

**BEFORE THE PUBLIC SERVICE COMMISSION
STATE OF MISSOURI**

In the Matter of the Application of Missouri Gas)
Energy, a division of Southern Union Company) Case No. GU-2005-0095
for an Accounting Authority Order Concerning the)
Kansas Property Tax for Gas in Storage.)

MGE'S INITIAL BRIEF

COMES NOW Missouri Gas Energy, a division of Southern Union Company (MGE or Company), and as its Initial Brief, states the following to the Missouri Public Service Commission (Commission):

INTRODUCTION

MGE has asked for an accounting authority order (AAO) allowing it to defer for consideration in its next general rate case, taxes assessed by Kansas tax authorities on inventories of gas held on MGE's account for resale and stored in underground formations in the state of Kansas.

These taxes resulted from legislation passed by the Kansas legislature, effective in July of 2004, which created a new property tax associated with those inventories of gas. The legislation was made retroactive to inventories held as of January 1, 2004.

MGE has since received tax bills from various Kansas counties for the year 2004. These tax bills total \$1,721,830. This expense is material to MGE as it represents over 9 percent of MGE's annual net income.

MGE initially requested that these new Kansas taxes be included in the cost of service in Commission Case No. GR-2004-0209. Those rates took effect on October 2, 2004. The Commission denied such treatment in part because the potential tax liability was not "known or measurable." The Commission further stated as follows:

This is a harsh result for MGE, as it will likely be paying taxes that are not included in its cost of service for calculation of rates in this case. An accounting authority order allowing MGE to defer those tax payments for possible recovery in its next rate case would be a means of avoiding that result. However, this case is not the appropriate forum for deciding whether to grant MGE such an AAO. The other parties have not been given a reasonable opportunity to present testimony and arguments to the Commission regarding this issue. If MGE wishes to request an AAO, it may file separate application to which the Commission will give due consideration.

In light of this result, MGE has filed this application for an accounting authority order (AAO).

The subject of this application is a new tax, never before paid by the Company, that is being retroactively imposed on the Company by a governmental entity. MGE's management has no control over this expense. The imposition of the Kansas gas storage tax is therefore extraordinary, unusual and unique and not recurring and MGE's expenses related to this tax are appropriate for the issuance of an AAO.

MGE will address the issues as they were identified in the Issues List, Witness List, and Order of Cross-Examination filed with the Commission on February 14, 2005 (herein labeled Discussion questions A and B). Additionally, MGE will address an issue raised by Staff's surrebuttal testimony (herein labeled Discussion question C).

DISCUSSION

A. Should the Commission grant an Accounting Authority Order (AAO) to MGE allowing it to defer property taxes assessed on gas stored underground on MGE's behalf in the state of Kansas?

MGE should be allowed to defer for consideration in its next general rate case, property taxes assessed by Kansas tax authorities on inventories of gas held on MGE's account for resale and stored in underground formations (gas in storage) in the state of Kansas. These new taxes are extraordinary, unusual and unique in that this is a new tax that has been retroactively imposed by a

governmental entity and MGE has never before paid property taxes on storage gas in the state of Kansas.

AAO Background

The Commission, pursuant to Section 393.140, RSMo, has promulgated Commission Rule 4 CSR 240-40.040, which prescribes the use of the Uniform System of Accounts (USOA) adopted by the Federal Energy Regulatory Commission. The USOA provides for the deferred treatment of extraordinary costs. An application for an AAO contains a single factual issue -- whether the costs, which are asked to be deferred, are extraordinary in nature. *In the matter of the application of Missouri Public Service*, 1 Mo.P.S.C.3d 200, 203-204 (1991). "By seeking a Commission decision [regarding the issuance of an AAO] the utility would be removing the issue of whether the item is extraordinary from the next rate case. All other issues would still remain, including, but not limited to, the prudence of any expenditures, the amount of recovery, if any, whether carrying costs should be recovered, and if there are any offsets to recovery." *Id.*

The Commission has specifically identified "acts of government" as a type of extraordinary event that may justify the issuance of an AAO. *In the matter of St. Louis County Water Company's Tariff Designed to Increase Rates*, MoPSC Case No. WR-96-263, p. 13 (December 31, 1996) (These include AAO's for costs "caused by unpredictable events, acts of government and other matters outside the control of the utility or the Commission." (emphasis added)).

There are many examples of AAO's based upon government-type action (i.e. new statutes, regulations and the like). These include AAO's for costs associated with: new gas safety rules (GO-97-301, GO-2002-0048); the implementation of FAS 87 for pension expense (*In the matter of Missouri Cities Water Company*, 2 Mo.P.S.C.3d 60 January 8, 1993); the implementation of FAS

106 (*In Re Union Electric*, 1 Mo.P.S.C.3d 328, 330 (EO-92-179) (June 12, 1992); *In Re St. Joseph Light and Power Company*, 2 Mo.P.S.C.3d 248, 270 (ER-93-41, EC-93-252) (June 25, 1993); *In Re Missouri Gas Energy*, 3 Mo.P.S.C.3d 203 (GO-94-255) (September 28, 1994); *In re Empire District Electric Company* (EO-93-35) (February 2, 1993); compliance with the Clean Air Act (*In the matter of the application of Missouri Public Service*, 1 Mo.P.S.C.3d 200, 203-204 (1991); and, the emergency cold weather rule (GA-2002-285, GA-2002-377).

Staff witness Hyneman indicated that “[t]he first time imposition of virtually any cost of any nature by an outside regulatory body on a Missouri utility, if significant, would likely qualify as an extraordinary event under the Commission’s policy on AAOs.” Exh. 5, Hyneman Dir., p. 3.

Opportunity to Earn Authorized Return (Significant and Material)

In Case No. GR-2004-0209, Staff witness Mark Oligschlaeger pointed out that over the past several years MGE has had a “tendency to under-earn in its short history to date.” Tr. 72-73 (Noack). This “short history” goes back to 1994. Tr. 91 (Hyneman). Mr. Oligschlaeger went on to state that “given the fact that MGE has added much plant in service to its rate-base in recent years and the nature of the rate-making process in Missouri, that phenomenon is exactly what would be expected to happen.” Tr. 73 (Noack).

The costs related to the Kansas gas storage tax are significant and material. The amount of tax associated with Kansas Senate Bill 147 due for the 2004 tax year is \$1,721,830. Exh. 1, Noack Dir., p. 3. This amount will be recorded on MGE’s books as an expense in the absence of an accounting authority order. Tr. 83 (Noack); Exh. 3, Noack Surr., p. 4.

Based on the final rate case model in GR-2004-0209, including the authorized increase, the property taxes on gas in storage would amount to 9.03% of MGE’s annual net income. Exh. 1,

Noack Dir., p. 6. This cost is material to MGE's annual income. Exh. 5, Hyneman Dir., p. 6. Assuming no change in revenue or expenses, these costs will serve to drive down MGE's return on its investment. Tr. 87 (Hyneman).

If an accounting authority order is not granted, MGE will not be afforded a reasonable opportunity to earn the return authorized by the Commission in Case No. GR-2004-0209. *Id.* at p. 7.

Prior Rate Case

MGE initially sought to address this property tax in the true-up phase of its recent rate case (GR-2004-0209). In its decision issued on September 21, 2004, effective October 2, 2004, the Commission found that this "potential tax liability is not currently known or measurable and on that basis it cannot be included in MGE's cost of service." *In the Matter of Missouri Gas Energy's Tariffs*, Report and Order, Case No. GR-2004-0209, p. 79. The Commission Staff suggested that the Commission issue an accounting authority order that would allow MGE to defer these property taxes until the next rate case. *Id.* at p. 79. The Commission further stated that if MGE wished to request an AAO, it could file a separate application, to which the Commission would give due consideration. *Id.* at p. 80.

Impact of Legal Challenge

MGE has stated that it will vigorously challenge the lawfulness of the Kansas gas storage tax. Exh. 1, Noack Dir., p. 4. To this end, MGE has appealed the assessments and applied for an exemption. Exh. 12. An initial hearing is scheduled for June of 2005. It is estimated that a final determination will not happen until mid-2006.

MGE's appeal is very much in the best interest of its customers. Tr. 217 (Bolin); Tr. 156

(Hyneman). This is because if the tax is found to be lawful, those taxes paid by MGE would generally be included in MGE's cost of service without controversy, thereby directly increasing the rates paid by MGE's customers. Tr. 217 (Bolin).

It is therefore interesting to note that this appeal has created greater financial risk and cost recovery risk for MGE. It is the existence of the appeal that led the Staff to argue that the taxes were not known and measurable at the time of Case No. GR-2004-0209. Tr. 157 (Hyneman). It is for that same reason that the Public Counsel continues to argue that while the Kansas gas storage taxes are now "measurable," they are still not "known." Tr. 215 (Bolin). Further, the Public Counsel acknowledges that because of the existence of the appeal, even if MGE were trying a rate case now, the Public Counsel would still argue that these costs should not be included in MGE's cost of service. Tr. 215 (Bolin). This situation will not be remedied for some time. Staff witness Hyneman believes that the taxes will not be "known" until the final legal determination of the legality of the tax, or in mid-2006. Tr. 92 (Hyneman).

Accordingly, MGE finds itself in an untenable position absent the grant of an AAO. Paying the tax, dropping (or never pursuing) the tax appeal and filing a rate case would have been MGE's least risky course of action from a financial and cost recovery stand point. That process would have almost certainly resulted in a sooner opportunity to obtain a cost of service determination that includes these taxes. On the other hand, because MGE has chosen to fight the statute (which fight, if successful, will be of substantial benefit to MGE's customers), it finds itself in a contested AAO proceeding that exposes it to increased financial risk that can vary depending upon whether an AAO is ultimately granted and, if so, what terms are included in the AAO.

MGE believes that this reality is a circumstance that should be considered by the Commission in this case and supports a grant of the requested AAO. Granting the AAO removes the disincentive

(in the form of increased financial and cost recovery risk) otherwise associated with MGE's appeal of the taxes in question (which, if successful, will be of primary benefit to MGE's customers).

Gas Storage Taxes Appropriate for Deferral

The fact that an underlying cost to be deferred may be of a type otherwise experienced by a utility (for example, property taxes) has not historically been a disqualifying factor for an AAO. Gas safety deferrals have even expressly provided for the deferral of traditional property taxes as one of the expenses associated with gas safety rule compliance. *In the Matter of Missouri Gas Energy's Tariff Sheets*, 2000 Mo. PSC LEXIS 1585, p. 6, GR-98-140 (October 10, 2000) ("While implementing the [safety line replacement program (SLRP)], MGE has been granted a series of accounting authority orders that permit MGE to accumulate expenditures that would normally be expensed in the period in which they were incurred. These items are depreciation expense, property tax expense, and carrying costs associated with the installed SLRP plant after the actual SLRP plant was placed in service, but prior to these related expenses being directly reflected in rates." (Emphasis added)).

The fact that it is not uncommon for property taxes to be deferred as a part of an Missouri Commission AAO was further supported by Public Counsel witness Kim Bolin. Tr. 210-214 (Bolin). Ms. Bolin confirmed that property taxes are a type of expense deferred under Commission granted AAO's for the safety line replacement program and are also included in an "act of god" AAO resulting from an ice storm. *Id.* Ms. Bolin further confirmed that AAO's commonly result in the deferral of many expenses of a type that a utility would commonly incur. *Id.*

The fact that the Kansas gas storage taxes are theoretically "property taxes" does not disqualify them for AAO treatment.

Not Normal and Recurring

Office of the Public Counsel (Public Counsel) witness Bolin has alleged that no AAO should issue in part because she takes the position that the subject taxes are a “normal and recurring annual expense.” Exh. 7, Bolin Reb., p. 3. Of course, “normal and recurring” expenses, if reasonably incurred, would usually find a place in a utility’s cost of service for rate making purposes. Tr. 214 (Bolin).

If the Public Counsel is correct that this new tax is normal and recurring, it begs the question as to why the Public Counsel encouraged the Commission to not include these taxes in MGE’s rates that were recently set in Case No. GR-2004-0209, in part, because the Public Counsel believed the taxes were not “known and measurable.” The Commission, in fact, found in that case that this “potential tax liability is not currently known or measurable and on that basis it cannot be included in MGE’s cost of service.” *In the Matter of Missouri Gas Energy*, Report and Order, Case No. GR-2004-0209, p. 79-80.

Surely, the Kansas gas storage taxes cannot be “normal and recurring,” as alleged by the Public Counsel, and yet only a “potential tax liability” that is not “known and measurable” and inappropriate for inclusion in rates. If ultimately paid, these are certainly expenses of a type that would be included in MGE’s cost of service. The Commission should not allow MGE to be placed in the rate making limbo suggested by the Public Counsel.

AAO Requested

For the reasons stated above, MGE requests a Commission order granting an AAO containing the following language:

The Company is authorized to record on its books a regulatory asset, which represents the expenses associated with the property tax to be paid to the state of Kansas pursuant to Senate Bill 147. MGE may maintain this regulatory asset on its

books until the effective date of the Report and Order in MGE's next general rate proceeding.

- B. If the Commission grants such an AAO, when should MGE begin to amortize any resulting deferral?**
- C. If the Commission grants an AAO, should the ability to defer these taxes be limited to the 2004 and 2005 calendar years?**

Staff has recommended that an amortization of any monies deferred begin the month following a final judicial determination of the legality of the Kansas gas storage tax. Exh. 5, Hyneman Dir., p. 3. Such an approach would force MGE to take actions that are not good public policy.

MGE believes that amortization should start with the effective date of the Report and Order in MGE's next general rate case. However, if the Commission believes that the deferral should be time limited in some way, then MGE would suggest the following language in order to provide some certainty to the deferral period:

In the event that MGE does not file a general rate case by May 31, 2008, MGE will commence amortization of these deferrals beginning June 1, 2008, over a five-year period, and will cease further deferrals unless the Commission grants a new accounting authority order.

It currently appears that a decision as to the legality of the Kansas gas storage tax could reasonably be expected in the summer of 2006. Exh. 2, Noack Reb., p. 3. In order to have new rates in effect at the time Staff's proposed the amortization would begin, MGE would have to file a rate case in the latter half of 2005. Tr. 95 (Hyneman). Failure to have rates in effect at such time as the amortization begins would have serious financial consequences for MGE. Staff's proposal would call for the amortization of approximately \$57,000 each month, or \$680,000 on an annual basis. Exh. 2, Noack Reb., p. 3.

Staff's recommendation that an AAO only allow MGE to defer the Kansas gas storage property taxes for the years 2004 and 2005 further compounds the issues discussed above. In fact, if MGE were to try to obtain rates that include the taxes as of the end of the Staff's proposed deferral period, January 1, 2006, MGE would have to have filed a rate case two months ago, or in February, 2005. Tr. 95 (Hyneman).

Of course, as stated above, even if MGE did file such a rate case anytime in 2005, it would still run the risk that the Kansas gas storage taxes would be found to still not be "known" and, therefore, not appropriate for recovery in MGE's cost of service. MGE likely could not make a rate case filing that would avoid the "known and measurable" issue until April of 2006. Tr. 81 (Noack).

A three-year rate case interval is much more appropriate than the Staff proposal. Justification for such an interval is found in both statute and practice. The recently enacted infrastructure system replacement surcharge (ISRS) statute requires that a public utility file a rate case within three years in order to use the ISRS mechanism. Tr. 100 (Hyneman). Because MGE has recently filed for such an ISRS rate element (Case No. GO-2005-0273), MGE will be required by statute to file a rate case no later than June, 2008, to continue using ISRS. Tr. 100 (Hyneman). Similarly, MGE's rates were recently set with the idea that a three year interval is reasonable as rate case expense in Case No. GR-2004-0209 was designed to be amortized over three years. Tr. 100 (Hyneman).

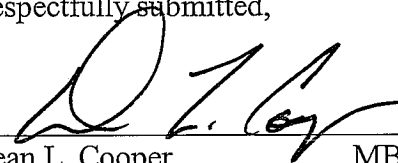
On the other hand, filing a rate case on the schedule that would be encouraged by the Staff's conditions is inappropriate. Doing so would unnecessarily accelerate substantial rate case expense and be an inefficient use of resources. In MGE's last rate case, the authorized rate case expense was approximately \$900,000, amortized over three years. Tr. 65 (Noack). Additionally, as stated before, a rate case on this time table might still result in a decision that the Kansas taxes are not known and measurable.

Accordingly, MGE's proposal that a deferral start no later than June 2008 (if MGE has not filed a rate case by May of 2008) is appropriate under the facts in this case. This is particularly so considering that the taxes in question are of a type that would clearly be recoverable from rate payers, if the Kansas statute is deemed to be lawful.

As stated previously, in order attempt to obtain rates that include the taxes as of the beginning of the Staff proposed amortization period, mid-2006, MGE would have to file another rate case this year. Tr. 95 (Hyneman).

WHEREFORE, MGE respectfully requests that the Commission consider this Initial Brief and, thereafter grant MGE the accounting authority order requested herein.

Respectfully submitted,



Dean L. Cooper MBE#36592
BRYDON, SWEARENGEN & ENGLAND P.C.
312 E. Capitol Avenue
P. O. Box 456
Jefferson City, MO 65102
(573) 635-7166
(573) 635-3847 facsimile
dcooper@brydonlaw.com

ATTORNEYS FOR MISSOURI GAS ENERGY,
A DIVISION OF SOUTHERN UNION
COMPANY

CERTIFICATE OF SERVICE

The undersigned certifies that a true and correct copy of the foregoing document was sent by electronic mail, on April 26, 2005, to the following:

Mr. Thomas Schwarz
Office of the General Counsel
Governor Office Building, 8th Floor
Jefferson City, Mo 65101

Mr. Douglas Micheel
Office of the Public Counsel
Governor Office Building, 6th Floor
Jefferson City, MO 65101

Mr. Stuart Conrad
Finnegan, Conrad & Peterson, L.C.
1209 Penntower Office Center
3100 Broadway
Kansas City, Missouri 64111

