BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

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

MISSOURI GAS ENERGY'S POST-HEARING BRIEF

TABLE OF CONENTS

Comes now Missouri Gas Energy ("MGE" or the "Company"), a division of Southern Union Company ("Southern Union"), by counsel, and submits this post-hearing brief in the captioned case.[1]

I. INTRODUCTION

In January 2007, the Missouri Public Service Commission ("Commission") held hearings on MGE's most recent rate case, its fifth general rate filing since 1996. Through this case, MGE seeks, among other things, to remedy a fundamentally unfair situation: *i.e.*, a rate design that has persistently deprived MGE of the ability to recover its Commission-approved rate of return on its natural gas distribution (also, "LDC") operations.

In its seminal decision in *Bluefield Water Works v. Public Service Comm'n*, 262 U.S. 679, 692 (1923), the United States Supreme Court held that under the Fifth and Fourteenth Amendments to the United States Constitution, a public utility is entitled to a non-confiscatory rate of return – *i.e.*, "such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties. . . ." *See also Fed. Power Comm. v. Hope Natural Gas Co.,* 320 U.S. 591, 603 (1944) ("[T]he return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks"). Missouri courts have echoed these fundamental principles, holding that "[t]here can be no argument but that [a utility company] and its stockholders have a constitutional right to a fair and reasonable

[1] Citations herein to written submitted testimony are in the form of "Exh. [Number] ([description]), [page number]". "Citations to the transcripts of the oral testimony before the Commission are in the form "[witness' last name] Tr. at [page number: line number of the Hearing transcript]."

return upon their investment." *State ex rel. Public Service Comm'n v. Fraas,* 627 S.W.2d 882, 886 (Mo. App. W.D. 1981).

Four times in the past, this Commission has determined what it believed was a fair and reasonable return for MGE. Four times in the past, erroneous assumptions and obsolete rate structures prevented MGE from realizing those returns. In this case, MGE seeks to change this reoccurring problem, implement a simple and fundamentally fair rate design and, hopefully, reduce the frequency of MGE's rate case filings in the future.

First, MGE seeks a new rate design which recognizes that most of MGE's costs are fixed, and therefore cannot fairly (or even logically), be tied to volumetric fluctuations in MGE's natural gas distribution service. This proposal, what MGE refers to as the Straight-Fixed Variable ("SFV") rate design, would decouple MGE's fixed costs from volumetric deliveries and charge each of MGE's residential ratepayers his or her *pro rata* share of MGE's fixed costs of service. The Staff of the Commission ("Staff") supports this approach.

The SFV rate design is a critical element of this case. The stark reality is that the illogical practice of linking nearly half of MGE's fixed costs to volumetric measures ensures that MGE cannot recover those fixed costs during periods of low natural gas consumption; given that natural gas usage has declined steadily in the past several years – and is forecasted to decline further in the future – MGE's present rate design ensures that its fixed costs cannot be recovered in full. In addition, the same illogical practice actually forces high usage ratepayers, for no identifiable policy reason, to subsidize low usage ratepayers with respect to the costs of being linked to MGE's distribution system. Further, MGE's current rate design also creates a perverse incentive that is contrary to important public policy concerns in the 21st Century: it actually encourages MGE to promote natural gas consumption and *discourage* much-needed energy conservation. Indeed, the SFV rate design is such a positive step forward in MGE's rate structure that, if the SFV rate design is implemented, MGE has agreed to: (a) implement important energy conservation programs, and (b) lower its requested rate of return.

Second, MGE has proposed weather normalization[2] of annual gas volumes to recognize what the scientific community – and increasingly, the general population – have known for some time: temperatures are getting warmer. The weather assumptions built into MGE's present rates are based on average temperatures going back to the notably colder years of the 1970s. Such distorted data have ensured that each year, as average temperatures increase, MGE's delivered volumes fall short of the volumes presumed by the Commission as an inherent part of MGE's rate structure. The Commission should update and correct its current protocol by utilizing more accurate data in its weather assumptions. Specifically, as MGE's weather experts have statistically demonstrated, the Commission should abandon the practice of using 30-year NOAA weather averages for normalizing MGE's annual gas volumes and, instead, use more accurate 10-year averages.

Third, MGE seeks a modest adjustment in the rate of return (also, "ROR") applicable to the rate design that the Commission ultimately approves. In 2004, the Commission approved an overall ROR of 8.36 percent for MGE based on a 10.5% return on equity ("ROE"); since that time, MGE, its parent company, Southern Union Company

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[2] The impact of this request will be significantly affected by the Commission's decision with respect to the SFV rate design. If the Commission adopts the SFV rate design, weather normalization issues will in large part be eliminated with respect to MGE's residential ratepayers, and the weather normalization adjustment will be applicable only to MGE's business customers. (Exh. 13 (Feingold Rebuttal), p. 26)

and the capital markets have all changed, and MGE submits that these changes support an increase in its ROR up to 8.85 percent based on a ROE of 11.75%. Of course, as noted above, should the Commission adopt MGE's proposed SFV rate design – and mitigate one of the more pronounced risks associated with MGE's business – MGE has agreed to lower its requested ROE to 11.5%, a revenue requirement reduction of more than $1 million.

MGE respectfully submits that its proposed SFV rate design and requested ROR are consistent with, and indeed mandated by, the Supreme Court's directives in *Bluefield* and *Hope, supra.* However, equally important is the fact that MGE's requested amendments are consistent with good public policy, including the critical need to promote energy conservation in an increasingly warming environment. The results that MGE seeks are simple, undeniably fair and good for MGE's customers and the community as a whole: a utility finally capable of realizing its approved ROR, natural gas users finally charged the actual costs of connecting to MGE's distribution system, and an environment where MGE, and its ratepayers, have an actual incentive to work together to conserve energy. No erroneous assumptions built into MGE's rates, no unwarranted subsidies among residential ratepayers and no obsolete incentives to actually encourage energy consumption. In short, MGE's proposals make good sense.

II. COST OF CAPITAL

Calculating MGE's ROR is a three-step process. First, a proper capital structure (*i.e.,* MGE's mixture of common equity, preferred stock and long-term debt) must be determined. Second, the required rate of return must be calculated for each component of MGE's capital structure. Third, MGE's overall required ROR (or the weighted average cost of capital (WACC)) must be calculated using the components of MGE's capital structure and each component's required rate of return.

As is usual in rate cases, the primary debate regarding MGE's requested ROR centered on two issues: (a) what ROE should be used in calculating MGE's ROR, and (b) how much equity (which is costlier than debt) should be included in the capital structure imputed to MGE, a division of Southern Union that has no capital structure of its own.

a. <u>Return on Equity</u>

As to the first of these two issues – the cost of equity – this Commission has recently adopted a "zone of reasonableness" test to guide its determinations. Beginning in MGE's rate case in 2004, and then following in two rate cases for The Empire District Electric Company ("Empire") and one case for Kansas City Power & Light Company ("KCPL),[3] the Commission has indicated that an approved ROE for a public utility should fall within a range that is 100 basis points from the national ROE average for similar utilities. In this proceeding, record evidence established that for the first three quarters of 2006, the national average ROE for natural gas distribution companies was 10.49 percent, creating an ROE zone of reasonableness of 9.49 to 11.49 percent in this case. MGE's rate of return expert, Frank J. Hanley ("Hanley"), has recommended a base ROE for MGE that, prior to adjustments, is within this range. (Exh. 2 (Hanley Rebuttal), pp. 26-27, and Sch. FJH-18, 26-30);[4] This base ROE of 11.3 percent is then adjusted for

[3] *See In re Kansas City Power & Light Company*, Case No. ER-2006-0314, 2006 Mo. PSC LEXIS 1734 (Report & Order, issued Dec. 21, 2006); *In re Empire District Electric Company,* Case No. ER-2006-0315, 2006 Mo. PSC LEXIS 1735 (Report & Order, issued Dec. 21, 2006); *In re Empire District Electric Company*, Case No. ER-2004-0570, 2005 Mo. PSC LEXIS 348 (Report & Order, issued Mar. 27, 2005); *In re Missouri Gas Energy Company*, Case No. GR-2004-0209 (Report & Order, issued Sept. 21, 2004).
[4] *See In re Kansas City Power & Light Company*, *supra*, at 22.

MGE's small size (upward adjustment of 30 basis points) and current absence of a protection in its rate structure from the vagaries of weather (upward adjustment of 15 basis points) to produce his recommended ROE of 11.75 percent under a volumetric-reliant rate structure. This would be reduced by 25 basis points, to 11.5 percent under the SFV rate design.[5]

In opposing MGE's recommendations, the Staff and Office of Public Counsel ("OPC") demonstrated, once again, that they remain mired in a period of time predating the Commission's "zone of reasonableness" test. Since adoption of that test, the Commission has approved ROEs for: (a) MGE of 10.5 (with 29.9 percent equity in its capital structure); (b) Empire of 11 percent (in 2005, with 49.14 percent equity) and 10.9 percent (in 2006, with 49.74 percent equity); and (c) KCPL of 11.25 percent (with 53.69 percent equity). However, in each of those rate cases, the Staff's and OPC's recommendations were significantly below the Commission's approved numbers and outside of the Commission's defined zone of reasonableness.

The Staff and OPC continue this pattern of apparent defiance here. For example, Staff witness Murray's recommended ROE range for MGE – 8.65 to 9.25 percent – was outside the zone of reasonableness parameters applicable in this case. In fact, as Murray conceded, his recommended range was virtually identical to the range he proposed, and the Commission rejected, in MGE's 2004 rate case. (Murray Tr. at 196:10-15 ("Q. And would it be fair to say that your results – your result in this MGE case does not differ significantly from the – your recommendation in the last MGE case? A. Actually, if you look at the midpoint, it's about exactly the same.") Further, Murray made it clear that

[5] (Exh. 3 (Hanley Surrebuttal) at 22-23). Staff witness Murray agrees that the ROE adjustment appropriate for the SFV rate structure is approximately 25-30 basis points. (Tr. at 255-256)

although he was fully aware of the Commission's "zone of reasonableness" test, he had no intention of abiding by it:

> Q. [Commissioner Murray:] Okay. Let me ask you a question about your direct testimony. On page 35,you're speaking there on that page about average ROE's, average authorized ROE's –
>
> A. Yes.
>
> Q. – for various time periods, including the first three quarters of 2006 –
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> A. Yes.
>
> Q. – is that correct? And you indicate there at lines 10 and following, that, "The average authorized ROE for the first three quarters of 2006 was 10.49 percent based on nine decisions." Is that your testimony?
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> A. Yes, that's directly from Regulatory Research Associates.
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> Q. Yes. And then going back to the last MGE rate case, the Report and Order there where the Commission talked about a variation of 100 basis points above or below the national average being appropriate; do you recall that?
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> A. I recall that.
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> Q. Now, relating that to – to your testimony and your recommendation and the averages that were shown through Regulatory Research Associates for the first three quarters of 2006, it appears to me that Staff's – even Staff's midpoint is about 60 basis points below what would be the floor of the zone of reasonableness.
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> A. According to what the Commission had indicated they, you know, they believed was a zone of reasonableness, yes. . . .
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> * * *
>
> Q. Okay. . . . My question is, do you think it's appropriate that you consider that range of reasonableness or did you consider it at all anywhere in your analysis?
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> A. I didn't – I didn't mention that 100-basis- point variance. I will point out – the reason why I pointed out – or provided all this average authorized ROE and rate of return information was being

> mindful of what the Commission had put in its previous orders. So, no, I did not relate my specific ROE recommendation to – to that zone of reasonableness.

(Murray Tr. at 233:9 - 234:14, 236:5-16)

As in MGE's 2004 rate case, Murray also failed to comply with established practices in utility finance and essentially relied solely on his market-based Discounted Cash Flow ("DCF") analysis. *See. e.g.,* R. Morin, REGULATORY FINANCE, p. 238 (Public Utility Reports 1994) ("REGULATORY FINANCE") ("If the cost of equity estimation process is limited to one methodology, such as DCF, it may severely bias the results"). In fact, Murray's reason for not using another prominent methodology for calculating ROE, the comparable company approach (*see In re Empire District Electric, supra,* 2006 Mo. PSC LEXIS 1735 at * 26-28), is all too apparent: the average ROE of the six utilities he used in his comparable company proxy group was 10.6 percent – *a full 135 basis points above the top of Murray's recommended range for MGE*. (Exh. 2 (Hanley Rebuttal), pp. 3, 15) Such gamesmanship should not be countenanced in the ratemaking process.

Of course, the OPC's recommendation was even lower than that of the Staff, and thus, in more blatant defiance of the Commission's zone of reasonableness test. Further, the OPC's witness, Russ Trippensee ("Trippensee"), failed to conduct any analyses, and simply took Murray's DCF calculations and adjusted further downward.[6] Although Trippensee attempted to defend his results based on the national average ROE in the third quarter of 2006, MGE's Hanley established that the third quarter figure – 9.6 percent –

[6] The credibility of Mr. Trippensee's ROE recommendation, highly suspect on its face due to the fact that it falls short of the national average ROE by more than 150 basis points, is diminished even further by the standard he applies to assess the efficacy of MGE's current volumetric-reliant rate structure. According to Mr. Trippensee, that rate structure must be fine because neither MGE nor any other Missouri LDC has sought bankruptcy protection. (Trippensee deposition, pp. 31, 38, 53; EFIS doc. 166) This is certainly not a standard any self-respecting regulatory body could seriously consider.

was based on only *one* rate case in New York. (Exh. 3 (Hanley Surrebuttal), pp. 23-24) In addition, the New York rate was the result of a settlement which provided for sharing profits as between ratepayers and the utility only at a 10.6 percent ROE – the more appropriate number to use and a number consistent with the national average for the rest of 2006. (*Id.*; Hanley Tr. at 118:16 - 120:20).

In the end, Hanley demonstrated that by using several different valuation methodologies, an appropriate base ROE for MGE is 11.3 percent. He then adjusted that number upwards by 45 basis points, to 11.75 percent, to account for two MGE-peculiar risks: its relatively small size and the fact that MGE's cost recovery is currently tied to volumetric sales. With adoption of MGE's proposed SFV rate design, one of these risks is reduced significantly, and Hanley recommends a 11.5 percent ROE.[7] This is the only ROE recommendation before the Commission that meets the Commission's ROE "zone of reasonableness" test based on the national LDC average for ROEs in the first three quarters of 2006. Given the open defiance of the Staff and OPC in rendering their recommendations, and the directive of *Hope* and *Bluefield* that rates be fair and reasonable, Hanley's recommendations should be accepted.

b. <u>Capital Structure</u>

Equity is more costly than debt, so a utility's ultimate ROR is substantially affected by adjusting the amount of common equity in its capital structure. More equity, a higher return; less equity, a lower return.

In 2004, this Commission used Southern Union's capital structure (with 29.99 percent equity at the time) as a proxy capital structure for MGE's LDC operations. However, Southern Union has changed dramatically since 2004, and MGE submits that

[7] See also, Hack, Tr. p. 591.

its divergent businesses preclude the treatment of its capital structure as an appropriate proxy for MGE in 2007. Accordingly, Hanley has used the capital structures of other, comparable LDC enterprises and recommended a hypothetical capital structure for MGE which contains 46 percent equity and 54 percent debt. (Exh. 1 (Hanley Direct), p. 20)

Since 2004, Southern Union has acquired a number of assets in the natural gas transportation and services industry and sold some of its LDC operations. (Exh. 1 (Hanley Direct), pp. 20-21) Thus, Southern Union's capital structure now reflects the significant diversity in its businesses and is not – if it ever was – reflective of LDC operations alone. Indeed, as Murray conceded, Southern Union is now a "midstream company." (Murray Tr. at 215:8-16)

Murray also:

(a) testified that the natural gas "gathering" and "processing" functions of a midstream company like Southern Union are more risky than a "utility" (*id.* at 215:17-24; *see also* Hanley Tr. at 93:16-96:14);

(b) testified that a recent Southern Union pipeline acquisition was "consistent with Southern Union's recent strategy of transforming itself from primar[il]y a natural gas utility company to a more diversified natural gas service provider which . . . involves more business risk . . ." (Exh. 101 (Murray Direct), p. 13); and

(c) agreed that "if you have more risk, you need a higher rate of return to attract capital." (Murray Tr. at 211:3-6)

Despite these admissions, however, Murray recommended a midpoint ROE of just 8.95 percent for MGE and a capital structure, based on Southern Union's capital structure, with only 36 percent equity. (Exh. 103 (Murray Surrebuttal), pp. 3, 5)[8]

Murray's position is at odds with basic concepts of utility finance: as a midstream company, Southern Union is no longer similar in its overall operations to a stand alone LDC, if it ever was. *See*, *e.g.*, REGULATORY FINANCE, p. 224 ("If the subsidiary does not engage in any financing at all, the parent's consolidated weighted average cost of capital can be assigned to the subsidiary, *again provided that the relative risks of the parent and subsidiary are similar*. If the parent's risk differs from that of the subsidiary, risk adjustment techniques must be applied…") Accordingly, in 2007 and in this Proceeding, it is particularly inappropriate to impose Southern Union's capital structure on MGE. Instead, MGE submits that the Commission should use the data available from the comparable companies analyzed by MGE's and the Staff's experts, and calculate a hypothetical capital structure based on averages in those groups. In short, MGE submits that as to utilities like MGE – those which are not stand alone utilities and, instead, are divisions of corporations with diverse operations – the Commission should utilize an additional "zone of reasonableness" test, this one for capital structure based on averages in the utility industry. *See, e.g., In the Matter of St. Joseph Light & Power Co.,* Case No. ER-93-41, 1993 Mo. PSC LEXIS 36, 2 Mo. P.S.C. 3d 248 (June 25, 1993) (applying zone of reasonableness analysis to capital structure).

Hanley has provided underlying factual support for just such a test from his two groups of comparable utilities. (Exh. 1 (Hanley Direct), p. 20 and Sch. FJH-6; Exh. 2 (Hanley Rebuttal), pp. 26-27) Further, he has also demonstrated that the comparable

[8] It should be noted that Murray's methodology is inherently arbitrary because he uses certain pipeline debt for one purpose - (calculating the amount of debt to be attributed to MGE's regulatory capital structure) - while rejecting it for another purpose - (calculating the cost of debt to be attributed to MGE). (Exh. 002 (Hanley Rebuttal) pp. 12-13; Murray Tr. 221-222)

companies analyzed by Murray had, on average, a capital structure with 48 percent equity at the end of 2005 (Exh. 2 (Hanley Rebuttal), pp. 6-7), more than the 46 percent recommended by Hanley. Further, by the time of the Proceeding, new data on Murray's comparable companies demonstrated that they had, on average, capital structures with 55.23 percent equity. (Murray Tr. at 207:25 - 208:20)

These capital structure averages – derived from Murray's own data sets – completely undermine his recommendation that the Commission use 36.06 percent equity in its ROR determination. (*See* Exh. 103A (Murray True-Up), p. 3) Debt makes a company more risky from the perspective of equity holders who, in a hypothetical liquidation, collect only after all debt is paid. As risk increases, equity holders demand greater returns. If an ROE of 10.5 is sufficient for a company with 55 percent equity, all other things being equal, it is clearly insufficient for a riskier company with 36 percent equity. Accordingly, either (a) a reasonable capital structure should be imputed to MGE, or (b) its approved ROE should be adjusted significantly higher. Murray's refusal to address this point – other than through his inherently contradictory 30 basis point adjustment (Exh. 101 (Murray Direct), p. 37)[9] – renders his testimony incredible.

In the end, the Commission should use a hypothetical capital structure in this proceeding of 46 percent equity and 54 percent debt in calculating MGE's approved ROR. As the chart in Appendix A indicates, this would result in a weighted ROE for MGE that is below recent decisions of this Commission, but nonetheless reasonable, particularly with the SFV rate design. The Staff's and OPC's recommendations are clearly outside any zone of reasonableness.

[9] Murray uses differences in market determinations of risk for *debt* to make an adjustment for differences in the risk of *equity*. (*Id.*) Murray provides no authority for this apparently self-invented process of comparing apples to oranges.

III. INCOME STATEMENT-REVENUES

a. Weather Normalization

MGE also seeks to amend its weather normalization adjustment by using 10-year, versus 30-year, Heating Degree Day ("HDD") averages in calculating that adjustment. The idea behind a WNA is straightforward: adjust MGE's rates when average temperatures are warmer than normal in the test year applicable to any rate application before the Commission. However, the theory can break down in practice if assumptions about what is "normal" weather prove to be incorrect. (Exh. 11 (Feingold Direct), pp. 6-7, 14-15 and Sch. RAF-9)

In all of MGE's past rate cases, test year temperatures were "normalized" using assumptions about temperature that were adopted by this Commission based on 30 years of weather pattern data. For this case, Feingold conducted a detailed statistical analysis and demonstrated that of proposed 5-year, 10-year, 20-year and 30-year HDD averages, the 10-year HDD average was by far the best predictor of temperatures for the following two years in the future. (Exh. 11 (Feingold Direct), pp. 9-12 and Sch. RAF-3 and RAF-4)

The Staff objected to use of a 10-year HDD average and, through its witness, Curt Wells ("Wells"), argued for a continued use of the 30-year HDD average promulgated by the National Oceanic & Atmospheric Administration ("NOAA"). In fact, Wells made matters even worse by contending that because of minor corrections NOAA belatedly makes to its 30-year averages, MGE's weather normalization adjustment should be calculated using weather data starting in 1971 and ending in 2000, seven years ago. (Wells Tr. at 729:16-33)

The Staff has no principled rationale for its position. In fact, Wells' justification for using NOAA data is a textbook example of begging the question: *i.e.*, because NOAA uses it. However, NOAA does not set utility rates or use 30-year HDD *averages* to predict weather in the immediate future. (*See also* Exh. 13 (Feingold Rebuttal), pp. 10-11) Indeed, NOAA meteorologists would be laughed out of their jobs if, in predicting weather for 2008, they simply calculated the *average* of various weather statistics for the period 1971 to 2000.

Wells also contends that NOAA's 30-year HDD averages are preferable in the ratemaking process because they are supposedly more "stable" and are better for establishing a "normal year." However, this argument makes no sense: the trend in weather has been increasing warmth. Accordingly, average weather measurements in the distant past – *i.e.*, 1971 – have no logical bearing on predicting temperatures in 2007 or 2008. Put another way, weather *trends* over the last 30 years might assist in predicting temperatures in 2007/2008, but weather *averages* over the same period do not.

Wells' apparent response to these points is that this Commission should not concern itself with predictability. Because he claims that both 10-year and 30-year HDD averages are not perfect predictors of future weather, he apparently abandons prediction all together, and focuses solely on the ill-defined concept of "stability." (Wells Tr. at 740:8 - 744:25, 745:4 - 746:11, 746:18 - 748:10, 752:17 - 754:8) Such a position ignores the basic responsibilities inherent in ratemaking.

Like it or not, one of the Commission's duties in determining utility rates is predicting the future. Further, as this Commission has stated, "the purpose of using a test year is to create or construct a reasonably expected level of earnings, expenses and investment *during the future period during which rates to be determined herein will be in effect.*" *In re Southwestern Bell Telephone Company*, 23 Mo. P.S.C. (N.S.) 374, 377 (1980) (emphasis added). This forward looking concept of ratemaking is consistent with the testimony of the Staff's own policy witness: "One of the fundamental principles that has long governed ratemaking in this jurisdiction is the axiom that ratemaking *is and should be a forward-looking and prospective process.*" (Exh. 104 (Schallenberg Rebuttal), p. 3; emphasis added) Accordingly, if the rate setting process is to truly be forward-looking then predictions about "normal" conditions in the future must be as accurate as possible. A reasonable ROR does not meet the requirements of *Hope* and *Bluefield* if, through faulty assumptions about the weather, its "impact" becomes unreasonable. *See Hope*, *supra*, 320 U.S. at 602 ("Under the statutory standard of 'just and reasonable' it is the result reached not the method employed which is controlling. It is not theory but the impact of the rate order which counts") (citations omitted).

Neither the Staff nor its witness, Wells, denied the persistent revenue shortfalls that MGE has experienced due, in part, to the 30-year HDD averages incorporated into its rate structure. Further, neither the Staff nor Wells offered any evidence to refute Feingold's statistical showing that 10-year HDD averages – although not perfect – are better at predicting future weather patterns than 30-year HDD averages. In fact, Staff witness James Gray testified that statistical analysis is the preferred method of describing the relationship between daily space-heating sales per customer in Ccf to the daily HDD. (Exh. 110 (Gray Direct), 6:7-11). If statistical analysis is the preferred method of analysis by staff in one area of weather normalized sales, it cannot be ignored or dismissed in the other areas of the analysis. Accordingly, the Staff's objections should be dismissed and MGE's proposal adopted.

IV. INCOME STATEMENT-EXPENSES

a. Property Tax Refunds[10]

Staff proposes to distribute to customers, through future rates, approximately $5.5 million in property tax refunds that MGE received in 2005, that relate to taxes paid for 2002, 2003, and 2004. Under Staff's proposal, estimates of amount of property tax expense that MGE will actually incur in the future are simply reduced by one-fifth of the total amount of the refunds,[11] resulting in an artificially reduced, net amount of property tax expense being included in the cost of service used to set MGE's rates. (Winter Tr. at 849:1-25) The rationale for Staff's proposal is the assumption that because the amount of property tax expense paid by customers through rates for the period 2002-2004 exceeded the Company's actual property tax expense the customers are entitled to share in the refunds. (Exh.111, p.20)

The Commission must reject Staff's proposal because it constitutes unlawful retroactive ratemaking. In *State ex rel. Util. Consumers Council of Missouri, Inc. v. Pub. Serv. Comm'n.*, 585 S.W.2d 41 (1979) ("*UCCM*"), the Missouri Supreme Court confirmed that retroactive ratemaking is unlawful in this state. In *UCCM*, the court defined retroactive ratemaking as "the setting of rates which permit a utility to recover past losses or which require it to refund past excess profits collected under a rate that did

[10] MGE adopts, and incorporates herein by reference, the discussion of this issue that appears at pp. 34-36 of its Prehearing Brief.
[11] The reduction by one-fifth of the deferred refunds is derived from Staff's proposal to amortize the full amount of the refund over five years.

not perfectly match expenses plus rate-of-return with the rate actually established."[12] The court's opinion also limits how the Commission can consider and use past losses or gains to set future rates:

> The Commission has the authority to determine the rate *to be charged*, § 393.270. In so determining it may consider past excess recovery insofar as this is relevant to its determination of what rate is necessary to provide a just and reasonable return in the future, and so avoid further excess recovery. [citation omitted] It may not, however, redetermine rates already established and paid without depriving the utility (or the consumer if the rates were originally too low) of his property without due process. (emphasis original)

Id. at 58.

Staff's proposal does not use the refunds that MGE received during the test year to help determine what level of property tax expense the Company likely will incur in the future – the only use permitted under *UCCM*. Instead, Staff asks the Commission to use the refunds to artificially reduce property tax expense used for ratemaking, which has the effect of flowing through to future customers past gains that MGE realized from the refunds. Staff then justifies its proposal with a rationale – a desire to rectify a less than perfect match between past expenses and past rates – that *UCCM* specifically rejected. Staff's proposal thus manages to include almost every element of what the Missouri Supreme court has held the doctrine of retroactive ratemaking prohibits, and the Commission must reject the proposal for that reason.

b. Unrecovered Cost of Service Amortization[13]

If the Commission interprets *UCCM* so as to allow it to approve Staff's proposal

[12] See, also, the definition of "retroactive ratemaking" that appears in the testimony of one of Staff's own witnesses, Robert Schallenberg. (Exh. 104, p. 4)

[13] MGE adopts, and incorporates herein by reference, the discussion of this issue that appears at pp. 36-38 of its Prehearing Brief.

to distribute the gain MGE realized from property tax refunds, then it must also accept the Company's proposal to recover past losses due to shortfalls in customer usage. To do otherwise would be irrational, legally inconsistent, and fundamentally unfair.

c. Rate Case Expense[14]

MGE proposes to add the unrecovered balance of rate case expense from the Company's last rate case to whatever rate case expense is allowed in the current case and then amortize that total over three-years. In Case No. GR-2004-0209, the Commission allowed rate case expense of approximately $894,000, providing for recovery of that amount through a three-year amortization.[15] Allowing recovery of irregularly-recurring costs – such as rate case expense – through amortization is the method generally favored by this Commission. Amortization allows the Commission to fix both the amount of the expense and the interval over which it will be recovered, providing assurance that rate case expenses the Commission has determined were prudently incurred will be recovered.

In contrast, Staff's approach attempts to normalize rate case expense based on estimates of two variables: the amount of the expense and the frequency of future rate cases. The normalized level of rate case expense is then included in the cost of service and used for ratemaking purposes. But because costs vary from case to case and it is difficult to predict how frequently companies will need to file cases in the future, Staff's stated policy of normalizing rate case expense is prone to error.[16]

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[14] MGE adopts, and incorporates herein by reference, the discussion of this issue that appears at pp. 38-39 of its Prehearing Brief.

[15] Report and Order in Case No. GR-2004-0209 (Sept. 21, 2004), p. 91.

[16] For example, Staff's proposed normalized level of rate case expense in this case is based on assumption that MGE will file a rate case once every three years. But the current case is the Company's fifth in ten years – a historical average of one case every two years. (Mapeka Tr. at 1052:19-1054:18, 1055:18-1058:23)

For the future, the Commission is free to choose whether rate case expense should be normalized or amortized. But, in MGE's last rate case, the Commission ordered amortization of rate case expense and that order must be respected in this collateral proceeding pursuant to the requirements of Section 386.550, RSMo. The Company should, therefore, be allowed to include in its cost of service for ratemaking purposes the unrecovered balance of rate case expense authorized in Case No. ER-2004-0209.

d. Depreciation Expense - SETTLED

e. Low-Income Weatherization/Natural Gas Conservation

1. Low-Income Weatherization

MGE incorporates by reference its summary of this issue in its pre-hearing brief at pages 48-49. MGE has proposed to increase funding for this long-standing program from its current level of $500,000 annually to $620,000.

2. Natural Gas Conservation

This issue became the topic of substantial inquiry by the Commission. As noted in its pre-hearing brief at pages 47-48, the Company has presented a program that will make a strong commitment to natural gas conservation through customer communications and funding for high efficiency gas water heaters which promises delivery of energy savings for the largest number of MGE customers on a year-round basis. The proposal is conditioned on approval of a rate design that neutralizes the financial effect on MGE of fluctuating customer usage and includes the cost of the initiatives in the rates to be set in this case.

The hearing revealed concerns on the part of one or more of the Commissioners that MGE's program perhaps does not go far enough. It is important to remember, however, this proposal represents the Company's first foray into natural gas conservation programs which is understandable given MGE's historic rate design which has linked to the Company's profitability to increases in natural gas consumption by its customers. As such, MGE has proposed a program that it believes it can implement and manage with the resources and expertise that currently is available to it. (Hack Tr. at 625:19-626:20). MGE wants the program to be successful if implemented and it also feels compelled to be prudent with the level ratepayers are being asked to fund. There was some discussion of a space heating program along the lines of AmerenUE's furnace rebate program but unlike water heaters which represent a relatively modest investment for an appliance that is used year-round, furnaces can cost thousands of dollars. (Ross Tr. at 507:13-508:19) Even then, the benefits will be seasonally limited. (Ross Tr. 640:2-8).

MGE has examined the "pay as you save" (PAYS) program as mentioned in the final report of the Energy Affordability Task Force in Case No. GW-2004-0452. As explained by MGE witness Robert Hack, however, the PAYS concept is complex and not practical or workable. (Hack Tr. at 650:22-651:15). MGE is not a financial institution.[17] Significantly, no LDCs in the United States have adopted or been directed to implement a PAYS program (Meisenheimer Tr. 963:4-14) and no rulemaking docket has been established in this state to examine its feasibility.

Public Counsel suggests that MGE’s conservation program will violate the Commission’s promotional practices rules appearing in Chapter 14 of the CSR[18] (the “Rules”) but fails to specify how. MGE disagrees with Public Counsel and notes that 14

[17] Any such program will need to be reconciled with the prohibited practice of a utility financing real estate appearing in Commission rule 4 CSR 240-14.020(1)(A) inasmuch as an installed furnace is a fixture under Missouri real property law and the PAYS program apparently contemplates taking a lien as against the customer’s premises.
[18] Meisenheimer Tr. 823.

CSR 240-14.010(6)(L)8 expressly *excludes* energy audits or other informational programs from the scope of the Rules. Further, MGE submits that if the Commission should approve MGE's proposal it implicitly will have found it to be in compliance with the standards set forth in the Rules.

f. Environmental Response Fund[19]

MGE seeks authority to create and fund an Environmental Response Fund ("ERF") that would be used to pay ongoing costs related to the investigation and environmental remediation of several former manufactured gas plant ("MGP") sites. Staff and the OPC oppose both the creation of the ERF and MGE's proposal to partially fund it through rates. But the arguments that Staff and the OPC make in support of their respective positions are unfounded. For example:

- Although both Staff and the OPC claim that Southern Union and WRI agreed that liability for remediation of the former MGP sites would be borne solely by those parties, insurance carriers, and other PRPs, the terms of the ELA states that ratepayers are among the groups that are primarily liable for remediation costs. (Exh. 120 HC, Sch. 1; Harrison Tr. 1011:9-1015:18, 1195:15-1199:20)

- Although the MGP sites are no longer used to manufacture gas, MGE uses the sites for various activities – such as for equipment storage and as service centers – that are necessary to provide gas service to the Company's customers. (Noack Tr. at 924:9-925:5)

- There is no evidence that previous customers of MGE or WRI compensated either of those companies – through depreciation rates or though the rates of return authorized for either company – for the costs that have been and will be incurred for environmental remediation of the former MGP sites. (Robertson Tr. 1204:14-1208:19; Uniform Sys. of Accts. for Nat. Gas cos.; Part 201 (10), (12) (B); (Robertson Tr. 1182:14-1191:12; 1201:12-1204:5)

- Establishment of the ERF and authorizing partial funding through rates will not eliminate incentives for MGE to continue to seek contributions from insurance carriers and other PRPs. (Exh. 7, Sch. MRN-3, p. 50)

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[19] MGE adopts, and incorporates herein by reference, the discussion of this issue that appears at pp. 49-57 of its Prehearing Brief.

- Although all of the costs payable from the ERF are not currently "known and measurable," disbursements from the fund will only be made to compensate MGE for remediation-related costs that it actually incurs, which will be both known and measurable. (Harrison Tr. 1020:6-1022:7)

MGE's proposal to establish and fund an ERF to pay the ongoing costs of remediation of the former MGP sites reasonably and responsibly balances the legitimate interests of both the Company and its customers. The Commission, therefore, should approve that proposal.

g. Infinium Software Amortization[20]

Both MGE and Staff propose to amortize over five years and collect through rates the remaining balance of its investment in the Infinium Software System. Although MGE continues to use some facets of that system, it discontinued its use of the general ledger and related financial reporting capabilities when it converted to the Oracle software system. Among its many benefits, the Oracle system is much less costly than Infinium, which has allowed the Company to reduce its overall cost of service. (Noack Tr. 1271:14-1272:6)

The OPC opposes collection of the unrecovered balance of MGE's investment in Infinium on grounds that the investment is not "used and useful" a contention based upon errors of both fact and law that must be rejected. As noted previously, portions of the Infinium system continue to be used. But, more importantly, the "used and useful" standard does not apply because that standard only applies to items of rate base for which a utility seeks to earn a rate of return. (Robertson Tr. at 1277:11-1278:4)

The OPC seeks to punish MGE for converting to the Oracle system before its investment in Infinium was fully recovered, even through as a result of that conversion

[20] MGE adopts, and incorporates herein by reference, the discussion of this issue that appears at pp. 57-59 of its Prehearing Brief.

the Company has been able to reduce its overall software expense. The OPC's attempt to have it both ways – reaping the benefits of conversion but refusing to pay the costs – must be rejected.

h. Emergency Cold Weather Rule AAO Recovery Mechanism[21]

Following the Commission's adoption of an emergency amendment to the Cold Weather Rule,[22] MGE was given permission to establish an Accounting Authority Order ("AAO") to maintain on its books, as a regulatory asset, all costs related to complying with the emergency amendment. As of June 30, 2006, the Company had accumulated a balance of approximately $900,000, which represents the difference between what MGE would have collected from customers, but for the emergency amendment, and what it actually collected while appropriately recognizing the impact of revenues that would not have otherwise been received absent the emergency amendment. Staff has audited and verified the amount of the regulatory asset and both Staff and MGE are proposing that the full amount of that asset be amortized and collected through rates over a period of three years.

Although the OPC has indicated it opposes this proposal, the basis for that objection is unclear: the OPC filed no testimony on this issue and, although it asked questions of both the Company's and Staff's witnesses during the hearing in this case, the point of those questions is not apparent. The OPC's objection should, therefore, be rejected and the Commission should adopt the amortization recommended by the Staff and MGE.

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[21] MGE adopts, and incorporates herein by reference, the discussion of this issue that appears at pp. 59-60 of its Prehearing Brief.

[22] See, 4 CSR 240-13.055; Order dated December 21, 2005, in Case No. GX-2006-0181.

V. RATE DESIGN AND MISCELLANEOUS TARIFF LANGUAGE

a. Class Cost of Service-SETTLED

b. Rate Design

MGE has submitted undisputed evidence that it has consistently failed to recover its fixed distribution costs – and realize its approved ROR – because, among other things, almost half of MGE's fixed costs are recovered through the ups and downs of volumetric sales. (Exh. 4 (Noack Direct), pp. 21-22, 25, and Sch. H-21 and G-4; *see also* Exh. 11 (Feingold Direct), p. 31 and Sch. RAF-9 (showing $6 million shortfall in cost recovery in 2005 alone).) In other words, under MGE's current rate design, 45 percent of its *fixed costs* are recovered based on the *variable factor* of how much natural gas it sells; if natural gas consumption goes down – because of warming temperatures, much-needed energy conservation or both – MGE cannot recover all of its costs.

Accordingly, through its expert witnesses Ronald J. Amen and Russell A. Feingold ("Feingold"), MGE, with the Staff's support, has proposed a simple solution: a flat monthly fee for residential ratepayers equal to their *pro rata* share of MGE's fixed costs in providing distribution services to the residential properties in its territories. (*See, e.g.,* Exh. 11 (Feingold Direct), pp. 19-21, 36-42 and Sch. RAF-11) This SFV rate design proposal, or another form of revenue decoupling with the same general intent and impact, has been adopted in some form in several of the jurisdictions analyzed by MGE's and Staff's ROR experts (*see*, *e.g.*, Exh. 3 (Hanley Surrebuttal), pp. 20-23; Hanley Tr. at 63:24-64:23), and has significant benefits for both MGE and ratepayers. (Exh. 11 (Feingold Direct), pp. 36-41)

The need for this straight forward rate design is clear. First, as counsel for the Staff emphasized during the Proceeding, the SFV proposal is fair. (Tr. at 32:25-33:16) Under MGE's existing rate design, users of significant amounts of natural gas actually subsidize users of smaller amounts, even though MGE's fixed distribution costs apply equally to all users. If MGE's plan is approved, each residential ratepayer will pay his or her own share of the fixed costs of being linked to MGE's distribution service, and no subsidies will exist. It also has the added benefit of lowering ratepayer bills in the winter – *i.e.*, the season when most residential natural gas bills are their highest. (Exh. 11 (Feingold Direct), p. 39)[23]

Second, the SFV proposal eliminates an undesirable incentive in MGE's present rate design: currently, MGE has every incentive to encourage natural gas consumption (thus, increasing its recovery of fixed costs) and discourage natural gas conservation. In fact, in full recognition of the impact of a SFV rate structure, MGE has committed itself to several natural gas conservation initiatives should the SFV design be approved. (Exh. 018 (Hendershot Direct), p. 2) MGE will not – and in the interests of its investors cannot – proceed with these conservation measures if significant amounts of its fixed cost recovery continue to be tied to volumetric sales.

Third, during the Proceeding, Commissioner Murray identified yet another benefit of a SPV rate structure: accuracy. In responding to questions from Commissioner Murray, the rate design witness for the OPC, Barbara Meisenheimer ("Meisenheimer"), conceded that MGE's current rate design is based on presumptions regarding the volumes

[23] This is the reason the Commission's Energy Affordability Task Force recommended that the Commission consider rate designs that eliminate reliance on volumetric rate elements for cost recovery. Task Force Report filed on March 31, 2005, in Case No. GW-2004-0452, p. 26, no. 5. Also, the Attorney General made a similar recommendation to Governor Holden after the 2000-2001 heating season. (Hack, Tr. 597)

of natural gas MGE will sell. If MGE sells more, ratepayers actually overpay MGE for its fixed costs; if MGE sells less, ratepayers underpay MGE for those same costs. Further, as Commissioner Murray recognized, and Meisenheimer agreed, the presumptions regarding MGE's sales are "usually probably not right on." (Meisenheimer Tr. at 568:24-570:19) With the SFV rate structure, such built-in inaccuracies – and over- and under-payments – are gone. (Exh. 11 (Feingold Direct), p. 36)

The sole objector to MGE's SFV rate design is the OPC, which inexplicably wants the Commission to maintain the *status quo.* The OPC's objections, however, are contrary to both the record evidence and the fairness standards set forth in *Hope* and *Bluefield.*

The OPC's principal objection seems to be that the SFV rate structure will somehow punish low income, low usage customers. Of course, this objection is premised on the erroneous assumption that low income households uniformly use low amounts of natural gas. The facts demonstrate otherwise: MGE has submitted compelling evidence demonstrating that natural gas usage in its territories actually decreases as income increases, until annual income reaches a range of $45,650 to 73,925. (Exh. 17 (Thompson Rebuttal), pp. 7-10 and Sch. PBT-2) MGE submits that instead of seeking to protect the interests of customers whose bills are already low (and who, logic would indicate, probably do not use natural gas for space heating purposes), the OPC should be more focused on the high bills being paid right now by low income, *high usage* households: under a SFV rate structure, their bills will indisputably be less.

The OPC also contends that a SFV rate structure eliminates incentives to cut costs and conserve energy. However, no principled arguments are made in support of these contentions. MGE is a regulated company; if it fails to control costs, such costs can be disallowed by this Commission. The OPC's speculation regarding costs and incentives fails to appreciate this fundamental fact.

As to conservation, the OPC has it exactly backward: with variations in natural gas bills linked directly and solely to consumption, the SFV rate structure actually encourages conservation. (*See, e.g.*, Exh. 13 (Feingold Rebuttal), pp. 3-5, 23-25) Further, as noted above, the SFV structure gives MGE the incentive to encourage energy consumption and work with its customers in doing so. Lastly, as Meisenheimer conceded during the proceeding, since the commodity cost of natural gas is the major component of any customer's natural gas bill, that customer can save money under the SFV rate structure – just like he or she can save money under MGE's current rate design – simply by "reducing their use of natural gas." (Meisenheimer Tr. at 579:25-580:25)

The OPC's lack of any principled rationale for its objection was readily apparent during the hearing.[24] Under cross-examination, Meisenheimer, the OPC's witness on MGE's SFV proposal, conceded that she had no evidence refuting MGE's showing that it had suffered earning shortfalls every year since 1999. (Meisenheimer Tr. at 539:22-540:22) Further:

- She did not dispute MGE's evidence that the average use per MGE residential customer (*i.e.*, what is currently used as a baseline in MGE's rate design) has fallen from 1,112 ccf/year in 1997 to 903 ccf/year in 2005;
- She did not dispute the American Gas Association's forecast that residential natural gas consumption will continue to decline from 2010 to 2020;

[24] It should also be noted that most of the primary reasons advanced by OPC in the pending Atmos rate case against adoption of SFV in that case do not apply to MGE in this case. For example: no overearnings in this case; no rate consolidation in this case, *etc*. (Meisenheimer Tr. 538-544)

- She agreed that MGE’s present rate design “requires customers to pay a substantial portion of fixed costs during high heating bill months” – *i.e.,* the winter;
- She agreed that under the traditional rate design now applicable to MGE, if residential consumption falls below the Commission’s assumed consumption levels, MGE will not achieve its authorized rate of return, all other things being equal; and
- She agreed that under her recommended rate design, MGE’s financial performance is tied to the use of *more,* not less, gas.

(Meisenheimer Tr. at 532:8-13; 534:1-536:15)

Meisenheimer did testify that under her own calculations, consumers of less than 75 CCF of natural gas on a monthly basis would see their bills increase under a SFV rate structure. However, Meisenheimer admitted: (a) that she has no idea how many households fall into that category, and (b) consumers of more than 75 ccf per month will actually see their bills decrease. Further, she offered no evidence even to suggest that the less than 75 CCF per month users in MGE’s territories are predominantly low income households. And, as Meisenheimer admitted, if her low income/low usage assumption is wrong at least part of her analysis is also wrong. (Meisenheimer Tr. at 555:1-11)

Finally, Meisenheimer conceded that the OPC, in purportedly representing the interests of ratepayers in the proceeding, had failed to do any survey of those ratepayers to determine their views on a SFV rate structure. (*Id.* at 551:17-24) An advocate that has lost sight of its client’s interests is no advocate at all. The OPC’s crusade against a SPV rate structure is in the interest of no one, is based on no actual facts or principled argument, and is contrary to the directives set forth in *Hope* and *Bluefield.*

c. MGE's Proposed Seasonal Disconnect Tariff Language (Sheet No. R-13)

As noted in its prehearing brief at pages 75 and 76, MGE has proposed that a customer who voluntarily disconnects service, and then subsequently reconnects service at the same address or premise within the next seven months, be charged a reconnection charge equal to the sum of the minimum bills for service during the period of disconnection plus a reconnection charge. (Exh. 006, Noack Rebuttal, p. 13) The intent of this new language would be to provide a disincentive to customers who disconnect during the non-heating months simply to avoid paying the basic service charge during those months.

The Company's proposal was derivative of one of a number of recommendations contained in the Final Report of the Commission's Cold Weather Rule and Long-Term Affordability Task Force dated March 31, 2005. Even though the Task Force included a representative of OPC, and even though the Final Report was stated to be a recommendation "supported by all of its members", OPC witness Meisenheimer spent nearly the entire time on this topic doing the moon walk in exactly the opposite direction. This is the most remarkable example of unprincipled, institutional backtracking in recent memory. It is difficult to understand what constructive role the OPC can be expected to play in important energy policy matters if the commitments of his office can be disregarded at a whim.

Not to be outdone, Staff apparently concluded in the eleventh hour that there is a revenue requirement impact of approximately ($114,000) associated with the Company's proposal[25] even though no dollar figure associated with this issue appears anywhere in Staff's Case Reconciliation filed on December 20, 2006.[26] The bottom line is that there is no revenue requirement impact that can be fairly assigned to this issue. As conceded by Staff witness Michael Ensrud, there is no way to know how many of MGE's customers

[25] Exh. 125A.
[26] EFIS doc. no. 150; Tr. 1130.

will pay anything under the Company's tariff proposal because there is no such tariff currently in effect and, consequently, the impact is not capable of being known and measured. (Tr. at 1135:13-22). Staff's recommendation is also plainly counterintuitive in the sense that if MGE's proposal works as intended, any customers that disconnect on a seasonable basis will realize no financial advantage by doing so. In any event, MGE does not propose to profit from its proposal. Company witness Michael Noack indicated that MGE would commit any revenues generated by the tariff up to the first $140,000 to additional conservation program initiatives. (Tr. 946:5-947:6).

d. MGE's Unopposed Tariff Changes

MGE's May 3, 2006, filing included proposed tariff sheets 24.3, 61.2 and R-34. None of the tariff sheets have been opposed by any party and should be approved by the Commission. (Exh. 007, p. 24).

VI. MISCELLANEOUS

a. Staff's Proposed PGA Language - WITHDRAWN (Tr. 1302)

b. The Kansas Property Tax AAO should be Continued

MGE's position on this issue is set forth at pages 78-79 of the Company's Prehearing Brief. The only significant fact that has changed since the conclusion of Case No. GU-2005-0095 is the Kansas appellate process has taken longer than anticipated. (Exh. 4, p. 20; Exh. 204, p. 20). There is no reason for the Commission to vacate the existing AAO as suggested by OPC. (Exh. 204, p. 20-22). As noted by the Commission in 2005, MGE's efforts have been for the benefit of its customers. The Commission should authorize MGE to continue deferral of the Kansas Senate Bill 147 property taxes until MGE concludes its next general rate proceeding.

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CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the above and foregoing document was electronically transmitted, sent by U.S. Mail, postage prepaid, or hand-delivered, on this 15th day of February, 2007, to:

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