



## **INTRODUCTION**

1. On November 18, 2004, the Staff filed its Recommendation concerning MGU's Application. The Memorandum attached to that Recommendation suggested that the Application be approved. However, it also recommended that the Commission impose several conditions on such approval. These conditions were summarized in a schedule entitled "Summary of Conditions" (Schedule 1 to the Memorandum). MGU will refer herein to the conditions by the numbers they were given in the referenced Summary of Conditions.

2. MGU is willing to accept Conditions 1 (Service Quality Conditions), 2 (Depreciation), 4 (Gas Supply), 6 (Tariff), 7 (Uniform System of Accounts), 8 (Corporate allocation issues), 11 (Affiliate Transactions), 12 (Surveillance), 13 (PGA/ACA review), 14 (Risk of project success) and 15 (Financial Issues).

3. MGU will first address in the following paragraphs those conditions with which it does not agree (Conditions 9 (Acquisition Costs), 10 (Accounting For Plant) and 16 (Diversify)). It will then discuss those conditions about which it must gain a greater understanding before it is able to state its final position as to acceptance or disagreement (Conditions 3 (Gas Safety) and 5 (Service Territory)).

### **ACCOUNTING FOR PLANT (RATE BASE)**

4. Condition 10 recommends as a condition that "MGU's plant in service accounts will reflect plant costs calculated based upon MGU's actual investment in Gallatin and Hamilton plant in service facilities." In other words, Staff recommends that rate base reflect the purchase price of the assets rather than the net original cost.

5. The net original cost, in this case, exceeds the purchase price. As recently as

February of this year, the Commission stated as follows concerning the treatment of differences between net original cost and purchase price in the context of an acquisition:

Missouri has traditionally applied the net original cost standard when considering the ratemaking treatment of acquisition adjustments. That means that the purchasing utility has not been allowed to recover an acquisition premium from its ratepayers. But it also means that ratepayers do not receive lower rates through a decreased rate base when the utility receives a negative acquisition adjustment. *Even if a company acquires an asset at a bargain price, it is allowed to put the asset into its rate base at its net original cost.* Similarly, ratepayers do not share in the gains a utility may realize from selling assets at prices above their net original cost. Those gains flow only to the utility's shareholders.

\* \* \* \* \*

For many years, the Commission has used a net original cost standard to place a value on utility plant after a merger. That standard has proven to be fair to utilities as well as to ratepayers. There is no reason to vary from that standard in this case.

*In the Matter of the Joint Application of UtiliCorp United Inc. and St. Joseph Light & Power Company*, Second Report and Order, MoPSC Case No. EM-2000-292 (February 26, 2004) (emphasis added).

6. In the most recent Missouri-American Water Company rate case (Case No. WR-2003-0500), the Staff similarly relied on original cost in regard to rate base treatment of three municipal water systems (systems not before regulated by the Commission) where the purchase prices of these systems represented both acquisition premiums (two of the systems) and an acquisition discount (one of the systems). *In the Matter of Missouri-American Water Company*, Direct Testimony of Stephen M. Rackers, Case No. WR-2003-0500, p. 4-6 (October 3, 2003).

7. There is no reason for the Commission's approach to differ in this case. MGU's utility plant for ratemaking purposes should reflect the systems' total depreciated cost actually paid for the systems.

8. By purchasing the systems, MGU has assumed the risk of making a failed system

profitable. MGU is the only entity prepared to make an investment in these failed systems and therefore it should receive any benefits that may accrue if the systems can approach serving the number of customers the systems were originally design to accommodate. Without MGU, or another entity, stepping forward to purchase the systems at a discount from book value, the existing natural gas users may have lost gas service all together.

9. The systems are located in an area of the state that is dominated by propane service companies. All of the homes and businesses in the area have energy for heating from propane, electric or natural gas. Further, there is little or no barrier to consumers switching from natural gas to propane. As a result, propane represents a competitive alternative to natural gas and the price of propane is a market force that limits MGU's natural gas rates.

10. However, without the opportunity to earn through expansion of the systems to the full potential for which the system was originally built (afforded by the cities book value of the utility plant), the risks being assumed by MGU are too large to justify MGU's investment.

11. The pro forma financial statements presented in MGU's Application used the MGU's purchase price as the value of the utility plant rather than the Cities depreciated value to calculate a pro forma rate of return. This was done to demonstrate that even at the lower value for the utility plant, MGU's rate of return is well lower than rates of return allowed other utilities in Missouri. At the current customer count, MGU's pro forma rate of return is less than 8% and even if MGU is successful in increase customer count by as much as 187% (740 to 1,387), as shown in the pro forma, the rate of return would not exceed a 10.5% rate of return. An increase of that magnitude is a "tall order."

12. Accordingly, MGU does not agree with Staff's proposed Condition 10 and

believes that MGU's plant in service accounts should reflect the original cost of the assets, net of depreciation.

### **ACQUISITION COSTS**

13. Condition 9 suggests in relevant part that all transaction costs incurred related to the Gallatin and Hamilton acquisitions will be booked "below-the-line" and that the Company will not "seek recovery in customer rates of these costs in any future Missouri proceeding."

14. Initially, MGU notes this condition uses "CNG" to refer to the Company. As discussed more fully below as to the "Gas Safety" condition, this use of "CNG" is somewhat confusing as MGU is the company that will be regulated by the Missouri Commission. MGU will assume that the Staff is referring to MGU in this context.

15. As to the substance of Condition 9, MGU would agree that the issuing costs associated with obtaining equity capital for MGU be paid by MGU's shareholder (CNG) and/or CNG's shareholders and not be included in MGU's rates nor recorded on MGU's balance sheet.

16. MGU proposes that other MGU transaction costs associated with securing Commission approvals and debt finance, including, but not limited to, legal fees, filing fees, printing, copying and the travel expenses of CNG employees, be capitalized by MGU and amortized over the term of MGU's franchise agreements with the Cities of Gallatin and Hamilton (20 years). MGU further proposes that all loan discount and/or origination fees, and loan closing costs be capitalized by MGU and amortized over the term of the loan. These amortized expenses will be an expense that MGU would expect to annually recover in its rates. However, in the alternative, MGU would agree to forego a Commission decision as to recovery of these expenses until a general rate case.

17. The cost of legal fees for regulatory compliance, filing fees, other associated costs, and the employee travel expenses would not have been incurred without the purchase of the Gallatin and Hamilton systems. These costs are rightly an expense that MGU ratepayers should bear. The same is true of the cost of securing debt capital for MGU. Loan discounts, origination fees and closing costs are as much a cost of debt capital as interest expense. An alternative to paying loan transaction fees would be for the lender to pay those costs and charge a higher interest rate.

### **DIVERSIFY**

18. Condition 16 recommends that the Commission include the following condition:

If CNG Holdings wishes to diversify outside of its current natural gas distribution business, whether it is directly or indirectly through one of its subsidiaries, then it will ask for approval from the Commission to do so.

19. It is not clear to MGU what precise activities will or will not be encompassed by this language. However, MGU has a fundamental disagreement with possibly submitting the activities of its parent and all of the parent's subsidiaries (existing or future) to the need for Missouri Public Service Commission approval.

20. MGU is certainly willing to agree to a similar condition related to MGU's operations and possible diversification, but it cannot agree to this condition as currently written.

### **GAS SAFETY**

21. Condition 3 relating to gas safety refers to obligations to be imposed on "CNG." MGU does not object to the substance of the conditions. It's possible disagreement relates to the entity to be responsible for these items.

22. MGU will be the Missouri public utility and gas corporation. MGU is unsure

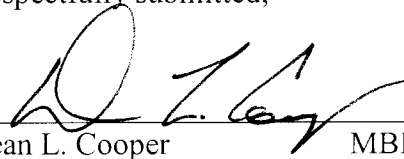
whether “CNG” is used to refer to CNG Holdings, Inc., its parent corporation, or Colorado Natural Gas, Inc., its affiliate. However, neither of these entities will be regulated by the Missouri Commission and should not have the identified gas safety obligations.

### SERVICE TERRITORY

23. Condition 5 suggests that only certain communities that are currently piped for gas be certificated at this time. MGU does not object to some reasonable reduction of the certificate territory it requested in the Application. However, MGU is unsure what exact service territory Staff proposes to include in a certificate. The Gallatin and Hamilton systems extend outside the communities cited by the Staff and serve customers outside these communities. In fact, in the case of the Gallatin system, the extension goes for approximately 46 miles. Accordingly, it is necessary for MGU to see precisely what sections Staff recommends be certificated before it can take a final position as to this condition.

WHEREFORE, MGU respectfully requests that the Commission consider MGU’s Response to the Staff Recommendation contained herein.

Respectfully submitted,



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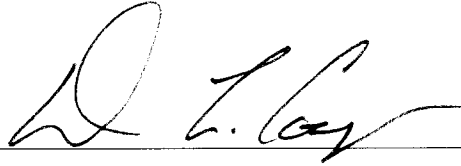
ATTORNEYS FOR MISSOURI GAS UTILITY, INC.

**CERTIFICATE OF SERVICE**

The undersigned certifies that a true and correct copy of the foregoing document was sent by electronic mail, on November 22, 2004, to the following:

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