BEFORE THE PUBLIC SERVICE COMMISSION
STATE OF MISSOURI

In the Matter of Missouri Gas Energy's Tariff Sheets Designed to Increase Rates for Gas Service in the Company's Missouri Service Area	))))	**GR-2004-0209**

REPLY BRIEF OF MISSOURI GAS ENERGY

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The undisputed record evidence shows that since 1996, MGE's earnings have consistently fallen short of Commission-authorized levels. Over this eight-year period, this actual earnings shortfall in comparison to authorized earnings levels amounts to $52,960,000, or more than $6.5 million per year, on average. (Ex. 49, Sch. MRN-5) This earnings deficiency translates into a revenue deficiency (*i.e.*, earnings plus the associated income tax obligation) of $86,266,000 over that eight-year period, or more than $10.75 million per year, on average. (*Id.*)

Schedule MRN-5

Missouri Gas Energy
COMPARISON OF ACHIEVED RATE OF RETURN
VS. AUTHORIZED RATE OF RETURN

	Rate Base (000)	Return Deficiency	Earnings Deficiency (000)	Revenue Deficiency (000)
6/30/1996	$347,927	-1.68%	($5,851)	($9,531)
6/30/1997	$354,022	-0.97%	($3,434)	($5,594)
6/30/1998	$420,041	-1.65%	($6,951)	($11,323)
6/30/1999	$429,082	-1.11%	($4,768)	($7,766)
6/30/2000	$442,899	-2.26%	($10,009)	($16,303)
6/30/2001	$453,468	-1.99%	($9,044)	($14,732)
6/30/2002	$496,740	-0.98%	($4,872)	($7,936)
6/30/2003	$503,359	-1.60%	($8,032)	($13,083)
Cumulative			($52,960)	($86,266)

(Ex. 49, Sch. MRN-5)

MGE has suffered earnings and revenue shortfalls each and every year even though MGE has regularly filed and prosecuted rate cases; increased rates from MGE's

three preceding rate cases took effect on March 21, 1997 (Case No. GR-96-285), September 2, 1998 (Case No. GR-98-140) and August 6, 2001 (Case No. GR-2001-292). (Ex. 49 at 14:6-8) Moreover, MGE has suffered earnings shortfalls even though the record evidence shows that MGE has been able to control its operating and maintenance ("O&M") costs very effectively in comparison to other Missouri natural gas local distribution companies ("LDCs"). (Ex. 8 at 24:13-17, Sch. G-1) The undisputed record evidence also shows that MGE's rates are considerably lower than other Missouri LDCs. (Ex. 8 at 24:20 to 25:2, Sch. G-2)

The record evidence is clear and unambiguous: 1) MGE's earnings have been less than adequate; 2) MGE's O&M cost efficiency has been superior; 3) MGE has regularly filed and prosecuted rate cases; and 4) MGE's rates are lower than other Missouri LDCs. Given this evidence, one need not stretch to conclude that the rate levels authorized for MGE in the past have been too low, not well structured, and that a different approach should be used in this rate case to ensure that the assumptions underlying the rate setting process more closely reflect MGE's operating reality. In particular, one might reasonably have expected the Staff -- the party in this case acting under color of authority of the Commission itself pursuant to section 386.240 RSMo. (and therefore supposedly responsible for advocating positions that reasonably balance investor and consumer interests in accordance with *Federal Power Commission, et al., v. Hope Natural Gas Company*, 320 U.S. 591, 603 (1944) ("*Hope*")) -- to have come forward with a different approach to produce a better match of MGE's rates and costs in the future than has been achieved in the past.

B. The Staff and OPC's Approach To Setting MGE's Rates In This Case Differs Little From The Approach Taken In MGE's Past Rate Cases And, Therefore, Will Hobble MGE's Ability To Compete For Capital And Will Produce Inadequate Earnings For MGE In The Future.

The Staff has chosen not to take a fresh look at MGE's rate levels and revenue requirement. In fact, the Staff has doggedly defended its outmoded approach to the regulatory ratemaking process. As the Staff policy witness, Mark Oligschlaeger ("Oligschlaeger"), testified:

> Q. Having made these points concerning MGE's earnings analysis, *do you disagree that MGE has had a tendency to underearn* in its short history to date?
>
> A. *No. Given* the fact that MGE has added much plant in service to its rate base in recent years, and *the nature of the ratemaking process in Missouri, that phenomenon is exactly what would be expected to happen.*

(Ex. 829 at 12:17-21) (emphasis supplied).

Oligschlaeger went on to re-iterate the Staff's apparent lack of concern for MGE's inadequate earnings:

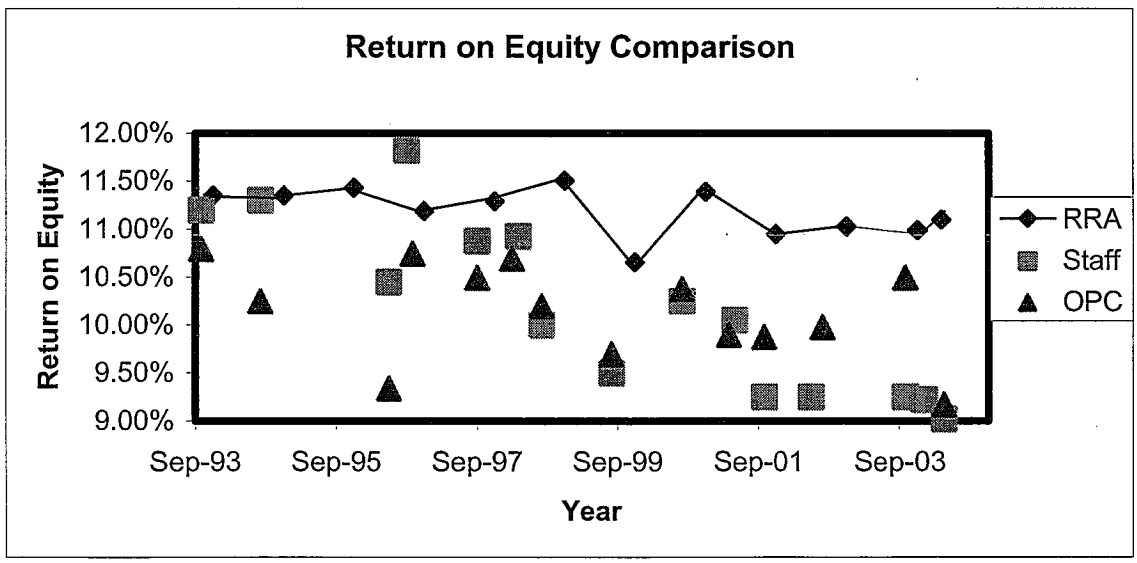
> Q. *Does under-earnings* by utilities due to the addition of plant in rate base *point out the need for changes in the regulatory process in Missouri?*
>
> A. *No.* This type of under-earning does not represent a flaw or defect in Missouri's regulatory process; *it is exactly how the regulatory process is intended to work.* * * *

(*Id.* at 14:3-6) (emphasis supplied)

The approach taken by the Staff in this rate case, and largely echoed by OPC, is essentially the same approach taken in all three of MGE's rate cases to date, with the exception of one position (recommended return on equity) that is *even worse* for MGE than in previous rate cases. As the record evidence has demonstrated, this approach will

not produce results significantly different than the inadequate earnings which resulted from those earlier rate cases.

In MGE's first three rate cases, the return on equity ("ROE") recommendations ultimately adopted by the Commission were reasonably close to the equity returns being authorized by other regulatory bodies for LDCs around the time of those decisions. In striking contrast, in this case both the Staff and OPC ROE recommendations are significantly lower, *by approximately 200 basis points*, than the 11% average ROE authorized for LDCs by other regulatory jurisdictions during this same general period of time. (Ex. 3 at 26:1-3) The paltry ROE recommendations by the Staff (9.02%, midpoint) and the OPC (9.175%, midpoint) in this case are facially inadequate and out of line with other jurisdictions, particularly when coupled with the unreasonably low common equity assigned to MGE by the Staff and OPC, and should not be adopted by the Commission.



(Ex. 3, Sch. JCD-7)

Unlike the Staff and OPC ROE recommendations in this case, in MGE's first three rate cases, the ROE ultimately adopted by the Commission was reasonably close to

the equity returns being authorized by other regulatory bodies for LDCs around the time of those decisions. In Case No. GR-96-285, the Commission authorized an ROE for MGE of 11.30% (*Re: Missouri Gas Energy*, 5 Mo. P.S.C. 3d 437, 468 (1997)); according to Regulatory Research Associates, Inc. ("RRA"), the average ROE authorized for LDCs by other regulatory jurisdictions during this same general period of time was approximately 11.3%. (Ex. 3, Sch. JCD-7) In Case No. GR-98-140, *et al.*, the Commission authorized an ROE for MGE of 10.93% (*Re: Missouri Gas Energy*, 7 Mo. P.S.C. 3d 394, 404 (1998)); according to RRA, the average ROE authorized for LDCs by other regulatory jurisdictions during the same general period of time was approximately 11.5%. (Ex. 3, Sch. JCD-7) In Case No. GR-2001-292, the Commission approved a stipulated resolution with an implicit ROE of 10.50%; according to RRA, the average ROE authorized for LDCs by other regulatory jurisdictions during the same general period of time was approximately 11%. (Ex. 3, Sch. JCD-7)

C. Adoption Of MGE's Positions Will Enable MGE To Compete For Capital And Will Provide A Reasonable Opportunity For MGE To Achieve The Commission-authorized Earnings Level.

Setting MGE's authorized rate of return well below the returns of other LDCs with which MGE competes not only contributes to continuing MGE's historical pattern of inadequate earnings into the future, it is also inconsistent with good public policy, binding legal principles, and fairness. Most importantly, it is contrary to the interests of MGE's customers. The Staff and OPC would have the Commission believe that the earnings level the Commission authorizes for MGE represents nothing more than a number that has no bearing on MGE's ability to attract capital on reasonable terms, and that whether the approved rate levels provide MGE with a reasonable opportunity to

actually achieve the authorized earnings is not the Commission's concern. These Staff and OPC positions are not, however, consistent with the United States Supreme Court mandates in *Hope* and *Bluefield.* The earnings level this Commission authorizes has significant bearing on MGE's ability to attract capital on reasonable terms, and the approved rates must provide MGE with a reasonable opportunity to achieve that earnings level. As a result, the Commission should reject the positions of the Staff and OPC and adopt MGE's recommendations on the contested issues in this case.

II. Issues

A. Rate of Return

1. Capital Structure

a. This Commission Should Adopt A Capital Structure For MGE That Is Consistent With *Hope* and *Bluefield* and Basic Principles of Utility Finance

This Commission, in calculating a rate of return for MGE, should use a capital structure consistent with the guidance of *Hope* and *Bluefield* and the paramount consideration that any rate of return for MGE must be competitive. In *Hope,* the United States Supreme Court held that "the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks." (*Hope*, 320 U.S. at 603.) Consistent with this principle, MGE has recommended a capital structure consisting of 40.3 to 41.13 percent equity, which is below, but nevertheless consistent with, the natural gas distribution industry average. (*See, e.g.,* Ex. 1, Sch. JCD-3; Ex. 32; Tr. 1696:17-24)

It is critical that this Commission adopt a capital structure for use in setting MGE's rates that is reasonably comparable to other natural gas distribution companies,

because those other companies are ultimately utilized in the calculation of a return on equity for MGE. Specifically, under MGE's recommendation, this Commission would calculate a return on equity for MGE (with a capital structure containing approximately 41 percent equity), by using data regarding comparable utility companies (with capital structures containing, on average, 45 percent equity). (MGE Br., pp. 8-45) This is a reasonable "apples to apples" comparison.

b. The Staff's and OPC's Proposed MGE Capital Structure Defies *Hope* and *Bluefield* And Sends A Dangerous Message To The Investment Community.

In defiance of *Hope* and *Bluefield,* the Staff and OPC argue in their initial briefs that this Commission should engage in an unreasonable comparison of "apples to oranges". Specifically, the Staff and OPC would have this Commission:

(a) impute Southern Union's temporary capital structure, which includes approximately 28-30 percent equity, to MGE;

(b) calculate a return on equity for MGE using so-called "comparable" companies which, on average, have a capital structure containing a much higher 45 percent equity; and

(c) ignore the unreliability and intellectual dishonesty inherent in this bogus analysis of so-called "comparable" companies.

(*See, e.g.,* OPC Br., pp. 3-6, 25-30; Staff Br., pp. 2-4) Adoption of the Staff's and OPC's proposal would unreasonably punish MGE with an unreasonably low rate of return.

This Staff and OPC analysis of so-called "comparable" companies ignores the huge difference in equity levels between the Southern Union consolidated capital structure and the average capital structure of the comparative group and is thus directly

contrary to *Hope* and *Bluefield.* Under those decisions, this Commission's authorized ROE must be "commensurate" with the returns on equity of other, equally-risked enterprises. That can never be the case if this Commission were to use companies with a less risky equity position (45 percent) to calculate the return on equity required of a company with a more risky equity position (28-30 percent). As the OPC concedes:

> **That companies must be similarly situated is part of the standard in *Hope* and *Bluefield.***

(OPC Br., p. 32; emphasis added) A 28-30 percent versus 45 percent equity capital structure is, under no one's definition, "similarly situated."

Further, the Staff's and OPC's position on MGE's capital structure also sends a dangerous message to the investment community. For example, the OPC makes the following argument in favor of including Panhandle's debt in MGE's capital structure:

> Debt holders of PEPL, by contractual agreement, have no recourse against the assets of SUC outside of PEPL. But they do have a superior claim on the assets of PEPL that SUC paid over $600 million in working capital to obtain. If severe financial hardship occurred at PEPL and if the Company failed to meet its debt service, the debt holders could exercise their superior claim on the assets of PEPL or the Company could be forced to sell assets to meet debt service.... Under that circumstance, *through [sic] extreme*, the loss of millions (up to $600+ million) in working capital that could have, alternatively, been used to finance (in part, or whole) the natural gas distribution business of SUC . . . . is most certainly a risk....

(OPC Br., p. 29; emphasis added)

This is nothing but a convoluted way of saying the following: all investments involve risk; *in an extreme case,* the investment can be lost; and if that extreme case occurs – and the investment is lost – it would have been better to invest in something else.

This obvious proposition applies to any investment. Nonetheless, the OPC would use it to punish MGE. Of course, the OPC cites no evidence suggesting that its

"extreme" case will ever occur with respect to Panhandle, and this OPC argument is so speculative and broad – and so unsupported by evidence or anything approaching hard data – that its adoption by the Commission could only be interpreted as a policy statement against diverse investments. In fact, if the Commission were to follow the OPC's recommendation, then every utility in this state that is owned by a company which invests outside of the utility's business should suffer a similar punishment. In short, the OPC is recommending the following policy: if you distribute natural gas, and if you also invest outside of the natural gas distribution business, you will be punished accordingly through lower than average authorized earnings levels.

Investment theory, however, teaches that diversification is a good thing. In fact, the CAPM model – a model calculated, and yet ultimately ignored, by OPC witness Allen – is premised on the assumption that investors diversify in order to decrease the risk that any one investment (*e.g.,* natural gas distribution) will suffer losses. R. Morin, REGULATORY FINANCE, P. 302 (Public Utility Reports 1994) ("REGULATORY FINANCE") ("The core idea of the CAPM is that investors can eliminate company-unique risks by appropriate diversification . . . ").

For what possible reason would this Commission want to adopt a policy punishing, without further consideration, investor diversification? The OPC and Staff do not offer an answer. In fact, in their rush to reach pre-determined rates of return for MGE below normal for the LDC industry, the OPC and Staff clearly did not even contemplate – much less address – these obvious ramifications.

c. The Staff's And OPC's Arguments In Support Of Their Proposed MGE Capital Structure Are Ridiculous.

The OPC and Staff offer various arguments in support of their inherently unfair approach to MGE's capital structure. Not surprisingly, all of them are ridiculous:

***Investors invest in Southern Union, not MGE*:** The OPC claims that Southern Union's consolidated capital structure should be imputed to MGE because investors invest in Southern Union, not MGE. (OPC Br., p. 3) This argument is absurd.

Investors *buy stock* in Southern Union, but *they invest in each business of Southern Union, including MGE*. Thus, basic financial theory teaches that investors care about the capital structure of each business or investment they are considering. *See, e.g.,* REGULATORY FINANCE, *supra,* p. 344 ("[T]he cost of capital for a division, investment project, or specific asset [MGE] investment depends on the riskiness of that investment, and not on the identity of the company undertaking that project [Southern Union]. *The cost of capital depends on the use of funds and not the source of funds")* (emphasis added). When considering an investment in Southern Union, reasonable investors will consider each of Southern Union's businesses, including MGE. Accordingly, when investors focus on MGE, they will want to know that MGE – as part of Southern Union – has a return on equity commensurate with its risk, which is a factor of its capital structure.

Supposed risks to MGE ratepayers: The OPC and Staff claim that as a result of Southern Union's acquisition of Panhandle, MGE ratepayers supposedly face increased "risk." (OPC Br., pp. 26-30; Staff Br., p. 2) Of course, as noted above, even the OPC

concedes that given the nonrecourse nature of Panhandle's debt, such risk is an "extreme" case.

The Staff and OPC have done nothing – *i.e.,* conducted no analyses, constructed no financial models and interviewed none of the management at Southern Union, Panhandle or MGE – that even attempts to substantiate the proposition that such an "extreme" case is even remotely likely with respect to Panhandle. And, of course, the facts demonstrate that it is not at all likely: Southern Union is an investment grade company, and its management is expeditiously working to reduce the temporary debt it incurred in Panhandle's acquisition. As noted in its initial brief, Southern Union has recently announced the issuance of over 11 million shares in new equity. (Ex. 55)

Indeed, if the Panhandle investment was so bad, why did the OPC and Staff recommend that the Commission approve it? Likewise, if the terms of the Stipulation do not protect MGE ratepayers from any Panhandle risk, why did the Staff and OPC agree to, and recommend that the Commission approve, those terms? The Staff and OPC were the main proponents of the Stipulation's provisions insulating MGE from the newly acquired Panhandle. MGE respectfully submits that it is poor regulatory policy to sanction – based on agreed-upon conditions by all parties involved – a utility's new investment and then, only a year later, blindside the same utility with unsubstantiated attacks on that investment. (*See* Ex. 2, 11:11 to 12:2)

***Management choice*:** The OPC also argues that Southern Union's consolidated capital structure should be imposed on MGE because it was the choice of management. (OPC Br., p. 4, 26) This argument is also absurd: *capital structures are supposed to be the choice of management.* Indeed, OPC witness Allen testified that each company's

optimal capital structure is different and is a management decision. (Tr. 474:4-15) Further, as MGE witness Dunn confirmed, Southern Union's choice of a temporary capital structure has no impact on MGE ratepayers. (Tr. 247:15 to 249:12) Nowhere does the OPC or Staff explain why these basic principles of corporate finance – and management conduct consistent with good financial practices – nonetheless justifies saddling MGE with a capital structure that is incompatible with the LDC industry as well as the ROE they advocate.

***Southern Union's intent to increase equity in its capital structure*:** Finally, and most remarkably, OPC argues that Southern Union's present capital structure should be imposed on MGE (rather than the Fully Adjusted MGE Capital Structure) because *Southern Union intends to increase the percentage equity in its capital structure to 45 percent in the near future* (OPC Br., p. 10), thus lowering its debt ratio. Basic principles of utility and regulatory finance establish that this is actually a reason *not to impose* Southern Union's present capital structure on MGE:

> One of the assumptions underlying the DCF model . . . is the expected constancy of the debt ratio. . . . The future dividends per share which drive the DCF model, depend on expected earnings per share, which in turn depend on the expected debt ratio. As long as the debt ratio has been constant historically and is expected to be maintained in the future, the DCF model is salvaged. But if a change in debt ratio is expected, the cost of equity obtained from the DCF model must be altered based on the expected debt ratio . . . .

REGULATORY FINANCE, *supra,* p. 436. The OPC does not seem to understand a fundamental concept of utility and regulatory finance: ratemaking is forward looking. (Ex. 2 at 14:1 to 14:13)

d. Other capital structure issues.

Short-term debt: MGE has addressed the illogic of OPC's decision to include short term debt in its recommended capital structure and will not repeat its points here. (*See* MGE Br., pp. 24-25) OPC's initial brief adds nothing new and provides no further support for its position.

Hypothetical MGE Capital Structure: In its initial brief, OPC argues that any hypothetical capital structure should be based on MGE witness Dunn's comparable companies. (OPC Br., pp. 6-8) The OPC's purpose here is blatantly result-oriented – *i.e.*, the OPC's arbitrary rule of assigning MGE the lowest point in its calculated "zone of reasonableness" produces an even lower number when Dunn's – and not Allen's – group is used. (*Compare* Ex. 32 and Ex. 201 at 12:22 to 13:1) Never concerned with appearing result-oriented, Allen chose Dunn's group.

Allen – with his limited experience in utility finance – is wrong. First, as Dunn testified, the OPC should be using the midpoint, and not the lowest point, of the capital structures of whatever comparable group it decides to use. (Ex 3, pp. 36:1-12.) Second, for purposes of intellectual honesty and consistency in its analysis, the OPC should use its own proxy group, and not Dunn's. As OPC witness Tuck indicated, developing the hypothetical capital structure based on the comparable companies that the analyst thought were comparable is the correct way to approach the issue. (Tr. 627:2 to 628:7)

Fully Adjusted MGE Capital Structure: The Staff attempts to refute the Fully Adjusted MGE Capital Structure with its own effort to remove Panhandle's debt and equity. (Staff Br., pp. 4-5) As MGE has shown, however, Staff witness Murray – who has conceded he is not an expert in accounting – uses a methodology that violates basic

accounting rules. (See Ex. 4 at 5:3 to 9:11 and Sch. JJG-1 and 2; Ex. 3 at 5:12 to 8:14) In fact, the Staff seems to misunderstand even the most basic balance sheet concepts underlying the Fully Adjusted MGE Capital Structure: at one point, the Staff argues that Dunn has removed the debt of Panhandle, but left its "assets." (Staff Br., p. 5) Of course, the proper analysis is to remove the debt and *equity* (not "assets") associated with Panhandle from Southern Union's capital structure, which is exactly what Dunn and Gillen did.

2. Cost of Long-Term Debt

The Staff's argument that Panhandle's debt should be included in MGE's capital structure remains a solitary, unsupported position. (Staff Br., p. 7) It is also flatly inconsistent with Staff witness Murray's testimony at the Hearing:

> Q. If the idea was to insulate MGE rate payers from the Panhandle acquisition and the Panhandle operations, isn't it appropriate to insulate it for rate-making purposes, also?
>
> A. Yes.

(Tr. 828:2-6)

Obviously, Staff includes Panhandle's debt in its calculation because that debt is cheaper than MGE's debt, and thus its inclusion advances the Staff's result-oriented purpose of lowering MGE's rate of return. However, the Staff's purpose here undermines its basic argument for using Southern Union's capital structure in the first place. According to the Staff, Southern Union's debt-rich capital structure – including Panhandle's debt – creates additional risk for MGE ratepayers, and thus should be imposed on MGE. However, Southern Union remains investment grade and its recently issued Panhandle debt is cheaper than its MGE debt. Where is the increased risk? Why

are the capital markets not charging a higher rate on Panhandle debt? The answer is clear: the "risk" bogeyman about which OPC and Staff complain simply does not exist.[1]

3. MGE's Required Return On Equity ("ROE")

a. This Commission Should Adopt An ROE For MGE That Is Consistent With *Hope* And *Bluefield.*

MGE's recommended ROE is the only one before this Commission which complies with the principles of *Hope* and *Bluefield.* MGE has provided this Commission with a calculated ROE range of 10.9 to 11.9 percent and a recommended upward adjustment to 12 percent. (MGE Br., pp. 27-31) The fairness of this recommendation is evidenced by the fact that it is within a reasonable range of the national average for approved ROEs for the natural gas industry – approximately 11 percent. (*Id.,* p. 30) An ROE within this range will ensure that MGE is competitive with other LDCs because equity investors will receive a return "commensurate with returns on investments in other enterprises having corresponding risks." (*Hope,* 320 U.S. at 603.)

b. The Staff's and OPC's ROE Recommendations Defy *Hope* and *Bluefield*

The Staff and OPC argue that in determining an ROE for MGE this Commission should: build walls around the State of Missouri, ignore what is happening in the other forty-nine states, and trust that the Staff's and OPC's result-oriented financial models (which lead to inexplicably low ROEs of 8.52 to 9.52 percent, in comparison to the roughly 11.1 percent average ROE currently being authorized by other regulatory bodies

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[1] In addition, Staff's proposal to use Panhandle's cost of long-term debt in MGE's capital structure would violate this Commission's affiliate transaction rules, which seek to prevent cross-subsidization of activities within a corporation, in the very same way as imputing to MGE's cost of service the pay levels of Panhandle's employees -- who obviously provide no service directly to MGE customers -- would. *See* 4 CSR 240-40.015

for LDCs) will guide the Commission to a just and reasonable ROE. (OPC Br., pp. 30-34; Staff Br., pp. 8-10)

Not surprisingly, in so arguing, the Staff never once cites *Hope* and *Bluefield:* placing MGE's authorized ROE 148 to 248 basis points below other similar natural gas distribution companies will, with virtual certainty, ensure that MGE is not competitive and defy the principles set forth in those cases. OPC responds by arguing that these other natural gas distribution companies may actually not be "similar" to MGE. (OPC Br., pp. 32-33) Of course, no such concern existed when the Staff and OPC were calculating an ROE for MGE using companies with dissimilar capital structures. And neither the Staff nor OPC put forward any evidence to show that MGE is significantly less risky than other LDCs as a rationale for their very low recommended ROE: as Dr. Morin demonstrated, companies in the Staff's and OPC's own proxy groups have approved ROEs significantly higher than what the Staff and OPC are recommending here:

> [DR. MORIN:] I have also examined the range of returns currently allowed on common equity for the eight natural gas utilities in Mr. Murray's sample group as reported in C.A. Turner Utility Reports survey for May 2004. The currently authorized ROEs for Mr. Murray's sample, shown in Table 1 below, average 11.14%:

TABLE 1

COMPANY	% ALLOWED ROE
AGL Resources	10.99%
Cascade Natural Gas	11.75%
New Jersey Resources	11.50%
Northwest Natural Gas	10.20%
Peoples Energy	11.20%
Piedmont Natural Gas	11.30%
South Jersey Industries	11.25%
WGL Holdings	10.95%
AVERAGE	**11.14%**

Source: C.A. Turner Utility Reports 05/04

(Ex. 5 at 10:6 to 11:2) Six of these eight companies are included in OPC witness Allen's group of comparable companies (*See, e.g.,* Ex. 32), and the average approved ROE for those six companies is 11.06 percent.

Remarkably, the OPC tries to argue that this Commission should ignore data on approved ROEs because utility equity investors' expectations of return can be different, and actually lower, than approved ROEs! (OPC Br., pp. 31-32) The irrationality inherent in this contention is overwhelming. If a natural gas distribution investor knows that Cascade Natural Gas ("Cascade"), or New Jersey Resources ("NJR"), has an approved ROE exceeding 11 percent, why would that investor expect any less from a comparable utility like MGE? The obvious answer is that the investor – if he or she is acting rationally – would not. Moreover, the investor would clearly be acting irrationally if he or she chose the 9.01 to 9.34 percent ROE the OPC recommends for MGE, over the +11 percent return offered by Cascade or NJR.

The OPC also argues that approved ROEs should rise and fall over time with changes in the market, and that the OPC's low recommended ROE recognizes this fact. (OPC Br., pp. 33-34) Of course, the approved ROE data before this Commission establishes that in the first quarter of 2004, the average ROE was 11.1 percent (Ex. 5 at 9:20 to 11:7) – *i.e.,* this is not stale data. Further, as noted above, MGE also provided this Commission with data demonstrating that the Staff's and OPC's recommended ROEs have lagged below the industry average for several years. (Ex. 3 at 23:20 to 24:6 and Sch. JCD-7) Even more disturbing, the Staff's recommended ROEs have fallen well below the national average and even below those of the OPC in the last several years. (Ex. 3 at 26:1-3) When Staff witness Murray was questioned during the Hearing by

Commissioner Clayton as to why the Staff's recommended ROE would *ever* be below that of the OPC – given that it is the Staff's job to consider the interests of ratepayers and investors and present a fair and balanced recommendation to the Commission – Murray had no reasonable explanation. Instead, incredibly, *he tried to blame the OPC!* (*Id.*)[2] (Tr. 860:19 to 862:16) It is clear that market events are not driving the OPC's and Staff's recommendations; instead, the OPC and Staff are driven by some long term agenda aimed at unreasonably lowering ROEs for regulated companies in the State of Missouri.

c. An Inadequate ROE Will Harm The Very MGE Ratepayers That This Commission Is Supposed To Protect.

An inadequate ROE – and the inadequate capital it will provide MGE – will, in due course, harm Missouri natural gas ratepayers. As MGE witness Quain, who chaired the Pennsylvania Public Utilities Commission for approximately six years, testified:

> Q Can authorizing an inadequate rate of return, or setting rates which consistently produce earnings short of the authorized rate of return, have any . . . negative effects on the public?
>
> A. Certainly, and at several levels. First, a utility needs to have a fair rate of return in order to invest capital into discretionary projects that can enhance service levels and bring greater efficiency to the enterprise, such as technological advances like the roughly $25 million automated meter reading system MGE deployed in the

[2] Staff witness Murray's lack of credibility throughout these proceedings has been remarkable. In addition to his failure to explain why the Staff's recommended ROE is so far below the industry average and continues to be below OPC's, other examples of Murray's bias include: (1) his baseless accusations that MGE violated the Commission order and Stipulation and Agreement in Case No. GM-2003-0238 regarding the submission of periodic reports; (2) his one-sided manipulation of the data used in his DCF calculations, including his refusal to use the most recent 2003 information and his use of a ridiculous five-year earnings per share growth rate of only 1.72 percent – when every projected growth rate was two to three times that much; and (3) his refusal to use proper accounting methodology in attempting to back out Panhandle from the capital structure. Murray's result-oriented actions in this rate proceeding are striking evidence of his lack of credibility. Accordingly, this Commission should place little to no weight on the Staff's capital structure and ROE recommendations.

1997-1998 time frame. Secondly, and related to the need for investment capital, it must be understood that investors have a choice as to where to put their money. If investors redirect funds to out-of-state utilities, in-state utilities' financial health will suffer. Likewise, if investment dollars flow to another state or region, then new businesses, jobs and tax revenues will soon follow. In addition, a state with an inadequately funded utility infrastructure may discourage businesses from either entering the state or expanding their existing in-state operations.

. . .

Q. Can you elaborate on your policy goal of encouraging "healthy" utilities?

A. Yes. A financially healthy and robust utility is an asset not just to shareholders, but to a state's economy. Customers also benefit. Effective public policy requires that we view public utility service to customers on both a short-term and long-term basis. That is to say, if rates are not set artificially low, then a utility should be able to attract adequate capital at reasonable rates, preventing customers from being harmed over the long term. The lack of a fair rate of return or the lack of a fair chance to realize that rate of return would have negative long-term effects for the utility's customers and shareholders alike. By establishing an accurate rate base, a fair rate of return, and the opportunity to earn that rate of return, effective regulation achieves the proper balance between the short-term objective of reasonable rates and the long-term objective of financial health for the utility.

(Ex. 6 at 6:9-23, 8:10-22.)

MGE witness Oglesby confirmed Quain's testimony, and explained that an inadequate rate of return will undoubtedly impact MGE's discretionary spending in the State of Missouri:

Q. Do you believe a negative ramification will result if the Commission adopts the rate of return recommended by either the Commission staff or the Public Counsel?

A. Yes. Under either of those circumstances, it would be difficult, if not impossible, for MGE to obtain the capital needed to fund improvements in our operations.

Q. Why?

A. The Staff return on equity recommendation mid-point is 9.02% and the Public Counsel return on equity recommendation is below 9.5%. Southern Union also operates gas distribution properties in three states other than Missouri (Pennsylvania, Rhode Island and Massachusetts). The authorized return on equity for Southern Union's Rhode Island distribution property is 11.25%; the other properties' rates are the product of settlement with no specific authorized return on equity. If either the Staff or Public Counsel rate of return recommendation is adopted, it is clear that the MGE operation would be the lowest priority for any discretionary capital expenditures and I believe it would be unreasonable to expect the MGE operation to obtain funding for any such expenditures.

(Ex. 15 at 2:3-18.)

The Staff and OPC do not even consider, much less address, these undeniable facts.

d. The Staff's And OPC's Criticisms Of MGE's ROE Recommendation Do Not Withstand Scrutiny.

With little to support their own ROE recommendations, the Staff and OPC attempt to criticize the analyses conducted by MGE witness Dunn. (OPC Br., pp. 34-52; Staff Br., pp. 10-15) However, these criticisms do not withstand scrutiny:

Dunn's initial ROE range of 10.9 to 11.9 percent: Both the Staff and OPC complain that in reaching his recommendation of an initial ROE for MGE of 10.9 to 11.9 percent, Dunn used 6 and 7 percent growth rates in his DCF model. (OPC Br., pp. 37-40; Staff Br., pp. 12-13) In so doing, the OPC and Staff focus on only one dataset in Dunn's analysis, the average of Thompson Financial's projections for earnings per share (EPS) growth for Dunn's proxy group, or 4.9 percent. However, Dunn also considered (a) the fact that the Thompson range was 2 to 6 percent, (b) Value Line projections for EPS growth, which were 6.93 percent for his proxy group; (c) the fact that the same proxy group is also projected to have, on average, dividend per share (DPS) growth of almost 2 percent; and (d) that in the past five years, Dunn's proxy group averaged 7.18

percent EPS growth and 2.46 percent DPS growth. (Ex. 1 at 37:21 to 45:2, Sch. JCD-4 to JCD-8) Based on all of this market data, it was entirely reasonable for Dunn to choose a 6 to 7 percent *overall* growth rate range (including EPS and DPS) for his DCF model.

Dunn's flotation cost adjustment: MGE demonstrated the appropriateness of a flotation cost adjustment in its initial brief (MGE Br., pp. 39-40), and the OPC and Staff offer nothing to refute this showing. However, two of the OPC's contentions in its initial brief deserve attention here: its misrepresentation that flotation costs are principally brokerage fees and its misguided notion that such fees are incorporated into the price of equity. (OPC Br., pp. 41-43)

First, flotation costs are much more than brokerage fees. As Dr. Morin testified:

> Flotation costs have a direct and an indirect component. The direct component represents monetary compensation to the security underwriter for marketing/consulting services, for the risks involved in distributing the issue, and for any operating expenses associated with the issue (printing, legal, prospectus, etc.). The indirect component represents the downward pressure on the stock price as a result of the increased supply of stock from the new issue. The latter component is frequently referred to as "market pressure".

(Ex. 5 at 12:5-12)

Second, the direct component of flotation costs – or what the OPC calls brokerage fees – is clearly not included in the price of the equity. As Dr. Morin testified, flotation costs are like the placement costs commonly amortized over time with respect to debt issuances. (Ex. 5, pp. 12:1-13:10) The debt issuer pays those costs.

Likewise, as is industry practice, Southern Union pays the costs of issuing equity, not the equity purchasers. This Commission is charged with calculating a "cost of equity" for Southern Union; not to include these very real flotation costs is unjustifiable.

Lastly, as MGE demonstrated in its initial brief, the OPC's (and Staff's) further argument that somehow all equity issues at Southern Union apply solely to Panhandle – and thus any flotation cost adjustment would be in violation of the Stipulation – is ridiculous. (MGE Br., pp. 39-40) As MGE witness Noack demonstrated, Southern Union has continually deployed capital for the benefit of MGE's customers, as evidenced by the fact that MGE's net plant balance has consistently increased from $360 million as of June 30, 1996 to $525 million as of June 30, 2003. (Ex. 11, Schedule MRN-5) Thus, MGE capital expenditures have averaged more than $23 million annually, in addition to reinvesting the full amount of depreciation expense each year. Such capital requirements must be raised in both the equity and debt markets.

Dunn's reliance on the DCF model: The OPC criticizes Dunn's reliance on the DCF model, arguing that he should have also conducted a CAPM or risk premium analysis in testifying before this Commission. (OPC Br., pp. 35-37) As Dunn testified, however, this Commission has indicated in the past that it places significant reliance on DCF modeling. (Tr. 258:25 to 259:7) Further, the OPC and Staff also place primary reliance on the DCF model:

(a) the Staff ignores the result of its risk premium analysis and makes several critical errors in its CAPM model (MGE Br., pp. 43-44); and

(b) the OPC fails to conduct a risk premium analysis, and ignores the result of its CAPM model (MGE Br., pp. 33-36).[3]

[3] Indeed, the OPC's intentional blindness as to its CAPM model – and the ROE of 10.27 percent it generated before any of the necessary corrections – continues in its initial brief. The OPC's entire discussion of this result is relegated to a brief footnote. (OPC Br., p. 24 n. 10)

In fact, Dunn is the only witness before this Commission that did not ignore the results of his ROE calculations. Should this Commission determine that, in the future, it will place reliance on all three methodologies – DCF, CAPM and risk premium – MGE will welcome that decision. In fact, MGE witness Dr. Morin testified that this is the preferred methodology. (Ex. 5 at 38:5 to 40:23) However, under no circumstance should it ever be acceptable to simply discard ROE calculations, and cling to one-sided results. The Staff and OPC do not synthesize DCF, CAPM and risk premium calculations to reach a ROE recommendation for MGE; they abuse and/or ignore these models to reach a pre-determined result.

***Dunn's consideration of specific MGE risks*:** The Staff and OPC also criticize Dunn for considering specific risks applicable to MGE. (OPC Br., pp. 46-52; Staff Br., p. 13) Of course, if risk increases, equity investors require a higher return, and not considering all the risks with which MGE must contend is contrary to basic utility finance. Dunn's considerations are supported by authoritative literature (*i.e.,* with respect to MGE's small company risk (Ex. 1 at 53:19 to 55:20)), a statistical analysis (*Id. at 58:18 to 61:5*) and hard data on MGE's past performance (*Id.,* p. 58:6-16; Ex. 11 at 2:21 to 3:4, 5:2 to 24:4).

As usual, the Staff's and OPC's criticisms are void of any sound reasoning. For example, the OPC argues that Southern Union – not MGE – is "not materially" smaller than Dunn's proxy group. (OPC Br., p. 48) Of course, the focus of this proceeding is MGE, not Southern Union, and the OPC proffers no principled argument refuting Dunn's observation that MGE is smaller, and thus riskier, than other natural gas distribution companies in the proxy groups.

The OPC also offers testimony from OPC witness Meisenheimer ("Meisenheimer") in an effort to refute Dunn's statistical analysis. (OPC Br., pp. 48-52) Meisenheimer opines that any risk analysis of Dunn's proxy group of companies should be conducted on an individual company-by-company basis. She then conducts an analysis and produces results fully consistent with Dunn's opinion that MGE is an inherently riskier natural gas distribution company. As Dunn testified:

> Q. Public Counsel witness Meisenheimer, in her rebuttal testimony, is critical of your statistical analysis of risk. What is the nature of her criticism?
>
> A. On page 4 of her rebuttal she states that it would be more relevant for the Commission to examine each of the individual companies in my proxy group against MGE rather than examining the average of the proxy group against MGE.
>
> Q. Did she make such a calculation?
>
> A. Yes.
>
> Q. What did that calculation show?
>
> A. According to the Public Counsel calculations, of the 15 companies in my proxy group, 10 are less risky than MGE as demonstrated by a lower standard deviation and 12 of the 15 companies are less risky as demonstrated by the calculation of the co-efficient of variation. This data, taken from Table 2 on page 8 of Ms. Meisenheimer's rebuttal testimony supports my conclusion that MGE is significantly riskier than the proxy group.

(Ex. 3 at 36:14 to 37:4.)[4]

* * *

Dunn's analysis is not mechanistic; instead, it is the product of deliberation and thought and involves none of the result-oriented manipulations inherent in the OPC's and

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[4] Other criticisms of Dunn's methodology – including the choice of his proxy group and the Staff's misguided view of how dividend yields should be calculated – are thoroughly refuted in Ex. 3 at 11:15 to 16:14 and Ex. 5 at 11:9 to 13:12.

Staff's submissions. He analyzes data, looks at growth trends, specifically studies MGE and its unique characteristics, applies his +30 years of experience and reaches the only ROE recommendation that is within a reasonable proximity of the ROEs approved for like-risked enterprises.

The deliberative approach underlying Dunn's ROE recommendation, which appropriately reflects the application of the DCF model using sound judgment based on a variety factors affecting capital markets, bothers the OPC and Staff, both of which ignore real world data and adhere to a mechanistic approach to financial modeling. MGE respectfully submits that the principles of *Hope* and *Bluefield* are clearly violated when, as the OPC and Staff would have it, considerations of fair and reasonable returns give way to robotic number-crunching.

e. Other ROE issues

MGE has demonstrated in its initial brief the numerous errors in the OPC's and Staff's ROE calculations in its initial brief, and the OPC and Staff have offered nothing to refute MGE's showing. However, one misrepresentation by the OPC deserves a brief response. The OPC claims that MGE witness Dr. Morin testified that "the retention growth (sustainable growth) method was an appropriate way to determine the growth component for the DCF model." (OPC Br., p. 17) This is a blatant misrepresentation. What Dr. Morin testified is as follows:

> Q. [OPC COUNSEL:] In arriving at growth estimates, is it reasonable to look at dividend earnings and the level of earnings being retained by a company?
>
> A. [DR. MORIN:] Yes. One of the drivers of growth is the increments to the asset base. In other words, the retention of earnings. What is -- what earnings are not paid out of dividends are plowed back or retained in the asset structure and then that will

translate into future growth later on. That's the sustainable growth model approach.

Q. And is that an acceptable approach?

A. *It is widely used and should be used except in the utility context. The problem with using it in the utility rate case, it's very, very circular. You have to assume an ROE to get an ROE so you're caught in a hopeless circular logical trap here.*

Q. What if you use projected growth?

A. What do you mean by that? You mean –

Q. For your sustainable growth rate.

A. But, again, if you're projecting an expected ROE, the only way that the company can earn it is if the Commission sets rates to produce that ROE. So how can the cost of equity be any different than the ROE? See the circular logic here?

(Ex. 3, Schedule JCD-3 at 82:20 to 83:17 (emphasis added)) (*See also* Ex. 2 at 51:6 to 52:8; Tr. 1713:24 to 1714:4) The OPC's DCF model lacks credibility, because it is tainted by this very circularity.

4. Management Efficiency Adjustment

Both the Staff and OPC oppose MGE's recommendation to adjust its authorized return upward by 25 basis points on account of high management efficiency. Specifically, the Staff and OPC dispute that: (1) the Commission should encourage management efficiency (Staff Br., p. 25 ;OPC Br., pp. 53-54); (2) MGE's high quality customer service levels do not warrant such an adjustment (Staff Br., p. 25; OPC Br., p. 57); and (3) MGE's demonstrated superiority in achieving operating and maintenance ("O&M") expense efficiency warrants such an adjustment (Staff Br., pp. 20-22; OPC Br., p. 61). Each of these items will be addressed in turn.

a. Commission Precedent Regarding Management Efficiency Adjustments Is Inconsistent; The Commission Should Clearly And Effectively Encourage Management Efficiency.

The record evidence establishes that Commission precedent regarding the use of rate of return adjustments as a way to encourage or discourage management action is inconsistent at best. In the early 1980s, the Commission made use of the practice with apparent regularity, making upward ROE adjustments for at least two companies on account of management efficiency (*see, The Empire District Electric Company*, Case No. ER-83-42, 26 Mo. P.S.C. (N.S.) 58, 68-71 (1983); *see also, Kansas City Power & Light Company*, Case No. ER-83-49, ER-93-72 and EO-82-65, 26 Mo. P.S.C. (N.S.) 104, 147-150 (1983)) and making a downward adjustment for at least one company due to the lack thereof (Ex. 807, p. 7, Case Nos. ER-83-19 and WR-82-50). In 1989, the Commission seemed to discard this concept (*see, Re: Southwestern Bell Telephone*, (1989)), yet in 1996 and 1998 rate orders for MGE, the Commission again referred to management action in the course of determining ROE. (*See, Missouri Gas Energy*, Case No. GR-96-285, 5 Mo.P.S.C.3d 437, 468 and *Missouri Gas Energy*, Case No. GR-98-140, 7 Mo. P.S.C.3d 394, 404)

Given this inconsistent history, this case presents the Commission with an opportunity to take a stand and deliver a message that a high level of management efficiency is valued and encouraged. Adopting the rate of return adjustment proposed by MGE would clearly and effectively send that message.

Some may ask, why should this message be sent at all; do we not expect our utilities to be efficient as a matter of course? The answer to this question is quite simple: performance levels should affect compensation levels. Therefore, below average

performance should yield less than expected compensation; average performance should yield expected compensation; and superior performance should yield higher than expected compensation. This concept is a fundamental basis of the operation of the capitalist markets in which MGE and Southern Union participate. MGE's employees, for example, are subject to the possibility of discipline as well as the possibility of above-expected compensation (whether in the form of a bonus, an extra day off, *etc.*) based on performance. (Ex. 16 at 4:17-20) Regulation is intended to be a surrogate for the operation of competitive markets; therefore, this concept of performance-based compensation should rightfully be an integral part of the regulatory process.

The record evidence establishes that the Commission has taken action in the past with respect to MGE that can only fairly be characterized as negative reinforcement. (*Id.* at 4:10-15) For example, in Case No. GR-96-285, the Commission adopted the low end of the Staff's recommended ROE range due to concerns about service quality (*Missouri Gas Energy*, 5 Mo.P.S.C.3d 437, 468 (1997)) and in Case No. GR-98-140, *et al.*, the Commission declined to adopt an upward ROE adjustment for leverage risk due to continued concerns about service quality (*Missouri Gas Energy*, 7 Mo. P.S.C.3d 394, 404 (1998)). Other examples also exist. (Ex. 14 at 15:16 to 16:12) In light of the fact that the Commission has taken such negative reinforcement action in the past -- action which has had very real negative financial consequences to MGE in the form of lower than expected compensation -- symmetry and fairness demand that the opportunity for above-expected compensation should be available under appropriate circumstances.

b. MGE Provides High Quality Customer Service.

MGE has exhibited a strong commitment to service quality. This commitment can be observed through any number of statistical measures. Abandoned call rate ("ACR") and average speed of answer ("ASA") are indicators of contact center performance levels. Over the past six years, MGE has achieved the following ACR and ASA performance levels:

	ACR (%)	ASA (seconds)
1998	8.35	62
1999	5.88	64
2000	6.08	64
2001	9.69	125
2002	4.48	58
2003 (to 10/12)	5.91	88

(Ex. 12 at 2:11-24)

MGE's estimated meter reads have been reduced to a point where they are almost non-existent:

Year	Number of Estimated Meter Reads
FY98	172,217
FY99	14,607
FY00	1,893
FY01	967
FY02	687
FY03	556

(*Id.* at 3:11-16)

In addition, the number of complaint/inquiry contacts made by MGE customers with the Commission's consumer services department has also trended favorably over the past several years:

Year	Number of Complaints/Inquiries
2000	448
2001	840
2002	389
2003	469

(*Id.* at 3:18-27; Ex. 205 at 16:4-5)

These statistics demonstrate MGE's commitment to providing high quality customer service.

MGE explained in its direct testimony that ACR, ASA and complaint/inquiry statistics during 2001 were negatively affected by the combination of cold weather and high gas prices, and in 2003 and early 2004 were negatively affected by high gas prices and unexpectedly high and sustained call volumes. (Ex. 12 at 2:18-24, 3:20-22; Ex. 13 at 2:19-21, 7:17 to 8:14) Both the Staff and OPC ignore the impact of these realities on MGE's operations in persisting to criticize MGE's statistics for those periods, despite the significant challenge posed in managing a contact center operation effectively and efficiently during peak periods. (Ex. 13 at 6:16 to 7:15; Staff Br., pp. 19-20, OPC Br., p. 60) Both the Staff and OPC also ignore the significant steps MGE has taken since September 2003 to address these unexpectedly sustained high call volumes, including the hiring of additional employees for the contact center and the implementation of a new technology called "Virtual Hold". (Ex. 13 at 4:9 to 6:14) These MGE actions demonstrate MGE's full commitment to delivering high quality customer service.

OPC also points to a document prepared by Theodore Barry & Associates ("TB&A") in 1997 to support its allegation that MGE's performance is below the industry average. The Commission should give no credence whatsoever to these OPC arguments. Although the TB&A document was useful when it was prepared in 1997 and for a reasonable length of time thereafter, it provides no reliable basis to assess industry average call center performance in 2004. The OPC witness who relied on the 1997 TB&A document testified that:

- She has never answered telephone calls as a customer service representative in a contact or call center (Tr. 1274:16-24);
- She has never supervised representatives in a contact or call center (Tr. 1274:25 to 1275:3);
- She has never hired or trained customer service representatives for, managed or supervised the manager of, a contact or call center (Tr. 1275:4-13, 1278:16-19);
- She has never consulted with companies, on a paid basis by the companies involved, for the purpose of evaluating the performance of any contact or call center (Tr. 1275:19-24);
- She has never visited MGE's contact center and has never discussed its operations with the MGE management personnel responsible for the operation of MGE's contact center (Tr. 1276:20-22, 1277:8-18);
- She does not know what the term "P-grade"[5] means or how it relates to contact or call center performance measures (Tr. 1275:14-18);
- She does not know the typical average talk time for a natural gas utility contact center (Tr. 1277:25 to 1278:4);
- She does not know the typical not ready time for a natural gas utility contact center and has never performed a study to assess that topic (Tr. 1279:5-12);

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[5] As indicated in Schedule KKB-5 of the OPC witness' own rebuttal testimony, P-grade is the number of busy per 100 calls and, consequently, affects the customers' perception of contact center responsiveness. (Ex. 205, Sch. KKB-5, page 4 of 12)

- She does not know the typical level of calls handled by automation for a natural gas utility contact center in 1997 (Tr. 1280:7-10);

- She does not know the level of calls handled by automation for MGE in 1997 or 2003 (Tr. 1280:11-16);

- She has not taken any training, and has had no education, regarding the operation, management, or evaluation of contact centers (Tr. 1280:21 to 1281:3, 1281:8-13);

- She did not talk with the TB&A personnel who authored the 1997 document and does not know over what period of time the evaluation was conducted (Tr. 1281:4-7, 1283:11 to 1284:2); and

- She does not know whether the TB&A personnel who authored the 1997 document consider it reliable for ascertaining the industry average ACR and ASA in 2004 (Tr. 1284:3-14).

Despite her lack of any education, training, experience or knowledge regarding the operation, management or evaluation of contact center performance, compounded by never visiting MGE's contact center or discussing its operation with MGE management personnel, and further compounded by never having discussed the 1997 TB&A document with the TB&A personnel who authored it, the OPC witness argues that the 1997 TB&A document should nevertheless be relied upon to ascertain industry average ACR and ASA in 1997 because, according to her, she read the 1997 TB&A document and because it was the only study provided by MGE. (Tr. 1281:1-3, 1284:15-20) There is no indication whatsoever in this record that the 1997 TB&A study is a reliable indicator to support this OPC witness' claims. MGE submits that the 1997 TB&A document has no bearing whatsoever on the industry average ACR and ASA performance in 2004, and that the opinion of the OPC witness in that regard based upon the 1997 TB&A document should be accorded *no weight*. *See* Section 490.065 RSMo.

As further proof that MGE provides high quality customer service and that the opinion of the OPC witness regarding industry average ACR and ASA statistics on the basis of the 1997 TB&A study is erroneous, MGE directs the Commission's attention to Hearing Exhibit 44HC, which is the Staff's response to MGE data request number 16 and shows call center performance data of several different companies as well as estimated meter reads. (Tr. 1300:11-22) Of particular note in Hearing Exhibit 44HC are the ACR and ASA statistics for Company C on the second page, the ACR and ASA statistics for Company D on the third page, and the estimated meter read statistics on the fourth page. Averaging the ACR and ASA statistics of Company C and Company D for the individual years, and comparing those statistics to MGE, reveals that MGE's statistics for those years are either **_____** or **_____** the ACR and ASA statistics of Company C and Company D. (Hearing Ex. 44HC; Ex. 12 at 2:15-16 and 22) Comparing the estimated meter read statistics to MGE reveals that MGE's estimated meter read statistics are **_____** the estimated meter reading statistics of Company A. (Hearing Ex. 44HC; Ex. 12 at 3:14-15)

The Staff also suggests that a reward mechanism as suggested by MGE should only be considered when customer service can be carefully monitored to ensure that cost savings initiatives do not impair customer service. (Staff Br., p. 22) In fact, this already occurs. As the Staff noted on page 18 of its Initial Brief:

> In the Stipulation and Agreement in Case No. GM-2000-43, objectives were established for the performance of the ACR and the ASA (Ex. 806, Bernsen Dir., p.4, ls. 15-16). These objectives were set based upon the historical performance of the Company's Call Center (Ex. 806, Bernsen Dir., p. 4, ls. 16-17). The company's performance would be measured against this objective and, if the performance measures exceed these maximum allowable levels, the Company is to initiate specific responses as defined in the Stipulation (Ex.. 806, Bernsen Dir., p. 4, ls. 18-21).

Clearly then, the baseless argument that MGE's customer service performance has not been subject to monitoring that is continuing and ongoing provides no principled reason to reject the rate of return management efficiency adjustment proposed by MGE. (Ex.13 at 2:3-9)

c. MGE's Operations Are Very Efficient.

MGE manages costs very effectively.[6] The record evidence shows that in terms of annual O&M expense per customer, MGE consistently out-performs other reasonably comparable LDCs in the State:

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[6] In a recent dissenting opinion in a case involving Southern Union and MGE, it was stated that "[W]hile it is important to note that we have not predetermined the issue of return on equity/rate of return in the pending rate proceeding [e.g., this case], we do note that a decision to transfer an entire gas procurement department may not necessarily be reflective of an 'efficient and economical' management." *Re: Southern Union Company*, Case No. GO-2003-0354, Dissenting Opinion of Chairman Steve Gaw and Commissioner Lin Appling, page 8 (August 11, 2004). (*See*, Appendix A) The implication from this language is inappropriate, not only because it appears in an unrelated case, but even more so because of the complete absence of any evidentiary support for it in either case. There is no evidence in any proceeding before this Commission that the decision of a number of the former employees of Southern Union Gas in Texas to accept other employment and the reconfiguration of MGE's gas supply department to Kansas City has had any detrimental impact on MGE's operations or customers. As a matter of fact the decision of the majority notes that Staff did not allege that Southern Union failed to meet its obligation to provide for the procurement of gas for MGE's operations and, further, "all the functions that had been provided by the former gas procurement personnel were thereafter performed either by in-house personnel or through other arrangements." (*See,* Appendix B, Order Closing Case, page 3) Southern Union was not found to have done anything unlawful, improper or imprudent in Case NO. GO-2003-0354, so there is no factual basis for making any adverse inference in this case.

Annual O&M Expense Per Customer ($)

	MGE	Laclede	AmerenUE	MoPub
1998	116.85	166.35	167.82	185.21
1999	115.37	162.00	167.01	180.30
2000	119.81	164.89	184.86	212.23
2001	141.59	188.43	215.26	224.42
2002	117.35	193.29	274.22	252.15

(Ex. 14 at 7:13-18)

The Staff and OPC's arguments that this annual O&M cost per customer comparison does not establish MGE's superior cost effectiveness are groundless.[7]

MGE agrees that different companies have different cost structures, but submits that the O&M cost comparison shown above is meaningful because each company provides the same service under the same regulatory requirements and subject to the same general economic conditions prevailing in the State of Missouri. To the extent that significant cost structure differences may exist to explain MGE's demonstrably superior O&M cost efficiency, MGE is not privy to such information, unlike the Staff and OPC. Each of these companies has been the subject of a rate case audit by the Staff and OPC within the past two years (*see,* Case Nos. GR-2002-0356, GR-2003-0517, and GR-2004-0072), so cost structure information pertaining to all of these companies should have been readily available to the Staff and OPC. The simple fact that the Staff and OPC have chosen not to bring forward any such information strongly indicates that no reasonable

[7] The Staff may argue that Atmos Energy Corporation ("Atmos") had lower O&M costs than MGE in 2003, but the Staff has not included any prior O&M cost information for Atmos to show a trend and the record demonstrates that because the costs shown by the Staff for Atmos in 2003 do not include corporate allocated costs while the costs shown for MGE do include such costs, and it is reasonable to expect that consideration of such costs would drive the Atmos O&M expense higher than MGE's. (Ex. 11 at 16:13 to 17:4)

explanation exists other than the fact, as shown above, that MGE manages its O&M expenses more effectively and efficiently than the other companies.

Moreover, the fact that different companies may have different cost structures in no way explains how MGE has been able to limit the increase in its annual O&M expense per customer to $0.50 from 1998 to 2002 while all of the other companies' annual O&M expense per customer has increased by a range of $26.94 to $106.40. (Ex. 14 at 7:13-18) MGE's ability to limit annual O&M expense per customer to such a great extent during this time period also fully debunks the Staff's assertion that all of MGE's efficiency advantages occurred nine or ten years ago. (Staff Br., p. 22) If this Staff argument was true, then the margin between MGE's annual O&M expense per customer and that of the other companies would not have increased from 1998 to 2002. As can be readily observed from even a cursory review of the above table though, MGE's marginal advantage in annual O&M expense per customer did increase over that period of time. In doggedly defending its outmoded approach to the regulatory ratemaking process, the Staff would apparently prefer that the Commission ignore the facts. MGE is confident that a majority of the Commission will not do so.

The fact of the matter is that managing O&M expenses efficiently benefits customers, and at least one Staff witness has agreed that such efficiency should be encouraged:

Q. [TO MR. EAVES:] And would you also agree that this Commission should encourage those utilities under its jurisdiction to be efficient?

A. Yes, I think that's correct.

Q. And is that because efficiency ultimately benefits customers?

A. Yes, I think efficiency would lead to decreased costs, thereby benefiting the ratepayers. Yes.

Q. And being efficient would encompass financial efficiency, would it not?

A. Yes.

(Tr. 1830:12-22)

Achieving cost savings, or mitigating cost increases, enables the a company to extend the time period between general rate increase cases such as this one, which is beneficial to customers.

Q. All right. With regard to that statement, my question is, how do you measure your proposed customer benefits?

A. Well, if we have cost savings and efficiencies between cases, obviously the length of time between cases is going to increase. We will not be here for a rate case. Obviously, as indicated by this case, it's very expensive to both company and shareholder and ratepayer to have a rate case. So any way that we can generate cost savings efficiencies which would reduce our number of rate cases or the frequency of them is definitely a benefit to ratepayers.

(Tr. 1797:20 to 1798:6)

Q. Please explain how customer interests significantly drive MGE achieving financial objectives.

A. To the extent any utility, including MGE, is able to achieve earnings it deems reasonable, it will be less likely to make filings, such as this one, seeking to implement general rate increases. Moreover, cost savings and efficiencies generated between rate cases should reduce the magnitude of a subsequent rate increase request to the benefit of customers. Financially based incentive compensation opportunities cause employees to seek out efficiencies that will help improve the bottom line and increase the likelihood of an award of incentive compensation.

(Ex. 10 at 16:4-12)

Moreover, to the extent cost savings have been achieved, or cost increases have been mitigated, when the time eventually comes for a general rate increase case to be

filed, the amount requested and authorized would be lower than if such efficiencies had not been achieved; this is also beneficial to customers. (*Id.*)

To quantify this beneficial customer impact, assume that instead of limiting the increase in its annual O&M expense per customer to $0.50 from 1998 to 2002, MGE was only able to limit this increase to $26.94 (the next lowest increase during this time period). Under that assumption, MGE's rate increase request in this case would have been approximately $13.5 million higher than it was (*e.g.*, $26.94 [annual O&M expense per customer] * 500,000 [approximate number of MGE customers] = $13,470,000). Next assume that instead of limiting the increase in its annual O&M expense per customer to $0.50 from 1998 to 2002, MGE was only able to limit this increase to $106.40 (the highest increase during this time period). Under that assumption, MGE's rate increase request in this case would have been approximately $53 million higher than it was (e.g., $106.40 [annual O&M expense increase per customer] * 500,000 [approximate number of MGE customer] = $53,200,000). In comparison to the potential for higher O&M expense, and the higher customer rate levels associated therewith, the $2.1 million management efficiency rate of return adjustment makes good economic sense from a customer perspective. It would also encourage MGE, and likely other companies as well, to seek out innovative ways to operate effectively and efficiently to the benefit of customers and shareholders alike in the future.

* * *

The record evidence demonstrates MGE's cost-effectiveness in comparison to other reasonably comparable Missouri LDCs. The record evidence also demonstrates that MGE provides high quality customer service and is committed to continuing to

provide high quality customer service. Clearly, the record evidence demonstrates that the combination of cost-effectiveness and service quality MGE has achieved is far superior to that of its peer companies in the State. This superior performance benefits customers, is directly attributable to management focus, attention and effort, and the continuation of such superior performance should be valued and encouraged by this Commission. Awarding the management efficiency rate of return adjustment of 25 basis points as recommended by MGE is a reasonable way for the Commission to show that it values and encourages such superior performance.

B. Capacity Release/Off-system Sales

1. Summary:

If *past* annual capacity release revenues were a reasonably accurate indicator of what future annual levels will be in 2005, 2006 and 2007, this would not be an issue because MGE would agree to continue with the present approach that assumes a certain level will be achieved each year. Back in 2001 when the current approach was implemented as a result of an agreement, MGE and the other parties could reasonably rely on past experience to predict the future for this type of activity because no major change was on the horizon.

What is different now is that the market for MGE's existing capacity on the Kinder Morgan Pony Express pipeline is going to change in just a few months because of a new interstate pipeline coming into operation that will compete with Pony Express. The new pipeline will open up 5 and 1/2 times more capacity per day than MGE currently has on Pony Express. Logic, history, and basic economic principles all dictate that the revenue MGE now receives from its occasional and temporary sales of its surplus

capacity on Pony Express will go *down* because of this huge increase in capacity hitting the market when Cheyenne Plains opens for business. No one can quantify exactly what the dollar impact will be. The Staff and OPC witnesses refused to predict any impact from the new pipeline, saying they were only looking at past results in reaching their conclusion. So just as the Commission is reluctant to set rates based on mere projections of future expenses, MGE is reluctant to have the Commission assume some hypothetical revenue level from this activity based solely on past experience when substantial changes in the market are going to be here in a few months.

The speculation and guesswork need to be taken out of this process. The recognition and accounting of this particular revenue need to go back into the PGA process where it was before and where there can be some assurance of accuracy. An incentive approach needs to be maintained. Perhaps, after some experience is gained over the next few years as to how much revenue can reasonably be expected in the new market conditions -- assuming the other proposed pipelines remain "proposed" and market stability resumes -- a return to the current approach could be appropriate. But that will have to wait for a future rate case.

2. Response to Staff's brief

The Staff's brief makes crystal clear that its view of the future comes only from a rear-view mirror. Staff has also mischaracterized the evidence in several instances in its brief.

At page 27 of its initial brief, Staff asserts that its suggested base revenue number is "a realistic target for the level of sales MGE can achieve" and cites as authority to Staff witness Allee's ("Allee's") direct testimony (Ex. 800), Schedule 3. That is *not*

what Allee's Schedule 3 of Exhibit 800 shows and it is *not* what her direct testimony says. Schedule 3 of Exhibit 800 does not contain any predictions. It is just three numbers: the results from MGE's capacity release sales for fiscal years ending June 2001, June 2002 and June 2003. Her direct testimony supporting Schedule 3 *never* said her proposed number was "realistic." What she actually said was that MGE's capacity release sales had "*fluctuated* over the last several years, *therefore* the Staff developed a three-year average … ." [emphasis supplied] (Ex. 800 NP at 5:14-15) That is all past tense and retrospective.

The word "realistic" didn't even surface until Commissioner Murray's question to Allee on the stand. (Tr. 1562:22) At that point, Allee agreed with the Commissioner and said the Staff's proposed number was "realistic", but Allee continued by saying – consistent with her direct testimony -- "it's, you know, based on actual capacity release levels that they've been able to achieve for the last three years." Schedule 3, her testimony, and Staff's proposed number therefore rest only on results that *were achieved in the past.*

The Staff is clearly *assuming* the past is going to be repeated in the future. But, significantly, neither Schedule 3 of Exhibit 800 nor her testimony proved or even attempted to prove what level of capacity release revenue MGE "can" or "will" achieve in 2005, 2006 and 2007 when the rates set in this case will be in effect. Allee admitted that she believes Cheyenne Plains will be placed in service. (Tr. 1554:15-19) But she said she *could not predict* and *was not predicting* what effect Cheyenne Plains will have once it goes into service: "Yes, I'm saying I don't have an opinion. I don't know how that is going to – to impact it, because I don't know what the demand is going to be." (Tr.

1577:9-12) With that sworn testimony, it is clear that Allee was not even attempting to present evidence on the level of MGE's future capacity release revenues.

The same approach was followed by, and the same criticism applies to, OPC witness Busch ("Busch"). His approach was documented when he testified as follows: "No, I did not take into account the Cheyenne Plains. The potential future which may or may not happen in January 2005. I relied on the – the historic facts that I had." (Tr. 1525:16-19)

Both Staff and OPC have therefore put blinders on and refused to consider this new pipeline and the effects it will have on MGE's ability to market its temporary surplus capacity on Pony Express. These actions of Staff and OPC put the Commission in a difficult situation since the Commission is legally obligated to set rates for MGE based upon due process, which includes a consideration of "all relevant factors." (*State ex rel. Missouri Water Co. v. PSC*, 308 S.W.2d 704, 718-719 (Mo. 1958)) The uncontroverted evidence that Cheyenne Plains is under construction right now (Tr. 1460:10-12) and is scheduled to be in operation in January 2005 cannot be lawfully ignored. Yet the testimony recounted above clearly demonstrates those witnesses have intentionally ignored the relevant factor of Cheyenne Plains.

In addition to requiring consideration of all relevant factors, Missouri courts have also held that "[T]he Commission must make an intelligent forecast with respect to the future period for which it is setting the rate; rate making is by necessity a predictive science." (*State ex rel. Missouri Public Service Co. v. Fraas* 627 S.W.2d 882 at 886 (Mo.App.W.D. 1981), citing *State v. N.J. Bell Tel. Co.*, 30 N.J. 16, 152 A.2d 35 (1959)) This means that in order to issue a lawful decision, the Commission must intelligently

consider what impact Cheyenne Plains will have on MGE's future level of capacity release revenue. The stated positions of Staff and OPC do not even attempt that.

MGE presented evidence of the effect of capacity expansions in this particular market in the recent past when MGE witness Hayes ("Hayes") did an analysis of the 13 months before and after the recent Kern River pipeline expansion. Based on his ten years of experience in this subject (Tr. 1482:19), he stated what results are logically expected to occur with the introduction of all this new capacity. (*See,* Ex. 17 at 8:1 to 12:10; MGE Br., pp. 53-56) Neither Staff nor OPC challenged the accuracy of that data.

Both Staff and OPC have overlooked the fact that past results *only* have future predictive value if the future is going to be the *same as, or reasonably similar to,* the past. Following their approach, and looking at the stock market for the years 1997, 1998 and 1999, they would probably conclude that the Dow Jones Industrial Average is now around 14,000 and Enron is a component company in the average.

The Staff is correct in concluding in its brief that Cheyenne Plains is being built because its owners apparently perceive an "increasing demand" for pipeline capacity in that market. (Staff Br., p. 29) The evidence shows that due to Cheyenne Plains, there is going to be a huge increase in the available pipeline capacity with the addition of 560,000 Dth per day of new pipeline capacity coming out of the Rocky Mountain region. The salient question, though, is what effect that *additional* pipeline capacity is going to have on the *price* of the *existing* pipeline capacity (*i.e.*, MGE's contracted capacity on Pony Express) when it becomes temporarily surplus, even if demand for the commodity itself might be rising? The answer is simple and can be found in today's headlines. Ask yourself what the effect would likely be if it were announced that the domestic supply of

crude oil will increase five fold next year due to the discovery of new supplies in an area of the United States where drilling is permitted. Is it an intelligent forecast to conclude that the price of gasoline will *increase* in that scenario?

MGE has been able to sell its temporary surplus capacity on Pony Express (and produce the revenue in the past) only because other people wanted to buy that capacity from time to time. The big question now, though, is whether those people are going to want to buy it when there is more of it available from a new source -- Cheyenne Plains -- and at a *lower* variable cost than they would have to pay on Pony Express. Allee admitted that as a general rule, competition tends to drive down those prices. (Tr. 1550:8-12) And she admitted that lower costs on the new pipeline could drive down prices that can be driven down (*i.e.*, those not fixed by tariff). (Tr. 1550:13 to 1551:12) Hayes testified that the customers for MGE's surplus capacity will either be "buying off of Kinder Morgan [Pony Express] or they're going to be buying off of Cheyenne Plains." (Tr. 1464:18-19) Cheyenne Plains will be more attractive to those buyers than Pony Express because it will have lower operating costs. (Ex. 17 at 9:9-13) These facts and common sense, as Hayes testified, dictate that those capacity buyers will go to Cheyenne Plains first to satisfy their demand for capacity. (Ex. 17 at 11:2-9) That means the people who own capacity on Cheyenne Plains -- which is *not* MGE (Tr. 1463:8-10) -- will likely be the new recipients of the capacity release revenue that Staff and OPC blithely want to assume MGE will receive in 2005, 2006 and 2007. This is why MGE is characterizing these as "phantom" revenues – there is no reasonable assurance they will materialize and no intelligent forecast would assume they will be there even six months after the rates from this case take effect.

Compounding its mischaracterization of Allee's testimony discussed above, the Staff concludes in an accompanying sentence on page 27 of its brief that "There is a *slight risk* (emphasis supplied) that MGE will not make the level of sales that is included in base rates, but MGE met the established level last year." The first part of the sentence appears to be another gross mischaracterization of the record if it is meant to predict what the future revenue levels will be in support of the Staff position. Staff's brief cites to cross examination of Hayes as the source. The transcript on page 1456 shows that Hayes was talking at that point about meeting MGE's budgeted numbers for fiscal years 2003 and 2004. He was not talking about 2005 and beyond when the rates set in this case will be in effect. Nowhere in the testimony of Hayes is there *any* basis for the Staff's assertion that there is only a "slight risk" of MGE not being able to meet the current assumed level in the future. Indeed, and quite to the contrary, Hayes made clear that "capacity release revenue levels MGE has been able to generate in the past are not a reasonable or reliable indicator of capacity release revenues that MGE may be able to generate in the future." (Ex. 17 at 12:8-10)

On page 29 of its brief, the Staff discusses in one paragraph four different interstate pipelines, concluding at the end that "plans can change" and that "pipelines are built as a result of need for more capacity." Well, no one in this case was arguing that plans can *never* change or that pipelines are built because of *reduced* demand for capacity. The salient point the Staff should have recognized is that there are other entities out there who can affect the market where MGE produces these revenues. Kern River has already affected the market with its 900,000 Dth expansion in 2003 (Ex. 17 at 8:9-15), despite the fact -- as Staff gratuitously points out on page 29 – that Kern River goes

to California. Which direction it goes is not relevant to this issue; what is relevant is that it takes Rocky Mountain gas to another region, and that affects prices. (Tr. 1469:5-7) Kern River, as pointed out by Mr. Hayes, did make an impact (Tr. 1471:4-6) and is planning yet another expansion. (Ex. 17 at 10:6-7) Advantage and Western Frontier, which are also discussed by Staff, are admittedly, at this time, just future possibilities. But as Staff says, "plans can change." Cheyenne Plains used to be just a "future possibility," too. Now it is under construction and scheduled to be in service in early 2005.

3. Response to OPC's brief

Since their positions are quite similar, much of what was said above regarding the Staff applies to the OPC. There are some additional arguments made by OPC that merit a response.

On page 69 of its initial brief, OPC argues that because personnel, equipment and other resources used by MGE to obtain capacity release revenues are recovered in non-gas (otherwise known as "base" or "non-PGA") rates, the revenues from that activity also belong in non-gas rates. That connection does not prove anything. MGE personnel and equipment are also used to purchase natural gas itself for the benefit of MGE's customers, but the cost of that natural gas is *not* recovered in non-gas rates. Said another way without the double negatives, the salaries of MGE personnel who purchase gas are recovered in base rates. The OPC's argument here ignores the fact that the interstate pipeline capacity -- without which these capacity release revenues would not even exist -- is recovered through the PGA rates. (Tr. 1549:22-24) The Staff witness admitted these revenues and the capacity costs were directly related. (Tr. 1549:19-21) Any such

revenues offset the capacity costs since it has the effect of having someone else paying for a portion of the capacity. (Tr. 1549:14-17)

On pages 70 and 71, OPC attempts to characterize all of the pending or planned pipeline projects as not having "an impact on MGE for years in the future, if at all." That is not correct. What Hayes testified is that there could be additional pipeline competition in "two to three years." (Tr. 1459:4) That is within the time period that rates set in this case will be in effect, since the discussions on the issue of rate case expense amortization are in the three to four year range.

This discussion of OPC also mischaracterizes Hayes' testimony in response to questioning by Staff counsel that he could only make a "wild guess" about the impact of Cheyenne Plains. A review of the transcript at page 1470, and placing his responses there in context with his other testimony, shows that Hayes was not comfortable making an *exact* prediction of the effect of Cheyenne Plains. That is why he said he did not do a "study" but that he could make a "wild guess." What he said was: "It would be difficult to do so [perform a study] at this point in time based upon the uncertainty." (Tr. 1470:19-22) His testimony overall (Ex. 17) shows how he carefully analyzed recent pipeline expansions and their effect on pricing to substantiate his opinion that capacity purchasers will gravitate first to Cheyenne Plains before seeking MGE's capacity on Pony Express.

OPC concludes on page 71 of its initial brief that there is no evidence to support MGE's claim that Cheyenne Plains will have an adverse effect on capacity release revenues. This conclusion does not pass the "smell test." As MGE has said repeatedly, if there were logical and objective indications that MGE's capacity release revenues were going to increase over the next three years, this would not be an issue. MGE would act in

its own economic best interest and maintain the current approach where it gets to "keep" all the capacity release revenues above the assumed threshold. But there is *nothing* in evidence that demonstrates MGE's capacity release revenues will *increase* after Cheyenne Plains' capacity becomes available. Neither the Staff nor the OPC witnesses testified to any such thing. They both said they were not predicting its impact. OPC's brief is apparently relying on the broad assertion that rising demand for natural gas itself will increase the value of pipeline capacity. Significantly, though, there was no evidence connecting that general assertion to the future purchasing behavior of the *particular* customers who have been buying MGE's Pony Express capacity in the past; *they* are the source of MGE's capacity release revenues. The *only* evidence about the future behavior of *that group* comes from Hayes. His ten years of working in this field and observing this activity first hand lead him to conclude that the customers will gravitate to Cheyenne Plains. No one directly challenged that assertion. Indeed, it would not be an intelligent forecast to conclude, as OPC does, that increasing demand for natural gas ties directly to MGE's particular situation. These are market-specific situations. As the Staff witness admitted, these revenues come from willing buyers in an open market. There are no guarantees there will be any sales at all. (Tr. 1544:14-20) For example, Enbridge (formerly Kansas Pipeline) was discussed at the hearing as a pipeline where MGE has capacity under contract and where there had been no capacity releases at all for many years. That pipeline continues to stand as an example of a situation where no one wants that release capacity, even in the face of an alleged overall rising demand for natural gas. The only capacity release on that system was because MGE's School Transportation

Tariff requires the School Boards Association to take capacity on that pipeline. (Tr. 1590 to 1592) Therefore, OPC's argument on this point lacks evidentiary support.

4. Inclusion of an Incentive Approach

Neither Staff nor OPC present any arguments in their briefs on this aspect of the issue that are different from the testimony of their witnesses. MGE has already addressed those aspects in its initial brief.

Whether to apply an incentive approach to these revenues essentially presents a policy question for the Commission. There is nothing inherently wrong with an incentive. An incentive approach has been applied to these revenues for several years. There is no indication in the record of this case that there has been anything unreasonable or inappropriate resulting from that approach. Similarly, there is no evidence that if the accounting for these revenues is placed back into the PGA the need for an incentive will disappear.

The Staff apparently just wants to abandon the incentive to be consistent with the other gas distribution companies that have their capacity release revenues accounted for through the PGA process. But the real difference, as explained in the initial brief, is that those other companies have relatively minor amounts of such revenue. It is Laclede Gas and MGE that have the most of this type of revenue, and that is why they both have incentives to maximize it. If, as MGE has shown, its level of revenues will be reduced in coming years because of new pipeline competition increasing the supply of capacity in this market, then it would be reasonable to continue to apply an incentive, and even to increase it, in order to encourage MGE to seek as much capacity release revenue as possible for the benefit of customers. It presumably will take more effort in the future to

convince buyers to purchase capacity from MGE as opposed to those who hold it on Cheyenne Plains.

The discussion of MGE's proposed tariff language in Staff's brief appears to be no different than what its witness said, except that the brief on page 30 incorrectly refers to it as "disallowed" capacity. The ACA case in which the Staff has made this allegation is at a very early stage and there has not even been any testimony filed, much less a hearing and a determination by the Commission that the cost of any capacity has been "disallowed." The fact that the Staff in past ACA cases has tended to be one-sided and only look at alleged detriments without balancing them against off-setting benefits is a major reason why the Commission should put these revenues back into the PGA where they can be examined simultaneously with the costs that are necessary to produce them in the first place.

5. Conclusion

Ultimately, this issue comes down to the credibility of the witnesses themselves and the logic supporting their positions. The Staff and OPC witnesses have no experience in the real world of capacity release markets. They are both from accounting backgrounds who admit they are looking only at past results and testifying they do not know what the impact of Cheyenne Plains is going to be. Hayes of MGE says he cannot quantify the exact impact either, but he lives in this market every working day and has been doing that for ten years. He has made a reasoned analysis of the impact Cheyenne Plains will make, and he concludes that MGE's past performance is not a reliable indicator of future results.

There is credible evidence that the market is going to change. The current buyers of MGE's capacity will logically gravitate to the lower costs of Cheyenne Plains, and with them will go capacity release revenues. In view of that, it is not reasonable to forecast that MGE's capacity release revenues will increase, or even stay at the same levels as experienced in the past. Since neither the Staff nor OPC has provided any evidentiary support for a new assumed level of revenues after Cheyenne Plains, because both Busch and Allee specifically said they were not predicting its impact, the only reasonable alternative is to put these revenues back into the PGA/ACA process. It is also reasonable to continue to apply an incentive approach to them that is fair and balanced. Only MGE's approach meets those criteria.

C. Environmental Response Fund

MGE proposes the creation of an environmental response fund for the rate recovery of environmental clean up costs related to manufactured gas plant facilities that were operated by former owners of the Company's properties. MGE's plan, which utilizes a mechanism similar to the purchased gas adjustment and related ACA process for gas companies (Tr. 1884:12-18), is described in detail in Schedule H-28 to Exhibit 8. The plan would allow MGE to recover environmental clean up expenditures which MGE experiences in the future. (Ex. 8 at 23:7-18)

Under its plan, MGE would *not* be allowed to recover for any past expenditures. All sums collected under the plan would be segregated in an interest bearing trust account and would be subject to audit and "true-up," with MGE only recovering prudently incurred environmental clean up costs. The procedure is designed to ensure that there is

no mismatch between the environmental clean up costs included in rates and those costs *actually experienced* by the Company. (Ex. 11 at 4:19-22)

MGE has spent approximately $9.3 million on manufactured gas plant environmental clean up activities since February of 1994. (Ex. 11 at 9:9-11) Thus far, none of these expenses have been included in rates. (*Id.*) This is because the Company has been able to obtain other forms of cost recovery sufficient to cover expenditures to date. However, because the Company has incurred millions in environmental clean up costs in the test year in this case (Ex. 22 at 2:13 to 3:1), and is certain to continue to incur a significant level of such costs in the future (Ex. 22 at 3:3 to 4:19), MGE can no longer continue to incur these costs without seeking rate recovery. MGE did not operate the manufactured gas plant facilities, but remediation matters are very real issues -- and costs -- for the Company.

Staff urges the Commission not to adopt MGE's "exceptional proposal." (Staff Br., p. 29) Staff points to the fact that the gas plants no longer serve Missouri customers. OPC makes this same argument. This assertion, however, is irrelevant to the issue of environmental clean up costs. OPC states that "[o]nly the costs associated with plant or property that currently provides utility service to the public should be authorized cost of service treatment." (OPC Br., p. 78) OPC, however, provides no statutory or case authority for this statement. This "used and useful" argument is inapplicable to the situation at hand. MGE seeks recovery of prudently incurred clean up *expenses*; environmental clean up costs related to manufactured gas plant facilities are not rate base items where the "used and useful" standard may come into play.