actual capital structure contained approximately 58% equity and 40% debt.

St. Joseph Light & Power's capital structure, because it included an excessive amount of high cost equity, was unreasonably expensive for ratepayers. The Commission, therefore, adopted a hypothetical capital structure to protect ratepayers from a management decision, not to protect management from the consequences of its own decisions.

Having determined that the actual consolidated capital structure of Southern Union is the appropriate capital structure to use, the Commission now must decide whether the structure proposed by Staff, or that proposed by Public Counsel is more appropriate. The difference between the two structures results from Public Counsel's decision to include short-term debt in the capital structure. The evidence indicates that Southern Union has used substantial amounts of short-term debt in the past. However, most of that debt was used to finance temporary working capital needs and has been repaid or refinanced as long-term debt. As of the true-up date, April 30, 2004, Southern Union had no short-term debt.[14] Since the Commission has determined that it should use the actual capital structure of Southern Union, and that actual capital structure has no short-term debt as of the true-up date, the Commission finds that short-term debt should not be included in the capital structure. Therefore, the capital structure that shall be used for the purpose of calculating rate of return in this case is as follows:

Common Stock:	29.99%
Preferred Stock	6.40%
Long-Term Debt	63.61%

Once an appropriate capital structure is established, the cost of the various types of capital – common equity, preferred equity, long-term debt, and short-term debt – are

[14] Dunn Rebuttal, Ex. 2, Page 27, Lines 5-17.

multiplied by the percentage of their prevalence in the chosen capital structure to arrive at the weighted cost of capital. But before that can be done, the cost of each of the types of capital must be determined. That task is encompassed by the next three issues.

2. Embedded Cost of Long-Term Debt

Issue Description: *What is the appropriate cost of long-term debt in calculating MGE's cost of capital?*

The cost of long-term debt is determined simply by reviewing the interest rates specified in the debt issued by Southern Union. The only issue between the parties concerns which debt should be included in the calculations. MGE and Public Counsel agree that the long-term debt to be counted is the debt of Southern Union excluding the long-term debt associated with Southern Union's Panhandle Eastern subsidiary. Based on that assumption, MGE set the cost of long-term debt, as of April 30, 2004, at 7.4342%.[15] Public Counsel used a cost of long-term debt of 7.397%.[16] The slight difference was attributed to rounding differences in the calculations. Staff, however, includes the debt issued by Panhandle Eastern when calculating Southern Union's cost of long-term debt. As a result, Staff recommends use of a cost of long-term debt of 6.151%.[17]

Panhandle Eastern's debt is the debt of a subsidiary company and is not the debt of Southern Union. That debt was raised by Panhandle Eastern for its own purposes and is rated separately by the rating agencies.[18] Furthermore, that debt is non-recourse to Southern Union. That means that the debt restricts the assets that the debt holders can

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[15] Noack, True-Up Direct, Ex. 49, Schedule F1.

[16] Allen, True-Up Direct, Ex. 233, Schedule TA-3.

[17] Murray True-Up Direct, Ex. 860, Schedule 2.

[18] Dunn Rebuttal, Ex. 2, Page 25, Lines 11-15.

use to satisfy the debt. In other words, if Panhandle Eastern were to default on its debt, the debt holders would not be able to seize the assets of Southern Union to collect the debt.[19] In addition, a stipulation and agreement entered into by Southern Union, Staff, Public Counsel, and other parties in Case No. GM-2003-0238 – the case in which this Commission approved Southern Union's acquisition of Panhandle Eastern – provides that MGE is to be insulated from the impact of the acquisition of Panhandle Eastern.[20] For all these reasons, the Commission finds that the cost of long-term debt of Panhandle Eastern is properly excluded from the calculation of Southern Union's cost of long-term debt.

Since the differences between the cost of long-term debt as calculated by MGE and Public Counsel is simply based on rounding differences, the Commission will split the difference between the two percentages and use 7.4155% as the cost of long-term debt.

3. Return on Equity

Issue Description: *What is the appropriate return on equity in calculating MGE's cost of capital?*

Determining an appropriate return on equity is without a doubt the most difficult part of determining a rate of return. The cost of long-term debt and the cost of preferred stock are relatively easy to determine because their rate of return is specified within the instruments that create them. In contrast, determining a return on equity requires speculation about the desires and requirements of investors when they choose to invest their money in Southern Union rather than in some other investment opportunity. As a result, the Commission cannot simply find a rate of return on equity that is unassailably

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[19] Allen Rebuttal, Ex. 201, Page 23, Lines 9-19.

[20] Dunn Rebuttal, Ex. 2, Page 23, Lines 18-26.

scientifically, mathematically, or legally correct. Such a "correct" rate does not exist. Instead, the Commission must use its judgment to establish a rate of return on equity that will be attractive enough to investors to allow the utility to fairly compete for the investors' dollar in the capital market, without permitting an excessive rate of return on equity that would drive up rates for MGE's ratepayers. In order to obtain guidance about that rate of return on equity is appropriate, the Commission must turn to the expert advice offered by financial analysts.

Three financial analysts offered recommendations regarding an appropriate return on equity in this case. MGE's witness John Dunn utilized a discounted cash flow (DCF) model to arrive at an initial return on equity estimate of 10.9% to 11.9%. Dunn then argued that the return on equity should be further increased to compensate for risks that are unique to MGE. Specifically, Dunn argued that MGE faces more risk because it is smaller than the average company in his proxy group; because its depreciation rates are substantially lower than those authorized for comparable companies; and because it faces greater regulatory risk because it operates in Missouri. Because of these extra risks, Dunn recommended a return on equity of approximately 12%.[21] Staff's witness David Murray primarily relying on a DCF model, arrived at a recommended a return on equity in the range of 8.52% to 9.52%, with a midpoint of 9.02%.[22] Public Counsel's witness Travis Allen also relying primarily on a DCF model, recommended that MGE be allowed a return on equity of between 9.01% and 9.34%.[23]

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[21] Dunn Direct, Ex. 1, Page 60, Lines 19-20.

[22] Murray Direct, Ex. 825, Page 33, Lines 3-4.

[23] Allen Direct, Ex. 200, Page 16, Lines 10-11.

Obviously, despite the fact that all three experts are relying on essentially similar DCF models, there is a very wide range in recommended return on equity between MGE's witness and those of Staff and Public Counsel. However, there is one more number that the Commission must consider in establishing an appropriate return on equity. In a survey of regulatory decisions from around the country, as reported by Regulatory Research Associates, the average allowed return in the gas utility industry for 2002 and 2003 was 11%. For the first quarter of 2004, the average return on equity reported was 11.1%.[24] That is the market in which Southern Union will be seeking to raise capital.

Not surprisingly, the low rates of return on equity espoused by the witnesses for Staff and Public Counsel led MGE to aggressively challenge the credibility of Murray and Allen. MGE engaged the services of Dr. Roger Morin to challenge the recommendation of Murray. Dr. Morin is a Professor of Finance for Regulated Industry at the Center for the Study of Regulated Industry at Georgia State University. He has a Ph.D. in Finance and Econometrics at the Wharton School of Finance, University of Pennsylvania. Dr. Morin wrote the textbook, Regulatory Finance,[25] upon which the other witnesses rely in their own testimony. Dr. Morin's rebuttal testimony cites 15 specific criticisms of the methods Murray used to arrive at his recommendation and concludes that "Mr. Murray employs inappropriate and stale model inputs throughout his analysis, which causes him to recommend returns that are well below investors' required returns."[26] Dr. Morin did not, however, offer his own recommendation regarding an appropriate return on equity.

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[24] Morin Rebuttal, Ex. 5, Page 10, Lines 6-11.

[25] Roger A. Morin, Regulatory Finance (1994).

[26] Morin Rebuttal, Ex. 5, Page 5, Lines 1-4.

MGE did not engage Dr. Morin to challenge the recommendation of Public Counsel's witness Travis Allen. Instead, MGE attacked Allen's credibility based on his lack of experience regarding regulated utilities. Allen has a master of science degree in Business Economic and Finance with a specialization in Finance from Southern Illinois University – Edwardsville. However, his current position with Public Counsel is his first professional position after he earned his master's degree. He did not have any professional experience dealing with regulated utility finance before he began working for Public Counsel, and he filed his direct testimony in this case only two weeks after he started working for Public Counsel.[27] In response to MGE's criticism of Allen, Public Counsel engaged the services of John Tuck, a former Public Counsel employee and currently Senior Investment Officer for the Public School and Non-Teacher School Employee Retirement Systems of Missouri,[28] to offer surrebuttal testimony to bolster the recommendation offered by Allen.

Whatever other credibility questions may be raised against the positions offered by Staff and Public Counsel, the fact is their recommendations are nearly 200 basis points lower than the national average return on equity. The Commission does not believe that it would be appropriate for its return on equity finding to unthinkingly mirror the national average. Obviously, if all commissions took that approach returns on equity would never change, despite changing economic facts, leading to unjust results. However, the national average is a good indicator of the capital market in which Southern Union will have to compete for the equity needed to finance MGE's operations. The Commission has an obligation under the law and well as a matter of practical necessity, to allow Southern

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[27] Transcript, Page 332, Lines 1-10.

[28] Tuck Surrebuttal, Ex. 203, Page 1, Lines 7-8.

Union an opportunity to earn a return that will allow it to compete in the capital market. No one, including ratepayers, benefits if MGE is starved for capital.

As indicated, the national average for return on equity is approximately 11%. Dunn's return on equity recommendation on behalf of MGE was 12%. The Commission will take that to mean that MGE believes a variation of 100 basis point above the national average would be appropriate. A variation of 100 basis points below the national average should also be appropriate. That means that the lowest reasonable return on equity would be 10%. The Commission will adjust that amount upward by 50 basis points to recognize that Southern Union's equity is more risky than that of the average gas company due to its debt heavy capital structure. The 50 basis point adjustment is based on the current spread between the average A bond rating for the comparable companies used in Murray's DCF analysis and Southern Union's BBB bond rating. That adjustment is described by MGE's witness, Dr. Morin, in his rebuttal testimony as a correction to the 32 basis point adjustment made by Murray.[29] After making that adjustment, the Commission arrives at a return on equity of 10.5%.

A return on equity of 10.5% is supported by the evidence presented in this case. First, Dunn's DCF analysis, if adjusted appropriately, will yield a number in the range of 10.5%. Dunn testified that his initial DCF analysis showed that a return in the range of 10.9% to 11.9% would be appropriate for his comparable companies.[30] He then increased his recommended return on equity to 12% to take into account what he asserted were additional risks associated with MGE beyond the risk associated with his comparable

[29] Morin Rebuttal, Ex. 5, Page 8-9, Lines 18-23, 1-2.

[30] Dunn Direct, Ex. 1, Page 51, Lines 8-11.

companies. The additional risks cited by Dunn are that MGE is smaller than the comparable companies, it experiences greater regulatory risk because it operates in Missouri, and its earnings are more volatile than those of his comparable group of companies.

None of those additional risks would justify Dunn's increase in his recommended return on equity. None of these risk factors are unique to MGE and they do not justify a deviation from the rate of return that would be established by an examination of the comparable companies. The comparable companies might have other factors that would increase their risk that do not apply to MGE. That is why comparable companies are chosen as a proxy for making that sort of detailed comparison of risk between companies. Furthermore, Dunn's contention that MGE should receive a higher return on equity because it is regulated by the Missouri Commission is undercut by Dr. Morin's testimony that the Missouri Commission is perceived by the investment community as an "average, fair, reasonable, supportive" commission.[31]

If Dunn's upward adjustment is not made, his testimony indicates that a return on equity in the range of 10.9% to 11.9% would be fair and reasonable. 10.9% is at the bottom of that range, but it is still fair and reasonable. Dunn's recommended return on equity should be further adjusted by removing flotation costs, which he includes in his DCF study.

Flotation costs are related to the direct and indirect costs associated with the issuance of new equity. The direct costs are the costs associated with issuing and

[31] Transcript, Page 1707, Lines 2-5.

marketing the stock. The indirect costs represent the downward pressure on the stock price as a result of the increased supply of stock from the new issue. Dunn makes an upward adjustment in his calculations to include such flotation costs.

Flotation costs should not be recovered from ratepayers in this case because the issuance of equity planned, and announced by MGE, for which flotation costs would be incurred, results directly from MGE's need to increase its equity as a result of the acquisition of Panhandle Eastern Pipeline. Thus the inclusion of flotation costs would violate the stipulation and agreement by which the acquisition of Panhandle was approved. That stipulation and agreement provides:

> Southern Union will not recommend an increase or claim Staff should make an adjustment to increase the cost of capital for MGE as a result of the Transaction. Any increases in cost of capital Southern Union seeks for MGE will be supported by documented proof: (1) that the increases are a result of factors not associated with the Transactions; (2) that the increases are not a result of changes in business, market, economic or other conditions for MGE caused by the Transaction; or (3) that the increases are not a result of changes in the risk profile of MGE caused by the Transaction.[32]

MGE's own witness testified that the sale of equity for which MGE is seeking to include flotation costs is required to maintain Southern Union's bond rating.[33] If Southern Union had not taken on approximately $1.2 billion in additional debt in the acquisition of Panhandle Eastern, a stock offering would not likely have been necessary to preserve the company's bond rating.[34] Therefore, the flotation cost would be an increased cost of capital relating to the Transaction that could not be passed on to ratepayers by the terms of the stipulation and agreement. Dr. Morin, MGE's witness, agreed that it would not be

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[32] Tuck Surrebuttal, Ex. 203, Page 45, Lines 9-15.

[33] Dunn Rebuttal, Ex. 2, Page 41, Lines 3-5.

[34] Tuck Surrebuttal, Ex. 203, Page 45, Lines 16-17.

appropriate for MGE to recover flotation costs for Southern Union's acquisition related equity.[35]

MGE proposed to increase Murray's return on equity by 30 basis points to add flotation costs.[36] Since flotation costs are not appropriate in this case, Dunn's return on equity could be reduced by 30 basis points to remove flotation costs. Removing 30 basis points from the low end of Dunn's recommendation leaves a return on equity of 10.6%. That is consistent with the 10.5% return on equity found to be appropriate by the Commission.

A return on equity of 10.5% is also supported by part of the analysis of Public Counsel's witness Travis Allen. Allen performed a Capital Asset Pricing Model (CAPM) analysis using 30-year treasury bonds as the risk-free rate – the risk-free rate endorsed by Dr. Morin[37] – that resulted in a return on equity of 10.27%.[38] That is in the vicinity of the 10.5%. Similarly, if the corrections to Murray's DCF analysis proposed by Dr. Morin are made, the result is a return on equity of between 10.4% and 11.4%.[39]

The Commission finds that 10.5% is a fair and reasonable return on equity for MGE that will allow Southern Union an opportunity to compete in the capital market for the funds needed to keep MGE healthy.

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[35] Transcript, Page 1688-1689, Lines 25, 1-8.

[36] Morin Rebuttal, Ex. 5, Page 11, Lines 12-14.

[37] Transcript, Page 1721, Lines 17-25.

[38] Allen Direct, Ex. 200, Schedule TA-9.

[39] Morin Rebuttal, Ex. 5, Page 41, Lines 20-23.

4. Cost of Preferred Stock

Issue Description: *What is the appropriate cost of MGE's preferred stock in calculating MGE's cost of capital?*

There was no disagreement about this issue. Staff, Public Counsel, and MGE agree that the appropriate cost of preferred stock as of April 30, 2004, is 7.758%. Therefore, the Commission finds that the cost of preferred stock is 7.758%.

5. Rate of Return Adder

Issue Description: *Should MGE be granted an additional 25 basis points of rate of return on account of its level of management efficiency?*

MGE asks the Commission to add 25 basis points to MGE's authorized rate of return in recognition of its high management efficiency. Thus if the Commission were to determine that the appropriate rate of return was 8%, MGE asks that the Commission authorize a rate of return of 8.25%.

MGE claims that such an adder is appropriate because MGE is currently operating very efficiently and should be rewarded for its efforts. In particular, MGE contends that it is providing good customer service and that its operating and maintenance expenses are low when compared to other Missouri local distribution companies. MGE points out that the Commission made such an upward adjustment for management efficiency in at least two rate cases in the early 1980s[40] and that in MGE's last two litigated rate cases, the Commission made a downward adjustment to MGE's allowed return because of customer

[40] In Re: Empire District Electric, 26 Mo. P.S.C. (N.S.) 58 (1983) and In Re: Kansas City Power & Light Company, 26 Mo. P.S.C. (N.S.) 104 (1983).

service problems.[41] MGE asks that the Commission recognize MGE's improved efficiency by bumping up its rate of return in this case.

MGE is correct that for a period in the early 1980s, the Commission had a policy of explicitly adjusting rates of return for the perceived efficiency or inefficiency of the utility. That policy actually began in a 1982 rate case for Missouri Public Service Company.[42] In that case the Commission was quite concerned about the company's failure to deal with a problem of unaccounted-for-water being lost from its water system. As a result, the Commission reduced the rate of return on the company's water rate base by a full percentage point.[43] A year later, in the cases cited by MGE, the Commission explicitly rewarded the affected utilities for management efficiency. Empire District Electric and Kansas City Power & Light Company were rewarded with a .4% increase to their return on equity.[44]

By 1986, however, the Commission had rejected that approach. In a Kansas City Power & Light rate case,[45] the Commission held as follows:

> In the Company's last rate case ... the Commission awarded the Company a 40 basis point upward adjustment to its return on common equity for its efforts in improving management efficiency. ... The Commission has reevaluated its prior order and determined it is not necessary nor appropriate to upwardly adjust the return on equity which has been found to be reasonable 'to encourage the provision of energy on the most efficient and

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[41] In Re: Missouri Gas Energy, 5 Mo.P.S.C. 3d 437 (1997) and In Re: Missouri Gas Energy, 7 Mo.P.S.C. 3d 394 (1998).

[42] In Re: Missouri Public Service Company, 25 Mo.P.S.C (N.S.) 136 (1982).

[43] In Re: Missouri Public Service Company, 25 Mo.P.S.C. (N.S.) 136, 177-180 (1982).

[44] In Re: Empire District Electric, 26 Mo. P.S.C. (N.S.) 58, 70 (1983), In Re: Kansas City Power & Light Company, 26 Mo. P.S.C. (N.S.) 104, 150 (1983).

[45] In Re: Kansas City Power & Light Company, 28 Mo.P.S.C. (N.S.) 228 (1986).

> economical basis possible.' Adequate encouragement is given through the recovery of all prudently incurred costs.[46]

The Commission again addressed the question of adjusting return based on management efficiency in a 1989 case, where the Commission explained that it was rejecting Staff's suggestion to set a company's rate of return at the low end of Staff's recommended range for alleged management inefficiency:

> The Commission has determined that it is not appropriate to adjust the rate of return SWB will be authorized to earn for management decisions. Now the Commission has determined that where it has made adjustments to ROE in other cases, these types of adjustments can rarely be supported by sufficient evidence to warrant such a decision. The difficulty of deciding how much value a certain management decision has in terms of ROE makes the determination almost impossible. The evidence in this case provides no real guide to the Commission on how to value the various allegations of inefficient management. The more appropriate method for making adjustments to a public utility's revenue requirement is where specific dollar adjustments can be addressed, not by adjusting the ROE.[47]

Clearly, the Commission has moved away from the idea of adjusting a company's rate of return for perceived management efficiency or inefficiency.

MGE correctly points out that in MGE's last two litigated rate cases the Commission cited MGE's failure to provide quality customer service as the basis for allowing the company a lower rate of return than it might have otherwise received. In the 1997 case, the Commission set the authorized rate of return on equity at 11.3%, which was the low end of Staff's recommendation, because of a great increase in the number of customer complaints after Southern Union bought the MGE system in 1994. In comparison, MGE's expert witness in that case recommended a return on equity in the range of 11.5% to

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[46] In Re: Kansas City Power & Light Company, 28 Mo.P.S.C. (N.S.) 228, 247 (1986).

[47] Staff v. Southwestern Bell Telephone Company, 29 Mo.P.S.C. (N.S.) 607, 654 (1989).

12.5%. Public Counsel's expert recommended a return on equity of 10.75%.[48] Similarly, in the 1998 case, the Commission set the authorized rate of return on equity at 10.93%, which was the midpoint of the range recommended by Staff. In doing, so the Commission again cited MGE's continuing customer service problems as one reason, among several others, for accepting Staff's recommended return on equity. MGE's expert had recommended a return on equity of 12%, with Public Counsel recommending 10.7%.[49]

In those cases, the Commission appropriately took into consideration the quality of service provided by MGE in determining a just and reasonable rate of return for the company. In both cases the allowed rate of return was within the range supported by the testimony of financial experts. The Commission did not determine a just and reasonable rate of return and then reduce that rate to punish MGE. In sum, the Commission did not, by citing the poor customer service record of MGE, return to the practice of using adjustments to the rate of return to reward or punish utilities for efficient or inefficient management practice.

As the Commission found in 1986, and as was demonstrated in this case, a rate of return adder is inappropriate in concept and unworkable in practice. Conceptually, the Commission must determine a just and reasonable rate of return for the utility that it regulates. To then tack an additional percentage to the rate as a reward for efficiency means that the company would be receiving a rate of return that is higher than the just and reasonable rate. In essence, the Commission would be making a gift to the company from the ratepayer's pocket. Obviously, that is not acceptable.

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[48] In Re: Missouri Gas Energy, 5 Mo.P.S.C. 3d 437, 467-468 (1997).

[49] In Re: Missouri Gas Energy, 7 Mo.P.S.C 3d. 394, 401-404 (1998).

As a practical matter, an adder is nearly impossible to support by any objective evidence. As was demonstrated in this case, there is really no way to determine with any degree of certainty that one company is more efficient than another. MGE attempted to do so by comparing its annual operating and maintenance expense to that of other Missouri gas companies.[50] However, as Staff pointed out, operating and maintenance expenses are subject to many variables and are not a good basis for determining management efficiency.[51] Although none of the evidence presented actually demonstrates that MGE is any more or less efficient than other gas companies, there was a lot of evidence filed on that question and its presentation took up a good deal of hearing time. The Commission does not wish to encourage a flood of indeterminate and ultimately pointless testimony on the question of management efficiency in future rate cases.

The Commission finds that a rate of return adder is not appropriate and will not be ordered in this case.

<u>Operating Expense Issues</u>

A second group of issues concerns the expenses that MGE incurred during the test year and will likely incur in the future. MGE asks to recover these expenses from its customers through the rates that will be established in this case.

6. Capacity Release/Off System Sales

Issue Description: *What, if any, is the appropriate level of capacity release/off-system sales revenues to be used in calculating MGE's cost of service? As an alternative to including capacity release/off-system sales revenues in the calculation of MGE's revenue*

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[50] Noack Direct, Ex. 8, Page 24, Lines 14-18, and Schedule G-1.

[51] Oligschlaeger Rebuttal, Ex. 829, Pages 3-4, Lines 22-23, 1-5.

requirement, should the PGA-based revenue sharing mechanism proposed by MGE be adopted?[52]

As an LDC, MGE must purchase enough pipeline capacity from an interstate pipeline company to meet its customers' anticipated demand for natural gas. Pipeline capacity is essentially the space on the pipeline required to move the amount of gas that MGE will need to supply its customers. MGE recovers the cost of purchasing that pipeline capacity from its customers through the PGA (Purchased Gas Adjustment) mechanism. Pipeline capacity is generally purchased using long-term contracts based on peak capacity needs. Sometimes not all of the pipeline capacity is needed and MGE can sell the unused capacity to a third-party that might need to transport gas on that pipeline at that time for its own purposes.[53] MGE is able to obtain some revenue each year from these sales.

MGE's current rates are based on the assumption that MGE will earn $1.2 million per year in capacity release revenue.[54] That amount was included as an offset in MGE's revenue requirement for purposes of calculating its rates. In other words, MGE's rates were set based on an assumption that it would earn $1.2 million per year from capacity release sales. If the company earned more than $1.2 million, it was able to keep the extra income. But, if it earned less than $1.2 million, MGE would have a revenue shortfall. As a result, the company has an incentive to maximize its capacity release sales, to the benefit

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[52] Although the issue refers to both capacity release and off-system sales, the dispute between the parties concerns only capacity release revenues.

[53] Hayes Rebuttal, Ex. 17, Page 7, Lines 8-12.

[54] Busch Direct, Ex. 211, Page 6, Lines 1-10.

of both the company and its ratepayers. Because it has an incentive to maximize capacity release sales, MGE aggressively markets its available capacity to potential buyers.[55]

Based on a past three-year average of MGE's capacity release earnings, Staff recommends that the Commission include $1,340,400 per year for capacity release revenue in MGE's revenue requirement for this case.[56] Public Counsel also analyzed the last three years of earnings and recommends that the Commission include $1,500,000 per year for capacity release revenue.[57]

MGE argues that the past is not a good guide to predict future capacity release revenue because a new pipeline is about to go into operation, which may drastically reduce the revenue MGE is able to achieve from capacity release sales. Much of MGE's current capacity release revenue is derived from sales on the Kinder Morgan Pony Express Pipeline.[58] The Cheyenne Plains Pipeline is scheduled to begin operations in January 2005, in competition with Kinder Morgan. Since Cheyenne Plains is larger than Kinder Morgan, and since its rates are expected to be lower, MGE is concerned that Cheyenne Plains may reduce or eliminate the market for release of MGE's capacity on Kinder Morgan.[59] If that happens, MGE would not be able to earn the anticipated revenues that have been included in its rates and, as a result, would suffer a revenue shortfall.

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[55] Transcript Pages 1474-1475, Lines 8-25, 1-8.

[56] Allee Direct, Ex. 800, Page 5, Lines 5-17.

[57] Busch Direct, Ex. 211, Page 9, Line 14. Public Counsel refers to this number as highly confidential but during the hearing – transcript page 1570, lines 18-20 – MGE indicated that total dollars of sales per month or year are not confidential.

[58] Transcript Page 1543, Lines 10-17.

[59] Hayes Rebuttal, Ex. 17, Page 9, Lines 4-18.

To avoid such a revenue shortfall, MGE proposes that capacity release revenue be included in the PGA mechanism. That way MGE would avoid any risk of revenue shortfall. In order to retain an incentive to maximize capacity release revenue, MGE asks that the Commission establish a sharing grid to allow MGE to retain a portion of each dollar earned through the sale of capacity release.

MGE requests that the Commission include the following language in its order to allow MGE to implement a capacity-release-sharing-grid in its PGA:

> MGE shall be authorized to implement, through its PGA mechanism, a revenue sharing grid pursuant to which revenues generated by capacity release and off-system sales (net of revenues from off-system sales made for "system protection" purposes) shall be shared between MGE and its customers as follows:
>
> First $300,000 – 15% to MGE and 85% to customers
> Second $300,000 – 20% to MGE and 80% to customers
> Third $300,000 – 25% to MGE and 75% to customers
> Above $900,000 – 30% to MGE and 70% to customers.
>
> Any excess capacity disallowance resulting from an actual cost adjustment ("ACA") proceeding shall be offset by capacity release revenues before application of the above sharing grid and before any shareholder funding may be required.[60]

Staff and Public Counsel argue that the capacity release revenue should remain in base rates. They contend that MGE has failed to present sufficient evidence to justify a conclusion that MGE will be unable to match its past capacity release revenue in coming years. They discount as mere speculation the suggestion that the new Cheyenne Plains pipeline will decrease MGE's revenues.

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[60] Noack Corrected Rebuttal, Ex. 10, Page 28-29, Lines 16-22, 1-13.

The Commission agrees with MGE that the capacity release revenue should be considered as part of the PGA rather than as an offset to revenue requirement. Staff's witness Anne Allee conceded at the hearing that the Cheyenne Plains pipeline will be going into service in competition with Kinder Morgan.[61] When the new pipeline goes into service, the demand for release of MGE's capacity on the Kinder Morgan pipeline is likely to decrease, along with the price that MGE can demand for the release of that capacity. It is a basic economic principle that when supply increases, prices in the market are likely to decline. The upcoming changes in the market make MGE's historical level of capacity release revenue an unreliable indicator of the amount of revenue that MGE can reasonably be expected to earn in the future.

Since the past is not a reliable indicator of future revenue, any amount of capacity release revenue that the Commission could ascribe to MGE's revenue requirement would be based on unsupported speculation. The inclusion of any speculative amount in revenue requirement would be unfair to MGE if it was set too high and MGE was unable to earn the designated amount. Similarly, if the amount is set too low and MGE's revenues do not decrease as much as feared, MGE's customers would be unfairly deprived of revenue while MGE collected a windfall.

Placing the capacity release revenue into the PGA is a logical and convenient solution to this problem. Those revenues have been handled through MGE's PGA process in the past; only in the last three years have they been placed in the company's revenue requirement.[62] Capacity release revenues are directly related to pipeline transportation

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[61] Transcript, Pages 1554-1556.

[62] Transcript, Page1548, Lines 8-21.

costs, which are a normal component of the PGA process.[63] Furthermore, other LDCs in Missouri already handle their capacity release revenue through their PGA processes.[64]

If the Commission disagrees with their proposals to include capacity release revenue as an offset to MGE's revenue requirement, Staff and Public Counsel are willing to accept the movement of the capacity release revenue into the PGA. However, they oppose the inclusion of any sharing grid in the PGA. Staff and Public Counsel contend that a sharing grid in the PGA would allow MGE to benefit from every dollar of capacity release while shouldering no risk. Since the ratepayers have already paid for the capacity that is being sold, Staff and Public Counsel believe that it would be unfair to allow MGE to benefit from those sales.[65]

Although MGE's ratepayers have undeniably paid for the capacity that is being released, sales of capacity do not just happen. Those sales occur because MGE's employees aggressively market the available pipeline capacity. Under the current system, MGE has a strong incentive to maximize sales of available capacity. If it does not, it faces either a revenue shortfall, or it foregoes income that it can keep. If capacity release income is placed in the PGA mechanism without any sort of sharing mechanism, then MGE is essentially told to do that work for free. As a result, it loses much of its incentive to maximize those sales.

It is easy to say that ratepayers pay the salary of MGE's employees and that ratepayers should expect aggressive marketing of that capacity even if the company cannot

[63] Transcript, Page 1549, Lines 18-24.

[64] Transcript, Page 1559, Lines 9-13.

[65] Allee Surrebuttal, Ex. 802, Page 4, Lines 18-19.

benefit from those sales. However, it is unrealistic to believe that MGE will put as much effort into marketing available capacity if it can achieve no benefit from doing so. Yes, the Commission has a stick that it can wield over MGE to encourage it to aggressively market its available capacity: it can adjust MGE's PGA recovery if it finds that the company has not sufficiently marketed its available capacity. However, that would entail the difficult task of proving how much revenue MGE could have obtained if it had tried harder to market available capacity. The Commission does not wish to undertake that daunting task when a simple incentive mechanism is sufficient to ensure that MGE markets available pipeline capacity as aggressively as possible, to the benefit of both ratepayers and the company's shareholders.

MGE's proposed capacity release tariff language also provides that:

> Any excess capacity disallowance resulting from an actual cost adjustment ('ACA') proceeding shall be offset by capacity release revenues before application of the above sharing grid and before any shareholder funding may be required.[66]

Staff contends that this language is a backdoor attempt by MGE to avoid the effect of a PGA adjustment proposed by Staff in another case, in which Staff alleges that MGE has purchased excess capacity beyond what it would need to meet even peak day demands.[67]

The Commission agrees with Staff. The provision that would mandate the offset of a capacity disallowance against capacity release revenue is inappropriate. The capacity disallowance that this provision would affect is unrelated to capacity release revenue. If such a disallowance were required by the Commission, it would be because MGE had

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[66] Noack Corrected Rebuttal, Ex. 10, Page 29, Lines 9-11.

[67] Allee Surrebuttal, Ex. 802, Page 7, Lines 8-15.

failed to properly plan for its peak day gas needs and had purchased more capacity than it would ever reasonably expect to need. In that circumstance, MGE's shareholders should be expected to pay for the cost of that imprudence without passing that cost off to the ratepayers through an offset of revenues obtained from revenue release sales.

The Commission will approve MGE's proposal to implement a revenue sharing grid through the PGA. It will, however, reject that portion of MGE's proposal that would offset any excess capacity disallowance against capacity release revenues.

7. Environmental Response Fund

Issue Description: *Should the environmental response fund proposed by MGE be adopted and what, if any, level of environmental costs should be used in calculating MGE's cost of service?*

MGE will, in the future, incur an unknown, and unknowable, amount of financial liability for the cleanup of environmental hazards left over from the operation of manufactured gas facilities 50 to 100 years ago. Manufactured gas facilities were used before the advent of interstate natural gas pipelines in the 1940s. Before there were interstate pipelines, gas could not be transported over long distances so gas companies manufactured gas by heating coal or oil and collecting the gas that was driven off in the process. A toxic tar was left over from this process and was frequently dumped on-site at the manufactured gas plant.[68]

Manufactured gas plants were located in various cities in MGE's service territory and the leftover toxic tar is now causing environmental problems requiring that it be

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[68] Noack Surrebuttal, Ex. 11, Schedule MRN-3.

cleaned up. Federal law, specifically the Comprehensive Environmental Compensation and Liability Act (CERCLA), also known as Superfund, imposes strict, joint and several liability on present or former owners or operators of facilities where hazardous wastes were released into the environment.[69] MGE owns six sites in Missouri for which it may be required to pay cleanup costs under CERCLA. There are fourteen additional sites that MGE does not now own but for which it may face liability.[70]

Since it purchased the gas system that is now operated by MGE in 1994, Southern Union has expended approximately $9.3 million in cleanup costs related to manufactured gas plants in Missouri.[71] However, Southern Union has been able to obtain reimbursement for these costs from other sources, including from insurance policies that were purchased many years ago by The Gas Service Company, a previous operator of the natural gas distribution system now operated by MGE.

In addition, when Southern Union purchased the system now operated by MGE, it entered into an Environmental Liability Agreement with the previous owner, Western Resources, Inc. by which the buyer and seller agreed to share liability for environmental cleanup costs for which reimbursement could not be obtained from insurance, or other third parties.[72] That agreement provides that Southern Union would be solely responsible for the first $3 million in unreimbursed costs and that the companies would equally share liability for additional unreimbursed costs up to $15 million until 2009.

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[69] Bolin Direct, Ex. 204, Pages 9-10, Lines 19-22, 1-12.

[70] The list of sites for which MGE may be responsible is highly confidential but may be found at Bolin Direct, Ex. 204HC, Schedule KKB-2.

[71] Noack Surrebuttal, Ex. 11, Page 9, Lines 9-11.

[72] A copy of the Environmental Agreement may be found at Bolin Rebuttal, Ex. 205, Schedule KKB-16.

Using insurance proceeds and the $3 million it set aside when it purchased MGE's system, Southern Union has thus far avoided paying out any unreimbursed costs for manufactured gas plant cleanup costs in Missouri.[73] As a result, MGE is not seeking to recover any such costs in this case. However, the $3 million set aside when Southern Union purchased the MGE system is nearly exhausted and, as a result, Southern Union expects to face unreimbursed costs in the future.

MGE proposes to create an environmental response fund to deal with these future expenses. The environmental response fund is essentially a tracking mechanism designed to avoid a mismatch between expenses and revenues. MGE proposes to include $750,000 per year in its revenue requirement for collection from ratepayers. That $750,000 would be paid into the environmental response fund and then paid out to cover cleanup expenses as they occur. Staff and Public Counsel would then have an opportunity to audit the fund to determine whether the expenses paid by MGE were prudently incurred.[74]

MGE also proposes that any insurance proceeds or contributions from Western Resources that it may obtain be shared 50/50 between the company and ratepayers. In other words, if MGE were to obtain $100,000 in reimbursement from an insurance company for an environmental cleanup cost, the environmental response fund would be credited with $50,000 and MGE would retain the other $50,000.[75]

Staff and Public Counsel oppose the creation of an Environmental Response Fund. The Commission agrees. The cleanup costs for which MGE seeks to establish the Fund

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[73] The details of the costs and reimbursements may be found in Ex. 855HC.

[74] Noack Surrebuttal, Ex. 11, Pages 6-7, Lines 21-22, 1.

[75] Harrison Rebuttal, Ex. 814, Page 6, Lines 13-20.

are not yet known and measurable. Indeed, there is no certainty that Southern Union or MGE will ever have to pay any costs associated with these cleanup efforts. Thus far the expenses that Southern Union has paid have been covered by insurance or from money set aside for that purpose at the time Southern Union purchased the MGE system.[76] In the future, at least until 2009, costs not covered by insurance will be paid, in part, by Western Resources under the Environmental Liability Agreement between those companies. In sum, MGE's proposal to include $750,000 per year in its cost of service for future environmental cleanup costs is based entirely on speculation regarding costs that the company may never incur.

Furthermore, the creation of a pre-funded source for the payment of these cleanup costs would remove much of Southern Union's incentive to ensure that only prudently incurred and necessary costs are paid. If the money has already been recovered from ratepayers and is being held in the Fund, Southern Union would have little incentive to not pay it out to settle claims brought against it. The Fund would be subject to audit by Staff and Public Counsel and they could seek a prudence adjustment if necessary. But the need for a prudence adjustment is difficult to prove and is not a good substitute for the company's own desire to prudently minimize its costs to improve its bottom line. For these reasons, the Commission finds that MGE's proposal to create an Environmental Response Fund should be rejected.

Public Counsel also argues that, aside from the rejecting the prospective Environmental Response Fund, the Commission should find that MGE will not be allowed

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[76] Transcript, Page 1865, Lines 6-17.

to recover environmental cleanup costs related to manufactured gas plants under any circumstances. Public Counsel contends that these cleanup costs relate to facilities that are no longer used and useful to MGE's ratepayers and on that basis should not be paid for by ratepayers. Since MGE is not seeking to recover any such costs in this proceeding and the Commission is rejecting the creation of the Environmental Response Fund on other grounds, the Commission need not further address that question and will not do so.

8. Lobbying/Legislative costs

Issue Description: *What is the proper ratemaking treatment of lobbying/legislative activities in calculating MGE's cost of service?*

Staff and Public Counsel contend that MGE should not be allowed to recover in rates its cost of lobbying the Legislature. MGE does not contest that general proposition and it does not seek to include the cost of hiring outside, contract lobbyists in its cost of service. Neither does it seek to recover the dues it pays to the Missouri Energy Development Association (MEDA), a lobbying organization.[77] The dispute concerns Staff's and Public Counsel's recommendation to also exclude 100% of the salary of Paul Snider, the company's legislative liaison, and 10% of the salaries of company president, Jim Oglesby, and legal counsel, Rob Hack, on the theory that they also engage in lobbying activities on behalf of MGE.

The parties agree that this Commission has defined lobbying as any attempt to influence the decisions of regulators or legislators.[78] Staff and Public Counsel also contend that FERC's Uniform System of Accounts requires that all lobbying costs – both internal

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[77] Noack Corrected Rebuttal, Ex. 10, Page 13, Lines 16-18.

[78] In Re: Kansas City Power & Light Company, 24 Mo P.S.C. (N.S.) 386, 400 (1981).

and external – be recorded "below the line" for ratemaking purposes.[79] That means that lobbying costs would not be included in MGE's revenue requirement for ratemaking purposes and that those costs would be borne by shareholders rather than ratepayers. MGE does not dispute that lobbying costs are to be paid by shareholders. It does, however, dispute Staff's and Public Counsel's conclusions about how much of the contested salaries should be excluded from revenue requirement. MGE did not provide any detailed information about the amount of time Snider spends lobbying but contends that he has job duties that are not related to lobbying and that therefore a 100% exclusion of his salary is not appropriate. It also contends that the proposed exclusion of 10% of the salaries of Oglesby and Hack is not supported by the evidence.

The problem is that there is no way to really know how much of the time of Snider, Oglesby, and Hack is spent lobbying. MGE does not keep detailed time records that separately account for the lobbying activities of its employees.[80] Staff and Public Counsel admit that their estimations of the time the three employees spend on lobbying is just an educated guess based on available time records and calendars. However, specific information that would allow a more precise determination of the amount of time these employees spend lobbying does not exist because MGE has failed to properly account for lobbying activities by its employees.

Since MGE has not properly accounted for the lobbying activities of its employees, the Commission must make adjustments based on the limited information that is available. The evidence presented to the Commission indicates that Snider, Oglesby, and Hack

[79] Hyneman Surrebuttal, Ex. 817, Page 3, Lines 23-27.

[80] Transcript, Pages 1172-1173, Lines 15-25, 1-6.

spend some amount of time engaged in lobbying. The Commission's inability to determine the exact amount of time that they spend in lobbying must be laid solely to MGE's failure to properly account for their time. Staff's proposal to exclude 10% of the salaries of Oglesby and Hack is reasonable and is accepted. However, the evidence established that Snider has substantial job duties relating to public affairs and press relations, aside from his lobbying activities.[81] As a result, excluding 100% of his salary would be unfair. The Commission finds that 50% of Snider's salary should be excluded as related to lobbying activities.

9. Incentive Compensation

Issue Description: *What, if any, is the appropriate level of MGE's incentive compensation expense to be used in calculating MGE's cost of service? What, if any, is the appropriate level of Southern Union's allocated incentive compensation expense to be used in calculating MGE's cost of service?*

Southern Union's compensation plan for its non-union employees includes an amount of incentive compensation to be paid to those employees if Southern Union and MGE meet certain goals. The incentive compensation is offered in addition to an employee's base salary. Specifically, the incentive plan contains financial goals relating to the earnings of Southern Union as a whole, and MGE as a division. Together, the financial goals make up 90% of the total incentive compensation plan.[82] The plan also offers an incentive relating to customer service. That portion of the plan rewards employees if a specified average speed of answer is achieved at MGE's call center. The customer service

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[81] Transcript, Pages 1963-1967.

[82] Transcript, Page 1611, Lines 1-5.

incentive makes up 5% of the total incentive compensation plan.[83] Finally, the plan offers an incentive relating to safety that rewards employees if the average time for response to gas leaks is below a specified threshold. The safety incentive also makes up 5% of the total incentive compensation plan.[84]

Staff and Public Counsel argue that the Commission should exclude from MGE's cost of service the incentive compensation that the company pays at the divisional and corporate level for achieving the company's financial goals. As indicated, the financial portion makes up 90% of the total incentive compensation plan. Public Counsel, but not Staff, would also exclude the cost of the customer service goal.

Staff and Public Counsel contend that incentive compensation based on meeting the financial goals of the company benefits shareholders and not ratepayers. On that basis, they would require the shareholders to pay the costs of the incentive compensation plan by excluding those costs from the company's revenue requirement for ratemaking purposes. Public Counsel opposes inclusion in rates of the customer service portion of the incentive compensation plan because it believes that the average speed of answer at which employees receive extra compensation is set slower than the industry average and therefore is not a fair basis for awarding additional compensation to MGE's employees.[85]

MGE replies that its compensation plan is simply a portion of the means that it has chosen to pay its employees. It contends that nothing in the incentive compensation plan would harm ratepayers. On the contrary, MGE contends that its incentive compensation

[83] Transcript, Pages 1608-1609, Lines 24-25, 1.

[84] Transcript, Page 1608, Lines 21-23. The entire plan may be found as an HC attachment to Bolin Rebuttal, Ex. 205HC, Schedule KKB-15.

[85] Bolin Direct, Ex. 204HC, Page 15, Lines 8-10.

plan encourages the efficient operation of the company to the benefit of both shareholders and ratepayers. MGE argues that it needs its incentive compensation plan to be able to compete with other companies for top employees. Furthermore, it contends that its decision to either pay its employees a straight salary or to offer incentives is simply a matter for its business judgment and should not be of concern to the Commission.

The Commission agrees with Staff and Public Counsel that the financial incentive portions of the incentive compensation plan should not be recovered in rates. Those financial incentives seek to reward the company's employees for making their best efforts to improve the company's bottom line. Improvements to the company's bottom line chiefly benefit the company's shareholders, not its ratepayers. Indeed, some actions that might benefit a company's bottom line, such as a large rate increase, or the elimination of customer service personnel, might have an adverse effect on ratepayers.

If the company wants to have an incentive compensation plan that rewards its employees for achieving financial goals that chiefly benefit shareholders, it is welcome to do so. However, the shareholders that benefit from that plan should pay the costs of that plan. The portion of the incentive compensation plan relating to the company's financial goals will be excluded from the company's cost of service revenue requirement.

Public Counsel's argument for excluding the cost of the customer service portion of the incentive compensation plan is not well founded. Public Counsel's position is based on a 1998 call center evaluation study that was commissioned by MGE, and conducted by Theodore Barry and Associates.[86] That study indicates that the industry average speed of

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[86] The entire study is attached to Bolin Rebuttal, Ex. 205 as Schedule KKB-4.

answer was 60 seconds.[87] The speed of answer for which the incentive compensation plan would reward employees is slower than 60 seconds and Public Counsel contends that MGE's employees should not be rewarded for achieving a goal that is slower than industry average.

The problem with Public Counsel's argument is that it relies entirely on a finding of industry average contained in a study completed in 1998, using data from 1996 and 1997. There is no evidence in this record that would demonstrate that the industry average in 1998 is still the industry average in 2004. A lot has changed in the natural gas industry in the last six or seven years, and it is certainly reasonable to believe that the industry average speed of answer may also have changed in that time. Admittedly, the 1998 study is the latest study available regarding MGE's call center, but that does not make it any more reliable in 2004. There is simply not enough evidence in the record to conclude that MGE's customer service incentive standard would reward below average speed of answer times in 2004. On that basis, the cost of the portion of the company's incentive compensation relating to customer service will be included in the company's cost of service revenue requirement.

10. Corporate Expenses: New York Office

Issue Description: *What, if any, is the appropriate level of cost associated with Southern Union's New York office to be used in calculating MGE's cost of service?*

Southern Union's corporate offices are located in Wilkes-Barre, Pennsylvania, and MGE's divisional offices are located in Kansas City, Missouri. However, Southern Union also maintains executive offices in New York City for the use of its Chairman, George

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[87] Bolin Rebuttal, Ex. 205, Schedule KKB-4, Page 6 of 23.

Lindemann, and Vice-Chairman, John Brennan. The New York office is also used by other company executives when conducting business in New York. The office space is sublet from Activated Communications, Inc., an entity owned by Lindemann and his family, and by Brennan.[88] The cost to Southern Union of subleasing the New York office in 2003 was $690,000.[89] Staff, supported by Public Counsel, argues that allowing Lindemann and Brennan to maintain an office in New York is not a benefit to MGE's ratepayers and that the costs associated with Southern Union's New York office should therefore be excluded from MGE's cost of service for ratemaking purposes.

MGE replies that the New York office are more than just the offices of Lindemann and Brennan: they are also used by Southern Union to meet with Wall Street investors and with other members of the New York financial community. Having a New York office helps Southern Union in its efforts to attract capital, and thus benefits ratepayers as well as shareholders. [90]

While the evidence indicates that Southern Union's executives frequently use the New York office to meet with the New York financial community, it is apparent that those meetings could be conducted at other locations. Certainly, not all utilities see the need to maintain offices in New York just to have a convenient place to meet Wall Street bankers. It is also troubling that Southern Union sublets the New York office space from a non-regulated company owned by Lindemann, and his family, and Brennan. Certainly, the

[88] Hyneman Surrebuttal, Ex. 817, Page 31, Lines 7-13.

[89] Hyneman Surrebuttal, Ex. 817, Page 31, Lines 14-18.

[90] McLaughlin Rebuttal, Ex. 18, Pages 8-9, Lines 18-22, 1-10.

possibility exists that Southern Union's sublease could be used to unfairly thrust part of the cost of Activated Communications' office onto the backs of MGE's ratepayers.

The evidence indicates that Southern Union maintains an office in New York City primarily for the convenience of its chairman and vice-chairman. Maintaining that office is not a prudent expenditure necessary to provide service to MGE's ratepayers in Missouri. On that basis, the cost of maintaining a New York office will be excluded from MGE's cost of service for ratemaking purposes.

11. Corporate Expenses: Lindemann/Brennan Salaries

Issue Description: *What is the appropriate amount of salaries for Southern Union's Chief Executive Officer/Chairman of the Board and Vice Chairman of the Board to be used in calculating MGE's cost of service?*

This issue is closely related to the previous issue regarding Southern Union's New York City office. As the Commission found for that issue, George Lindemann is the Chairman of the Board for Southern Union and John Brennan is Vice-Chairman. Lindemann also holds the title of Chief Executive Officer for Southern Union. Lindemann and Brennan, along with Tom Karam, who is President and Chief Operating Officer of Southern Union, serve on the Executive Committee of the Southern Union's Board of Directors. The Executive Committee of the Board has the authority to exercise many of the powers of the Board of Directors between meetings of the full board.[91]

Staff, supported by Public Counsel, would limit the recovery in rates of the salaries that Southern Union pays to Lindemann and Brennan. For purpose of inclusion of the corporate joint and common costs ascribed to MGE, Staff would limit each man's salary to

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[91] McLaughlin Rebuttal, Ex. 18, Page 6, Lines 1-15.