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Overview of Staff's Filing
Witness: *Mark L. Oligschlaeger*
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MISSOURI PUBLIC SERVICE COMMISSION
UTILITY SERVICES DIVISION

DIRECT TESTIMONY
OF
MARK L. OLIGSCHLAEGER

MISSOURI GAS UTILITY
CASE NO. GR-2008-0060

Jefferson City, Missouri
January, 2008

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Q. Please state your name and business address.

A. Mark L. Oligschlaeger, P.O. Box 360, Suite 440, Jefferson City, MO 65102.

Q. Please describe your educational background and work experience.

A. I attended Rockhurst College in Kansas City, Missouri, and received a Bachelor of Science degree in Business Administration, with a major in Accounting, in 1981. I have been employed by the Missouri Public Service Commission (Commission) since September 1981 within the Auditing Department. In November 1981, I passed the Uniform Certified Public Accountant (CPA) examination and, since February 1989, have been licensed in the state of Missouri as a CPA.

Q. Have you previously filed testimony before this Commission?

A. Yes, numerous times. A listing of the cases in which I have previously filed testimony before this Commission, and the issues I have addressed in testimony in cases from 1990 to current, is attached as Schedule 1 to this direct testimony.

Q. What knowledge, skills, experience, training and education do you have in the areas of which you are testifying as an expert witness?

A. I have been employed by this Commission as a Regulatory Auditor for over 25 years, and have submitted testimony on ratemaking matters numerous times before the Commission. I have also been responsible for the supervision of other Commission

1 employees in rate cases and other regulatory proceedings many times. I have received
2 training at in-house and outside seminars on technical ratemaking matters since I began my
3 employment at the Commission.

4 Q. Have you participated in the Commission Staff's (Staff) audit of Missouri Gas
5 Utility (MGU or Company) concerning its request for a rate increase in this proceeding?

6 A. Yes, I have, with the assistance of other members of the Staff.

7 **EXECUTIVE SUMMARY**

8 Q. Please summarize your direct testimony in this proceeding.

9 A. I am sponsoring the Staff's Cost of Service Report in this proceeding that is
10 being filed concurrently with this testimony. As was done in several other recent filings by
11 the Staff, a "report" format is being used to present the Staff's direct case findings,
12 conclusions and recommendations to the Commission. The "report" approach to the case
13 filing is an effort to make the Staff's testimony filings more manageable. The Staff believes
14 that, under this approach and without sacrificing the quality of the evidence presented, fewer
15 witnesses will be required to file direct testimony and the Staff's case will be presented more
16 clearly.

17 In my direct testimony, I will also provide an overview of the Staff's revenue
18 requirement determination. The Staff has conducted a review of all cost of service
19 components (capital structure, return on rate base, rate base, depreciation expense and
20 operating expenses) which comprise MGU's Missouri jurisdictional revenue requirement.
21 My testimony will provide an overview of the Staff's work in each area.

1 **REPORT ON COST OF SERVICE**

2 Q. Please explain the organizational format of the Staff's Cost of Service Report
3 (Report).

4 A. The Staff's Report has been organized by topic as follows:

5 I. Executive Summary

6 II. Background of Rate Case

7 III. Major Issues

8 IV. Rate of Return

9 V. Rate Base

10 VI. Corporate Allocations

11 VII. Income Statement

12 VIII. Other Staff Recommendations

13 This organizational format has been condensed for ease of explanation. The Rate
14 Base, Corporate Allocations and Income Statement sections have numerous subsections,
15 which explain the adjustments made by Staff to the March 2007 test year. The Staff member
16 primarily responsible for writing each subsection of the Report is identified in the narrative
17 for that section.

18 **OVERVIEW OF STAFF'S RECOMMENDED REVENUE REQUIREMENT**

19 Q. In its audit of MGU for this proceeding, Case No. GR 2008-0060, has the Staff
20 examined all of cost of service components comprising the revenue requirement for MGU's
21 natural gas operations in Missouri?

22 A. Yes.

1 Q. What are the cost of service components that comprise the revenue
2 requirement for a regulated utility?

3 A. The revenue requirement for a regulated utility can be defined by the following
4 formula:

$$\text{Revenue Requirement} = \text{Cost of Providing Utility Service}$$

6 or

$$RR = O + (V - D)R \text{ where,}$$

8 RR = Revenue Requirement

9 O = Operating Costs (Fuel, Payroll, Maintenance, etc.), Depreciation and Taxes

10 V = Gross Valuation of Property Required for Providing Service

11 D = Accumulated Depreciation Representing Recovery of Gross Property

12 Investment.

13 $V - D$ = Rate Base (Gross Property Investment less Accumulated Depreciation = Net
14 Property Investment)

15 $(V - D)R$ = Return Allowed on Net Property Investment

16 The “revenue requirement” addressed by this formula is the utility’s total revenue
17 requirement; i.e, the total annual revenue level needed to equal its current cost of service. In
18 the context of Commission rate cases, the term “revenue requirement” is generally used to
19 refer to the utility’s necessary incremental change in revenues as measured from the utility’s
20 existing rates and cost of service.

21 Q. What objectives must be met during the course of an audit of a regulatory
22 utility in determining the revenue requirement components identified in your last answer?

1 A. The objectives required for determining the revenue requirement for a
2 regulated utility can be summarized as follows:

3 1) Selection of a Test Year. The test year income statement represents the starting
4 point for determining a utility's existing annual revenues, operating costs and net operating
5 income. Net operating income represents the return on investment based upon existing rates.
6 The test year selected for this case is the year ended March 31, 2007. "Annualization" and
7 "normalization" adjustments are made to the test year results when the unadjusted results do
8 not fairly represent the utility's most current annual level of existing revenue and operating
9 costs. Examples of annualization and normalization adjustments are explained more fully later
10 in this direct testimony.

11 2) Selection of a "test year update period." A proper determination of revenue
12 requirement is dependent upon matching all components, rate base, return on investment,
13 existing revenues and operating costs at the same point in time. This ratemaking principle is
14 commonly referred to as the "matching" principle. The update period established for this case
15 is the six months ending September 30, 2007. The Staff's direct case filing represents a
16 determination of MGU's revenue requirement based upon known and measurable results for
17 major components of MGU's operations as of September 30, 2007.

18 3) Selection of a "true-up date" or "true-up period," if any. A true-up date generally
19 is established when a significant change in a utility's cost of service occurs after the update
20 period but prior to the operation-of-law date and the significant change in cost of service is
21 one the parties and/or Commission has decided should be considered for cost of service
22 recognition in the current case. In this proceeding, no party to date has recommended that a
23 true-up audit be conducted for MGU.

1 4) Determination of Rate of Return. A cost of capital analysis must be performed to
2 determine a fair rate of return on investment to be allowed on MGU's net investment
3 (rate base) used in the provision of utility service. Staff witness David Murray has performed
4 a cost of capital analysis for this case.

5 5) Determination of Rate Base. Rate base represents the utility's net investment used
6 in providing utility service. For its direct filing, the Staff has determined MGU's rate base as
7 of September 30, 2007, consistent with the end of the test year update period established for
8 this case.

9 6) Determination of Net Income Required. The net income required for MGU is
10 calculated by multiplying the Staff's recommended rate of return times the rate base
11 established as of September 30, 2007. The result represents net income required. Net income
12 required is then compared to net income available from existing rates to determine the
13 incremental change in MGU's rate revenues required to cover its operating costs and provide
14 a fair return on investment used in providing electric service. Net income from existing rates
15 is discussed in the next paragraph.

16 7) Net Income from Existing Rates. Determining net income from existing rates is
17 the most time consuming process involved in determining the revenue requirement for a
18 regulated utility. The starting point for determining net income from existing rates is the
19 unadjusted operating revenues, expenses, depreciation and taxes for the test year which is the
20 twelve month period ending March 31, 2007 for this case. All of the utility's specific revenue
21 and expense categories are examined to determine whether the unadjusted test year results
22 require annualization or normalization adjustments in order to fairly represent the utility's
23 most current level of operating revenues and expenses. Numerous changes occur during the

1 course of any year which will impact a utility's annual level of operating revenues and
2 expenses.

3 8) The final step in determining whether a utility's rates are insufficient to cover its
4 operating costs and a fair return on investment is the comparison of net operating income
5 required (Rate Base x Recommended Rate of Return) to net income available from existing
6 rates (Operating Revenue less Operating Costs, Depreciation and Income Taxes). The result
7 of this comparison represents the recommended increase and/or decrease in the utilities net
8 income. This change in net income is then grossed up for income tax to determine the
9 recommended increase and/or decrease in the utilities operating revenues through a rate
10 change.

11 Q. Please identify the four types of adjustments made to unadjusted test year
12 results in order to reflect a utility's current annual level of operating revenues and expenses.

13 A. The four types of adjustments made to reflect a utility's current annual
14 operating revenues and expenses are:

15 1) Normalization adjustments. Utility rates are intended to reflect normal ongoing
16 operations. A normalization adjustment is required when the test year reflects the impact of
17 an abnormal event. One example in the revenue area is the Staff's weather normalization
18 adjustment made in all gas rate cases. Actual weather conditions in the test year are compared
19 to a 30-year normal. The weather normalization adjustment restates the test-year sales
20 volumes and revenue levels to reflect normal weather conditions.

21 2) Annualization adjustments. Annualization adjustments are the most common
22 adjustment made to test year results to reflect the utility's most current annual level of
23 revenue and expenses. Annualization adjustments are required when changes have occurred

1 during the test year and/or update period, which are not fully reflected in the unadjusted test
2 year results. For example if a 3% pay increase occurred on November 1, 2006, the
3 March 2007 test year will only reflect five months of the impact of the payroll increase. An
4 annualization adjustment is required to capture the financial impact of the payroll increase for
5 the other seven months of the year. If the payroll increase were effective June 1, 2007, then
6 the test year would not reflect any of the annual cost of the 3% payroll increase.

7 MGU had a payroll increase effective April 1, 2007. The Staff's payroll
8 annualization, based upon employee levels and wage rates as of September 30, 2007, restates
9 the March 2007 booked test-year payroll expense to reflect the annual cost for this payroll
10 increase in the rate calculation for MGU.

11 3) Disallowance adjustments. Disallowance adjustments are made to eliminate costs
12 in the test year results which are not considered appropriate for recovery from ratepayers. An
13 example in this case is corporate ownership costs (allocated to MGU from its parent company,
14 CNG Holdings, Inc.). These ownership costs include costs associated with consideration of
15 mergers/acquisitions and different corporate structures. In the Staff's view, these costs are
16 incurred to primarily benefit and/or protect shareholder interests and do not benefit ratepayers.
17 Therefore, these costs should not be included in cost of service for recovery from ratepayers
18 and the Staff has proposed to disallow them from recovery in rates.

19 4) Proforma adjustments. Proforma adjustments are made to reflect a cost increase
20 that results entirely from increasing or decreasing the utility's annual revenue as a result of a
21 rate increase or rate reduction. The most common example of a proforma adjustment is the
22 grossing up of net income deficiency for income taxes. The example below illustrates this
23 proforma adjustment:

1	Net Income Required based upon Staff's Rate Base and Rate of Return	\$ 1,000,000
2	Net Income Available based upon Existing Rates	<u>\$ 600,000</u>
3	Additional Net Income Required	\$ 400,000
4	Tax Gross Up Factor based upon a 38.39% Effective Tax Rate	<u>x 1.6231</u>
5	Recommended Revenue Requirement Increase	<u>\$ 649,240</u>

6 In this example the utility must increase its rates \$649,240 in order to generate an
7 additional \$400,000 in after-tax net income required to provide the return on investment
8 considered reasonable by the Staff. The example reflects \$249,240 in additional revenue to
9 pay the current income tax, which applies to any increase in MGU's operating revenue.
10 Another example using the same assumptions will clarify the need for this proforma
11 adjustment for additional income tax:

12	Additional Revenue Collected in Rates from Rate Increase	\$ 649,240
13	Less Income Tax Due the IRS Based Upon a 38.39% Tax Rate	<u>\$ (249,240)</u>
14	Additional Net Income for Return on Investment	<u>\$ 400,000</u>

15 The above examples represent the normal proforma factoring up for income taxes
16 associated with a Commission approved rate increase.

17 Q. Please describe the Staff's direct revenue requirement filing in this proceeding.

18 A. The results of the Staff's audit of MGU's rate case request can be found in the
19 Staff's filed Accounting Schedules, and is summarized on Accounting Schedule 1, Revenue
20 Requirement. This Accounting Schedule shows the Staff's recommended revenue
21 requirement for MGU in this proceeding ranges from approximately \$200,360 to \$215,671,
22 based upon a recommended rate of return range of 7.84% to 8.11%%. The Staff's
23 recommended revenue requirement at the midpoint of the rate of return range is \$207,732.

1 Q. What rate increase amount did the Company request from the Commission in
2 this case?

3 A. MGU requested that its annual revenues be increased by approximately
4 \$443,100.

5 Q. What return on equity range is the Staff recommending for MGU in this case?

6 A. The Staff is recommending a return on equity range of 8.80% to 9.30%, with a
7 midpoint return on equity of 9.05%, as calculated by Staff witness Murray. The Staff's
8 recommended capital structure for MGU is 52.23% common equity and 47.77% long-term
9 debt, based upon CNG Holdings, Inc.'s (Holdings) actual capital structure as of September
10 30, 2007. When Holdings' cost of debt and above-referenced cost of equity is input into this
11 capital structure, the resulting cost of capital to apply to rate base is measured in a range of
12 7.84% to 8.11%, with 7.97% the midpoint value. The Staff's recommended low and high end
13 return on equity and weighted cost of capital are explained in more detail Section IV of the
14 Staff's Report.

15 Q. What items are included in the Staff's recommended rate base in this case?

16 A. All rate base items were determined as of the update period ending date of
17 September 30, 2007, either through a balance on MGU's books as of that date or a 13-month
18 average ending on September 30, 2007. These rate base items included:

- 19 • Plant in Service
- 20 • Accumulated Reserve for Depreciation
- 21 • Materials and Supplies
- 22 • Prepayments
- 23 • Gas Storage Inventory
- 24 • Customer Deposits
- 25 • Accumulated Deferred Tax Reserve

1 Q. Has the Staff proposed any significant adjustments to the Company's above
2 rate base items?

3 A. Yes. The Staff has adjusted MGU's plant in service, depreciation reserve and
4 accumulated deferred tax reserve balances to remove the impact of past inappropriate
5 capitalization of marketing and sales related expenses by MGU.

6 Q. What are the significant income statement adjustments made by the Staff in
7 determining MGU's revenue requirement for this case?

8 A. A summary of significant adjustments made by the Staff in determining
9 MGU's revenue requirement follows:

10 **Operating Revenues**

- 11
 - Retail Revenues adjusted for customer growth and weather.

12 **Depreciation and Amortization Expense**

- 13
 - Depreciation Expense annualized based upon existing rates and plant in service
14 as of September 30, 2007.

15 **Payroll and Employee Benefit Costs**

- 16
 - Payroll cost annualized based upon employee levels and wages as of
17 September 30, 2007.
 - Payroll taxes and payroll benefits annualized as of September 30, 2007.
 - Test year payroll expenses adjusted to reflect appropriate income statement
20 treatment of labor costs associated with marketing and sales activities.

21 **Other Non-Labor Expenses**

- 22
 - Property Taxes – Calculated on a consistent basis with the plant in service
23 balance as of January 1, 2007.

- 1 • Bad Debt Expense – Calculated using the updated amount of actual net bad
- 2 debt write-offs.
- 3 • Rate Case Expense – Annualized over a three-year period.
- 4 • Start-up Costs – Costs associated with Holdings’ acquisition of MGU in late
- 5 2004 and early 2005 eliminated from expense.

6 **Corporate Allocations**

- 7 • Ownership Costs – Corporate cost allocations from Holdings reduced by 15%
- 8 to reflect a reasonable estimate of the costs incurred by Holdings associated
- 9 with ownership activities of a non-utility nature.
- 10 • Capitalization Adjustments – Corporate allocations improperly capitalized to
- 11 plant were removed from rate base and placed in expense.

12 Q. What reliance did you place on other Staff members in the determination of the

13 Staff’s recommended revenue requirement for MGU in this proceeding?

14 A. An expert determining the revenue requirement for a regulated utility must rely

15 on the work from others responsible for developing specific inputs into the cost of service

16 calculation. I and the other assigned Staff auditors relied on the work from numerous other

17 Staff members in calculating a revenue requirement for MGU in this case. Depreciation rates,

18 weather normalized sales, and recommended rate of return are some examples of data

19 supplied to the Audit Department as inputs into the Staff’s cost of service calculation. In my

20 opinion, the impact of these inputs on MGU’s revenue requirement appears to be reasonable

21 based upon my prior experience in other cases. The qualifications for all Staff members not

22 filing testimony who provided input to the sections to the Staff’s Report are attached as

23 Appendix 1 to the Report.

1 Q. What are the biggest differences which contribute to the different rate increase
2 recommendations filed by the Company and the Staff in this proceeding?

3 A. From the Staff's perspective, there are two primary differences. The first issue
4 is the return on equity component of the rate of return calculation. MGU's return on equity
5 recommendation is 12.0%, while the Staff's midpoint ROE recommendation is 9.05%. MGU
6 has proposed a higher ROE, at least in part, on the basis that Holdings is currently a privately
7 held entity instead of having its stock publicly traded. The dollar difference between the
8 Company and the Staff on this issue is approximately \$86,000.

9 Another significant issue between the Company and the Staff is ratemaking treatment
10 of costs associated with marketing or sales activities. For MGU, these costs are associated
11 with efforts to persuade potential customers to switch from propane or electric use to MGU's
12 natural gas service. Per the Federal Energy Regulatory Commission Uniform System of
13 Accounts, adopted by Commission Rule, all such costs should be charged to expense as
14 incurred. In contrast, MGU has chosen to capitalize these costs into plant in service since it
15 took over operation of its Missouri service territory in early 2005.

16 To remedy MGU's over-capitalization of its plant in service, the Staff has removed its
17 best estimate of all such improperly capitalized labor and advertising costs from MGU's plant
18 balances, and made consistent adjustments to the MGU's depreciation reserve and deferred
19 tax reserve as well. The Staff also reflected a higher payroll expense ratio in its case to
20 properly include MGU labor and Holdings' allocated costs associated with marketing and
21 sales activities into expense.

22 In this case, the increased expense related to the higher expense ratios for MGU labor
23 costs and Holdings' allocated costs outweighed the impact of the rate base disallowances

1 proposed by the Staff, and the Staff's position on this issue has an value of at least \$100,000
2 higher in revenue requirement as compared to the Company's capitalization approach to
3 marketing costs.

4 As a result of its audit of other various areas of the Company's operations, the Staff
5 has proposed other adjustments as appropriate to either increase or decrease MGU's cost of
6 service. However, these adjustments are not of the same overall magnitude of the adjustments
7 discussed above.

8 Q. Please identify the Staff witness responsible for addressing each area with a
9 known and significant difference between the Staff and the Company that is addressed in this
10 testimony or in the Report in Section III, Major Issues.

11 A. The Staff witness for each listed issue is as follows:

<u>Issue</u>	<u>Staff Witness</u>
Return on Equity	David Murray
Plant-in Service Capitalization	Kim K. Bolin
Payroll Ratios	Kim K. Bolin
Plant in Service Valuation	Kim K. Bolin
Rate Case Costs – Expense and Rate Base	Kofi A. Boateng
Start-Up Costs	Paul R. Harrison
Deferred Tax Reserve	Paul R. Harrison
Corporate Allocations	Paul R. Harrison

21 Q. When will the Staff be filing its rate design testimony and report in this
22 proceeding?

23 A. The Staff's direct rate design recommendations are scheduled to be filed on
24 February 1, 2008.

25 Q. Does this conclude your direct testimony in this proceeding?

26 A. Yes, it does.

