

## **MEMORANDUM**

**TO:** Missouri Public Service Commission Official Case File  
Case No. GO-2004-0242 – Missouri Gas Energy

**FROM:** Charles Hyneman, Auditing Department  
Tom Imhoff – Energy Tariffs/Rate Design Department

/s/ Greg Meyer 01/28/04

/s/ Thomas R. Schwarz, Jr. 01/28/04

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Project Coordinator / Date

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General Counsel's Office / Date

**SUBJECT:** Staff Report and Recommendation Regarding the Application And Petition Of Missouri Gas Energy Seeking The Missouri Public Service Commission's Approval To Establish An Infrastructure System Replacement Surcharge

**DATE:** January 28, 2004

### **BACKGROUND**

On December 3, 2003, Missouri Gas Energy (MGE) a division of Southern Union Company (Southern Union) filed an Application and Petition for Establishment of an Infrastructure System Replacement Surcharge (Application) with the Missouri Public Service Commission (Commission). For convenience the surcharge is referred to by the acronym ISRS. The Company submitted its Application based upon new Missouri statutory sections in Chapter 393 RSMo, which became effective on August 28, 2003, as part of House Bill No. 208 (HB 208). Attached to this Memorandum as Attachment A, is that portion of HB 208 that applies to a gas company's ISRS filings. The new Missouri Statutory Sections 393.1009, 393.1012 and 393.1015, contained within HB 208, provide eligible gas corporations with the ability to recover certain ISRS costs without a general rate case filing and prohibits a Staff review of any increase in the gas company's revenues or decrease in other costs which may offset the ISRS revenue requirement.

Section 393.1015.2(2) RSMo states that the Staff of the Commission may examine information of the gas corporation to confirm that the underlying costs are in accordance with the provisions of Sections 393.1009 to 393.1015 and to confirm proper calculation of the proposed charge. The Staff may submit a report regarding its examination to the Commission not later than sixty days after the petition is filed. This Memorandum is being filed in accordance with this provision.

### **STAFF'S INVESTIGATION**

Staff members from the Auditing and Energy Departments participated in the Staff's examination of the Application. All Staff participants, the participants' up-line supervisors and the assigned attorney from the General Counsel's Office were provided the opportunity to review and comment on this Memorandum prior to filing. Charles Hyneman of the Auditing Department created the

initial draft of this Memorandum and comments received from the reviewers were incorporated therein to create this final version of the Memorandum.

The Staff's examination included a review of the Application and the supporting documentation, a review of the new Missouri Statutory Sections 393.1009, 393.1012 and 393.1015, discussions with MGE personnel, a review of selected ISRS work orders and a review of additional data provided by MGE. Additionally, information regarding the status of MGE's assessment payment histories and annual report filing histories are set out below.

## **THE APPLICATION**

Specifically MGE seeks approval of a surcharge designed to recover the pre-tax ISRS revenues necessary to produce net operating income equal to MGE's weighted cost of capital multiplied by the net original cost of the requested infrastructure replacements and facilities relocations. MGE also seeks recovery of all federal, state and local income and excise taxes applicable to such ISRS income and to recover all other ISRS-related costs, which include depreciation expense and property taxes

on ISRS plant investments. In addition to ISRS-related costs, MGE's Application includes the cost to remove the non-ISRS gas plant prior to the installation of new ISRS plant (cost of removal).

MGE asserts that all of its proposed eligible infrastructure system replacements meet the following requirements stated in Section 393.1009:

1. They replace or extend the useful life of existing infrastructure;
2. They are in service and are used and useful;
3. They do not increase revenues by directly connecting the infrastructure replacement to new customers; and
4. They were not included in the Company's most recent general rate case, Case No. GR-2001-292.

MGE also asserts that all of its proposed eligible infrastructure system replacements include the type of gas utility plant projects required by Section 393.1009, which are:

1. Mains, valves, service lines, regulator stations, vaults, and other pipeline system components installed to comply with state or federal safety requirements as replacements for existing facilities that have worn out or are in deteriorated condition;
2. Main relining projects, service line insertion projects, joint encapsulation projects, and other similar projects extending the useful life, or enhancing the integrity of pipeline system components undertaken to comply with state or federal safety requirements; and
3. Facilities relocations required due to construction or improvement of a highway, road, street, public way, or other public work by or on behalf of government entities

having the power of eminent domain provided that the costs related to such projects have not been reimbursed to MGE.

In its Application, MGE requested an adjustment to its rates and charges through the implementation of an ISRS rate schedule intended to generate \$3,358,400 of additional revenues on an annual basis. The Company's proposed ISRS tariff would take effect on April 1, 2004, (120 days after MGE's Application was filed) and would remain in effect until the operation of law date, currently scheduled to be October 2, 2004, associated with its current rate case, No. GR-2004-0209. Based on the approximately six months that the ISRS would remain in effect, the Company's calculation of \$3,358,400 of additional annual revenues would produce approximately \$1,693,002 of ISRS revenues.

Section 393.1012.1 contains a ISRS materiality requirement that prevents the Commission from approving MGE's ISRS if it would produce annual ISRS revenues below the lesser of one million dollars or one-half of one percent of MGE's base revenue level approved by the Commission in MGE's most recent general rate proceeding. Both MGE's proposed and the Staff's recommended level of annual ISRS revenues exceed one million dollars.

### **ADJUSTMENTS TO MGE'S REVENUE CALCULATION**

Based on the results of its examination, the Staff recommends the following adjustments to ISRS costs components included in MGE's Application:

1. MGE's proposed property tax expense of \$272,389 should be reduced by \$92,321 for an adjusted amount of \$180,068. MGE's Application included property tax expense on plant placed in service on or after January 1, 2003. The taxes on this plant will not be due to be paid until December 31, 2004. HB 208 paragraph 393.1009(7) defines ISRS costs as depreciation expense and property taxes that will be due within twelve months of the ISRS filing. Since MGE's ISRS filing was on December 3, 2003, the property tax on this plant is not an ISRS cost. Also, MGE used a 3-year average of property tax rates to calculate ISRS property tax expense. HB 208 calls for the use of the current property tax rate. The Staff compared the actual property taxes paid by MGE in 2003 to MGE's plant account balances at December 31, 2002, to establish a current property tax rate of 1.14%.
2. To correct a calculation discrepancy, MGE's proposed level of deferred taxes should be changed from the \$2,439,716 amount included in its Application to \$2,400,531.
3. MGE incorrectly included cost of removal expense in the amount of \$198,162 as a component of total ISRS revenues. HB 208 paragraph 393.1009(7) defines ISRS costs as depreciation expense and property taxes. Cost of removal is not included in this definition. The Staff is removing this expense because it is not an ISRS cost allowed by HB 208 to be considered in the ISRS calculation. The provisions of HB 208 [in particular Section 393.1015.2(2)] specifically prohibits examination of other revenue requirement or ratemaking issues in consideration of filings made pursuant to the provisions of Sections 393.1009 to 393.1015.

### **THE ISRS RATE SCHEDULES**

To compute the monthly ISRS charge, MGE has recommended that it should be derived by dividing the appropriate pre-tax revenues by the customer numbers reported in MGE's filed 2002 annual report, and then further dividing this quotient by twelve. MGE recommends that all customers in its Residential, Small General Service, Large General Service and Large Volume classes pay identical monthly ISRS charges. The Energy Staff takes the Auditing Department's Revenue Requirement and computes the ISRS charge based on the provision of HB 208, in particular, Section 393.1015.5(1) which allows that "each customer class maintains a proportional relationship equivalent to the proportional relationship of the monthly customer charge for each customer class."

### **STAFF'S CONCLUSIONS**

Based on its examination and calculations, the Staff has determined that the Company's ISRS rates should be designed to recover annual revenues of \$3,072,903. The Staff's determination of this amount and the supporting calculations are shown in Attachment B to this Memorandum. These calculations reflect the cost of debt and overall rate of return proposed by MGE at paragraph 16 of its Application. In that paragraph, MGE states:

As an alternative to the average values for overall rate of return, capital structure, cost of debt, and return on equity drawn from the testimony in MGE's most recently completed general rate proceeding, Case No. GR-2001-292, as shown in paragraphs 11, 12 and 13 above, MGE hereby states that it is agreeable to using the values for such items implicit in the Stipulation and Agreement approved by the Commission with regard to MGE in that case, such values being 9.03% overall rate of return based upon a 10.50% return on equity. These were the values for such items implicit in the Stipulation and Agreement approved by the Commission with regard to MGE in that case, as can be seen by reviewing the final Staff Accounting Schedules (dated June 22, 2001), Staff Suggestions in Support of Second Revised Stipulation and Agreement (filed June 28, 2001), and Supplemental Testimony in support of Revenue Requirement of Steve M. Traxler.

MGE's proposal to use an overall after-tax rate of return of 9.03% based on the capital structure and debt and equity cost components described in paragraph 16 of MGE's Application is acceptable to the Staff. The weighted cost of equity included in the overall 9.03% rate of return must be "grossed-up" to reflect the amount of income taxes on the ISRS revenues. Using MGE's effective tax rate, the "before-tax" overall rate of return is calculated to be 11.10%. This is the rate of return reflected on Attachment B to this Memorandum.

Based on a "spot-check" of the project work orders included for recovery in the Company's proposed ISRS, the Staff believes that the projects included meet the requirements of HB 208 Sections 393.1009, 393.1012 and 393.1015. However, the Staff believes that further review of the

projects included is necessary and will perform that review during MGE's current rate case. Accordingly, the Staff reserves the right to propose adjustments to any future MGE ISRS if it finds that any project costs included in this ISRS should not have been included.

Based on its examination and calculations, the Energy Staff has designed the Company's ISRS rates for each customer class based on the Auditing Department's ISRS revenue requirement of \$3,072,903. This proposal maintains the proportional relationship that is equivalent to the proportional relationship of the monthly customer charge for each customer class. The Staff's determination of these rates and the supporting calculations are shown in Attachment C to this Memorandum.

### **ASSESSMENTS AND ANNUAL REPORTS**

In accordance with established practice regarding the submission of Staff recommendations to the Commission, the Staff has reviewed the status of the Applicant's assessment payments and annual report filings. In this regard, the Staff reviewed electronic information maintained by the Commission's Budget and Fiscal Services Department and Data Center, and information in the Commission's Electronic Filing and Information System. The assessment information reviewed covers fiscal years (FY) 1996 through 2004, and the annual report information reviewed covers calendar years 1997 through 2002. Based on its review of this information, the Staff notes that MGE has no delinquent assessments for fiscal years 1996 thru 2003 and is also current on its payments for its FY 2004 assessment (it is making quarterly payments). Likewise, MGE does not have any past due annual reports.

### **STAFF'S RECOMMENDATIONS**

Based upon the above, the Staff recommends that the Commission issue an order in this case that:

1. Rejects the tariff sheet file by MGE on December 3, 2003, (assigned tariff number YG-2004-0712);
2. Authorizes MGE to file a tariff to impose an Infrastructure System Replacement Surcharge that is sufficient to recover appropriate annual pre-tax revenues in the amount of \$3,072,903; and
3. Authorizes MGE to file an ISRS rate for each customer class that is reflected in Attachment C to this Memorandum.

393.1009. As used in sections 393.1009 to 393.1015, the following terms mean:

(1) "Appropriate pretax revenues", the revenues necessary to produce net operating income equal to:

(a) The gas corporation's weighted cost of capital multiplied by the net original cost of eligible infrastructure system replacements, including recognition of accumulated deferred income taxes and accumulated depreciation associated with eligible infrastructure system replacements which are included in a currently effective ISRS; and

(b) Recover state, federal, and local income or excise taxes applicable to such income; and

(c) Recover all other ISRS costs;

(2) "Commission", the Missouri public service commission;

(3) "Eligible infrastructure system replacements", gas utility plant projects that:

(a) Do not increase revenues by directly connecting the infrastructure replacement to new customers;

(b) Are in service and used and useful;

(c) Were not included in the gas corporation's rate base in its most recent general rate case; and

(d) Replace, or extend the useful life of an existing infrastructure;

(4) "Gas corporation", every corporation, company, association, joint stock company or association, partnership and person, their lessees, trustees or receivers appointed by any court whatsoever, owning, operating, controlling, or managing any gas plant operating for public use under privilege, license, or franchise now or hereafter granted by the state or any political subdivision, county, or municipality thereof as defined in section 386.020, RSMo;

(5) "Gas utility plant projects", may consist only of the following:

(a) Mains, valves, service lines, regulator stations, vaults, and other pipeline system components installed to comply with state or federal safety requirements as replacements for existing facilities that have worn out or are in deteriorated condition;

(b) Main relining projects, service line insertion projects, joint encapsulation projects, and other similar projects extending the useful life, or enhancing the integrity of pipeline system components undertaken to comply with state or federal safety requirements; and

(c) Facilities relocations required due to construction or improvement of a highway, road, street, public way, or other public work by or on behalf of the United States, this state, a political subdivision of this state, or another entity having the power of eminent domain provided that the costs related to such projects have not been reimbursed to the gas corporation;

(6) "ISRS", infrastructure system replacement surcharge;

(7) "ISRS costs", depreciation expense and property taxes that will be due within twelve months of the ISRS filing;

(8) "ISRS revenues", revenues produced through an ISRS exclusive of revenues from all

other rates and charges.

393.1012. 1. Notwithstanding any provisions of chapter 386, RSMo, and this chapter to the contrary, beginning August 28, 2003, a gas corporation providing gas service may file a petition and proposed rate schedules with the commission to establish or change ISRS rate schedules that will allow for the adjustment of the gas corporation's rates and charges to provide for the recovery of costs for eligible infrastructure system replacements. The commission may not approve an ISRS to the extent it would produce total annualized ISRS revenues below the lesser of one million dollars or one-half of one percent of the gas corporation's base revenue level approved by the commission in the gas corporation's most recent general rate proceeding. The commission may not approve an ISRS to the extent it would produce total annualized ISRS revenues exceeding ten percent of the gas corporation's base revenue level approved by the commission in the gas corporation's most recent general rate proceeding. An ISRS and any future changes thereto shall be calculated and implemented in accordance with the provisions of sections 393.1009 to 393.1015. ISRS revenues shall be subject to a refund based upon a finding and order of the commission to the extent provided in subsections 5 and 8 of section 393.1009.

2. The commission shall not approve an ISRS for any gas corporation that has not had a general rate proceeding decided or dismissed by issuance of a commission order within the past three years, unless the gas corporation has filed for or is the subject of a new general rate proceeding.

3. In no event shall a gas corporation collect an ISRS for a period exceeding three years unless the gas corporation has filed for or is the subject of a new general rate proceeding; provided that the ISRS may be collected until the effective date of new rate schedules established as a result of the new general rate proceeding, or until the subject general rate proceeding is otherwise decided or dismissed by issuance of a commission order without new rates being established.

393.1015. 1. (1) At the time that a gas corporation files a petition with the commission seeking the establish or change an ISRS, it shall submit proposed ISRS rate schedules and its supporting documentation regarding the calculation of the proposed ISRS with the petition, and shall serve the office of the public counsel with a copy of its petition, its proposed rate schedules, and its supporting documentation.

(2) Upon the filing of a petition, and any associated rate schedules, seeking to establish or change an ISRS, the commission shall publish notice of the filing.

2. (1) When a petition, along with any associated proposed rate schedules, is filed pursuant to the provisions of sections 393.1009 to 393.1015, the commission shall conduct an examination of the proposed ISRS.

(2) The staff of the commission may examine information of the gas corporation to confirm that the underlying costs are in accordance with the provisions of sections 393.1009 to 393.1015,

and to confirm proper calculation of the proposed charge, and may submit a report regarding its examination to the commission not later than sixty days after the petition is filed. No other revenue requirement or ratemaking issues may be examined in consideration of the petition or associated proposed rate schedules filed pursuant to the provisions of sections 393.1009 to 393.1015.

(3) The commission may hold a hearing on the petition and any associated rate schedules and shall issue an order to become effective not later than one hundred twenty days after the petition is filed.

(4) If the commission finds that a petition complies with the requirements of sections 393.1009 to 393.1015, the commission shall enter an order authorizing the corporation to impose an ISRS that is sufficient to recover appropriate pretax revenue, as determined by the commission pursuant to the provisions of sections 393.1009 to 393.1015.

3. A gas corporation may effectuate a change in its rate pursuant to the provisions of this section no more often than two times every twelve months.

4. In determining the appropriate pretax revenue, the commission shall consider only the following factors:

(1) The current state, federal, and local income tax or excise rates;

(2) The gas corporation's actual regulatory capital structure as determined during the most recent general rate proceeding of the gas corporation;

(3) The actual cost rates for the gas corporation's debt and preferred stock as determined during the most recent general rate proceeding of the gas corporation;

(4) The gas corporation's cost of common equity as determined during the most recent general rate proceeding of the gas corporation;

(5) The current property tax rate or rates applicable to the eligible infrastructure system replacements;

(6) The current depreciation rates applicable to the eligible infrastructure system replacements; and

(7) In the event information pursuant to subdivisions (2), (3), and (4) of this subsection is unavailable and the commission is not provided with such information on an agreed upon basis, the commission shall refer to the testimony submitted during the most recent general rate proceeding of the gas corporation and use, in lieu of any such unavailable information, the recommended capital structure, recommended cost rates for debt and preferred stock, and recommended cost of common equity that would produce the average weighted cost of capital based upon the various recommendations contained in such testimony.

5. (1) The monthly ISRS charge may be calculated based on a reasonable estimate of billing units in the period in which the charge will be in effect, which shall be conclusively established by dividing the appropriate pretax revenues by the customer numbers reported by the gas



corporation in the annual report it most recently filed with the commission pursuant to subdivision (6) of section 393.140, and then further dividing this quotient by twelve. Provided, however, that the monthly ISRS may vary according to customer class and may be calculated based on customer numbers as determined during the most recent general rate proceeding of the gas corporation so long as the monthly ISRS for each customer class maintains a proportional relationship equivalent to the proportional relationship of the monthly customer charge for each customer class.

(2) At the end of each twelve month calendar period the ISRS is in effect, the gas corporation shall reconcile the differences between the revenues resulting from an ISRS and the appropriate pretax revenues as found by the commission for that period and shall submit the reconciliation and a proposed ISRS adjustment to the commission for approval to recover or refund the difference, as appropriate, through adjustments of an ISRS charge.

6. (1) A gas corporation that has implemented an ISRS pursuant to the provisions of sections 393.1009 to 393.1015 shall file revised rate schedules to reset the ISRS to zero when new base rates and charges become effective for the gas corporation following a commission order establishing customer rates in a general rate proceeding that incorporates in the utility's base rates subject to subsections 8 and 9 of this section eligible costs previously reflected in an ISRS.

(2) Upon the inclusion in a gas corporation's base rates subject to subsections 8 and 9 of this section of eligible costs previously reflected in an ISRS, the gas corporation shall immediately thereafter reconcile any previously unreconciled ISRS revenues as necessary to ensure that revenues resulting from the ISRS match as closely as possible the appropriate pretax revenues as found by the commission for that period.

7. A gas corporation's filing of a petition or change an ISRS pursuant to the provisions of sections 393.1009 to 393.1015 shall not be considered a request for a general increase in the gas corporation's base rates and charges.

8. Commission approval of a petition, and any associated rate schedules, to establish or change an ISRS pursuant to the provisions of sections 393.1009 to 393.1015 shall in no way be binding upon the commission in determining the ratemaking treatment to be applied to eligible infrastructure system replacements during a subsequent general rate proceeding when the commission may undertake to review the prudence of such costs. In the event the commission disallows, during a subsequent general rate proceeding, recovery of costs associated with eligible infrastructure system replacements previously included in an ISRS, the gas corporation shall offset its ISRS in the future as necessary to recognize and account for any such overcollections.

9. Nothing in this section shall be construed as limiting the authority of the commission to review and consider infrastructure system replacement costs along with other costs during any general rate proceeding of any gas corporation.

10. Nothing contained in sections 393.1009 to 393.1015 shall be construed to impair in any

way the authority of the commission to review the reasonableness of the rates or charges of a gas corporation, including review of the prudence of eligible infrastructure system replacements made by a gas corporation, pursuant to the provisions of section 386.390, RSMo.

11. The commission shall have authority to promulgate rules for the implementation of sections 393.1009 to 393.1015, but only to the extent such rules are consistent with, and do not delay the implementation of, the provisions of sections 393.1009 to 393.1015. Any rule or portion of a rule, as that term is defined in section 536.010, RSMo, that is created under the authority delegated in this section shall become effective only if it complies with and is subject to all of the provisions of chapter 536, RSMo, and, if applicable, section 536.028, RSMo. This section and chapter 536, RSMo, are nonseverable and if any of the powers vested with the general assembly pursuant to chapter 536, RSMo, to review, to delay the effective date, or to disapprove and annul a rule are subsequently held unconstitutional, then the grant of rulemaking authority and any rule proposed or adopted after August 28, 2003, shall be invalid and void.

<b>Missouri Gas Energy</b>				
<b>ISRS Calculation</b>				
<b>GO-2004-0242</b>				
<u>ISRS Activity:</u>				
<u>Gas Utility Plant Projects--Replacement Mains, Services and Associated Valves and Regulators (RM) RSMo 393.1012:</u>				
Replacement Mains, Services and Associated Valves and Regulators		\$11,724,503		
Deferred Taxes		(\$1,208,083)		
Accumulated Depreciation		(\$283,636)		
Total Net 393.1012		\$10,232,784		
<u>Gas Utility Plant Projects--Main Rebuildings (RM) RSMo 393.1012:</u>				
Main Rebuildings		\$4,183,256		
Deferred Taxes		(\$427,037)		
Accumulated Depreciation		(\$116,094)		
Total Net 393.1012		\$3,640,125		
<u>Gas Utility Plant Projects--Facilities Relocations (FR) RSMo 393.1012:</u>				
Relocated Facilities		\$8,429,923		
Deferred Taxes		(\$765,411)		
Accumulated Depreciation		(\$260,492)		
Total Net 393.1012		\$7,404,021		
Total ISRS Rate Base		\$21,276,930		
Before Tax Rate Of Return ( 9.03% After Tax)		11.10%		
Total Revenue Requirement on Capital		\$2,361,527		
Depreciation Expense		\$531,308		
Property Taxes		\$180,068		
Total ISRS Revenues		\$3,072,903		

<b>Missouri Gas Energy</b>		
<b>ISRS Calculation</b>		
<b>GO-2004-0242</b>		
<b>Property Tax Calculation</b>		
ISRS Investment Subject to Property Taxes		\$16,276,130
Less: Retirements		(\$499,902)
Net Change in Property Base		\$15,776,228
Current Property Tax Rate		1.14%
Property Tax Expense		\$180,068
2003 Property Tax Paid		\$8,372,866
Plant Accounts 101, 106 and 107 at 12/31/2002 (less intangibles)		\$733,568,370
Current Property Tax Rate		1.14%
<b>Depreciation Expense Summary</b>		
Replacements Depreciation Expense		\$266,328
Relocations Depreciation Expense		\$191,666
Main Rebuildings Depreciation Expense		\$98,122
Retirements Depreciation Expense		(\$24,809)
Total Depreciation Expense		\$531,307