BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

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

STATEMENT OF THE POSITION OF
MISSOURI GAS ENERGY

I. COST OF CAPITAL

a. Capital Structure and Costs of Capital Other Than Common Equity

What is the appropriate capital structure (i.e., the relative proportions of long-term debt, short-term debt, preferred equity, and common equity) to use in calculating MGE's cost of service?

Missouri Gas Energy ("MGE" or "Company") is a division of Southern Union Company ("Southern Union") and, therefore, the Company has no common stock and no discretely identifiable capital structure of its own.

Southern Union is a company with diverse financial interests whose risk characteristics differ significantly from those of MGE. This is reflected in the fact that investors view Southern Union as a "midstream company" and not as a local gas distribution company ("LDC"). Accordingly, although MGE is one of Southern Union's many business units, because investors view MGE and its corporate parent as being engaged in different businesses and attended with different risks, it would not be appropriate to use Southern Union's capital structure as a proxy for MGE in determining an overall rate of return for the Company in this case.

In order to accurately reflect the business risks that MGE faces as a regulated LDC, a hypothetical capital structure should be used for ratemaking

purposes in this case. The Company proposes a capital structure consisting of 54 percent total debt and 46 percent common equity. MGE's proposal was developed based on an analysis of two proxy groups of LDCs who, over a five-year period, had an average debt component that ranged from 53-55 percent and an average equity component that ranged between 47-45 percent. In addition, a debt/equity ratio within these ranges is required for an "A" bond rating from Standard and Poors.

The hypothetical capital structure that MGE proposes to use for ratemaking purposes in this case accurately reflects investors' expectations of the risks that attend an LDC. Moreover, the ratio of debt to equity in the Company's proposed hypothetical capital structure satisfies the principles of a fair rate of return established in the *Bluefield* and *Hope* decisions.

Company Witness: Frank J. Hanley, President, AUS Consultants – Utility Services.

What cost of long-term, short-term debt, and preferred stock should be applied to the capital structure?

The Company's recommended cost rate for long-term debt is 6.57 percent, which is based on an analysis of the debt costs of two proxy groups of LDCs.

Company Witness: Frank J. Hanley, President, AUS Consultants – Utility Services.

b. Return on Equity

What is the appropriate return on equity to use in calculating MGE's cost of service?

MGE recommends that the Commission authorized a common equity cost of 11.75[1] percent for ratemaking purposes in this case. The recommended equity

[1] MGE's initial ROE recommendation of 11.95% was updated and revised to 11.75% in rebuttal testimony.

return reflects current capital market conditions based on the application of four established, market-based cost of equity models – discounted cash flow ("DCF"), risk premium ("RPM"), capital asset pricing ("CAPM"), and comparable earnings ("CEM") – plus an additional, upward adjustment of forty-five (45) basis points to reflect the increased risk associated with MGE's relatively small size (30 basis points) and its lack of protection from the effects of weather fluctuations (15 basis points). The combination of the recommended return on equity and cost of long-term debt yields an overall cost of capital for MGE of 8.85 percent.

The Company applied each of its common equity models to two proxy groups of LDCs whose risk characteristics are comparable to those of MGE. The cost of equity estimates produced by applying the DCF to the companies in the two proxy groups ranged from 11.60-11.69 percent, after adjustment to reflect the added financial risk when applied to the book value of equity. The estimates produced by applying the RPM, CAPM, and CEM ranged from 10.25 percent to 14.37 percent. An analysis of these estimates, coupled with an upward adjustment to reflect the additional risk associated with MGE's size and its lack of protection from the effects of fluctuations in weather, yielded the 11.75 percent cost of equity that the Company proposes the Commission use for ratemaking purposes in this case. However, if the Commission adopts the Straight Fixed-Variable rate design that MGE is proposing, the Company's cost of equity recommendation is reduced to 11.50 percent to reflect the lower risks associated with a rate design that allows fixed costs to be recovered from fixed instead of volumetric charges.

Company Witnesses: Frank J. Hanley, President, AUS Consultants – Utility Services.

II. INCOME STATEMENT – REVENUES

a. Weather Normalization

What is the appropriate measure of normal weather to be used in calculating: 1) MGE's revenue requirement, and 2) the billing determinants to be used in establishing MGE's volumetric rate elements?

MGE proposes to use a 10-year Heating Degree Day ("HDD") average to normalize its annual gas volumes for ratemaking purposes. Historically, the Company has used a 30-year HDD average computed by the National Oceanographic and Atmospheric Administration ("NOAA") to normalize its gas volumes for weather. MGE has proposed this change in the calculation of HDD because it believes that the use of a 10-year HDD average will result in improved forecasting for normalizing MGE's gas volumes and that the 10-year average will better reflect the expected normal weather conditions during the period in which its base rates will be in effect.

MGE analyzed data that showed that over a 106-year period, the 10-year HDD average outperforms the 30-year average in predicting weather two years into the future. In other words, 10-year averages tend to produce more accurate forecasts of HDD than 30-year averages. Specifically, the forecast errors of 30-year averages are typically higher than those of 10-year averages by approximately 4.6% in Kansas City and by approximately 1.2% in Springfield. The 10-year average represents a better basis for purposes of forecasting HDD during the time when the Company's approved rates in this case will be in effect. The

deficiency in the use of the 30-year average in the past has contributed, in significant part, to the Company's chronic and continuing volumetric revenue shortfalls that have prevented it from earning the return on investment approved by the Commission in prior rate cases.

The weather normalization adjustment has the effect of increasing test year volumetric revenues because MGE's gas volumes and the resulting revenues were abnormally low due to temperatures (and HDD) in the test year being warmer than normal. Weather was approximately 3.8% warmer than normal in the Kansas City and St. Joseph areas and approximately 4.0% warmer than normal in the Joplin area during the test year. The weather normalization adjustment is designed to adjust base rates in order to produce the base revenue anticipated under normal temperature conditions which are expected to be in effect after the new rates become effective.

The adjustment consists of the difference between the volumes statistically explained with normal HDD and volumes experienced with actual HDDs. Pricing the volumetric weather adjustments at the Company's current base rates results in revenue increases of $1,506,308 in residential gas sales, $542,095 in commercial gas sales (or $495,544 in SGS rate class and $46,551 in the LGS rate class), and $112,397 in transportation revenues. Pricing these adjustments at the Company's current base rates results in an $840,063 increase in test year margin.

Company Witness: Russell A. Feingold, Managing Director, Navigant Consulting, Inc.

III. INCOME STATEMENT – EXPENSES

a. Property Taxes

What is the proper treatment of $5,554,068 in property tax refunds received by MGE during the test year?

During the test period, MGE received and booked property tax refunds totaling $5,554,068 that related to taxes paid for tax years 2002, 2003, and 2004. The refunds in question are non-recurring and relate to periods during which rates lawfully prescribed by the Commission were in effect.

The Commission Staff ("Staff") proposes that the entire amount of these refunds be set up as a deferred credit and amortized over five years to offset property tax expense during the test period and into the future. MGE opposes Staff's proposal for several reasons. First and foremost, Staff's proposed adjustment constitutes retroactive ratemaking, which is unlawful in Missouri. It would be unlawful for the Commission to reach back to prior periods to seize the tax refunds related to those periods and utilize them for the benefit of future customers by setting property tax expense for ratemaking purposes in this case at an artificially low level. See, e.g., *State ex rel. Util. Consumers Council of Missouri, Inc. v. Pub. Serv. Comm'n*., 585 S.W.2d 41, 58 (Mo. 1979).

The rationale underlying Staff's position is the belief that the fact that MGE received tax refunds shows that for the period 2002-2004 MGE did not owe the full amount of annual property tax expense that was assumed for ratemaking purposes in the Company's last rate case. Staff believes this resulted in a "windfall" to MGE that should now be returned to its customers. But beyond the fact that the doctrine of retroactive ratemaking prohibits the future return or any past windfall as well as the future recovery of any past losses, Staff's conclusions are factually unfounded. Just because MGE received property tax refunds does not mean its tax payments

– on either a gross or net basis – were not at or above the level assumed for ratemaking purposes in previous cases. The refunds simply reflect the fact that the Company paid more property taxes than it owed – nothing more. It says nothing about the whether the Commission's allowance for property taxes in past cases was too much or too little.

Company Witness: Michael R. Noack, Director of Pricing and Regulatory Affairs.

b. Unrecovered Cost of Service Amortization

Should MGE Recover $15.6 million in rates amortized over five years for alleged revenue loss due to lower customer gas use for the period January through June, 2006?

In MGE's last rate case, Case No. GR-2004-0209, the Company asked the Commission: 1) to authorize a weather normalization clause or a weather mitigation rate design similar to one that had been previously authorized for Laclede Gas Company; 2) to base its weather normalization adjustment on recent weather data that would more accurately predict customer usage; and 3) to approve an attrition adjustment to normalized sales volumes to recognize the fact that MGE has experienced a consistent decline in average, per-customer usage. MGE also proposed to increase the proportion of revenues recovered by way of fixed rate elements as opposed to volumetric rate elements. The Company made these proposals in an effort to assure that the rate structure adopted by the Commission would give the Company a realistic opportunity to actually recover its allowed cost of service. None of these proposals was adopted and, as a predictable consequence of extraordinarily warm weather during the first three months of 2006, average per-customer usage for the residential class fell 27.36%

below the level that was assumed when rates were set in the last case. To recover this shortfall, the Company proposes to amortize over five years the difference between MGE's actual revenues for the period January 1, 2006, through June 30, 2006, and the level of revenues that was assumed in Case No. GR-2004-0209. The total amount of that shortfall is $15.6 million, and of that total one-fifth, or approximately $3.125 million, would be added to the test period cost of service to be used to set rates in this case.

Staff argues that the Company's proposal constitutes unlawful retroactive ratemaking, and opposes the adjustment on that basis. As stated in the testimony of Staff's witness on this issue:

> "Retroactive ratemaking" is the setting of rates to allow a utility to recover the specific costs of past events incurred by the utility so as to make utility shareholders "whole" or, conversely, it is the setting of rates to reimburse customers related to past over-earnings of a utility so as to make the customers "whole." Both of these instances contrast with normal ratemaking practices, which are intended to allow a utility to recover a normal ongoing level of costs.

Staff also asserts that allowing a utility to recoup past losses, or forcing it to return past gains, through future rates represents a "significant disincentive to utility efficiency," which makes adoption of the Company's proposal bad regulatory policy. In addition, Staff argues that the Commission should reject MGE's proposed adjustment because "[a] utility assumes the risk that it will not be able to earn its authorized ROE under traditional ratemaking practices . . .."

The Company agrees with Staff's argument that the proposed adjustment for unrecovered cost of service during the first half of 2006 may constitute retroactive ratemaking. But the Commission should also recognize and

acknowledge that Staff's proposed property tax adjustment is afflicted with the same legal infirmity. As stated in Staff's testimony on this issue, the doctrine of retroactive ratemaking prohibits recouping *both past losses and past gains* through future rates. Accordingly, if MGE's unrecovered cost of service adjustment must be rejected as Staff proposes, then so must Staff's property tax adjustment.

Company Witness: Michael R. Noack, Director of Pricing and Regulatory Affairs.

c. Rate Case Expense

What is the appropriate amount and treatment of rate case expense, including amortization of prior rate case expense, in this case?

In MGE's last rate case, the Commission allowed rate case expenses totaling $893,823.75 and authorized a three-year amortization of that amount. Rates approved in that case took effect on October 2, 2004, so as of the end of the test period in this case – June 30, 2006 – only approximately 40 percent of the amortization period prescribed by the Commission for recovery of those costs had elapsed and only about $373,000 of the total amount authorized had been collected.

In the current case, MGE proposes that it be allowed to collect he unrecovered balance of rate case expense allowed in the last case. This balance would be added to rate case expense incurred for the current case and the total would then be amortized over an appropriate period. Both the Company and Staff favor a three-year amortization period for rate case expense. but Staff, however, opposes any recovery of the unrecovered balance from the last case.

The Commission authorized a three-year amortization of rate case expenses from MGE's last rate case and Staff should not be allowed to flout that

directive. Whatever level of rate case expense the Commission finds to be reasonable and prudent in the current case should be adjusted to reflect the uncollected balance that remains from the last case. This combined amount should then be amortized over an appropriate period. To do otherwise would deny the Company an expense it was previously authorized to collect, thereby further exacerbating its already substantial earnings shortfall.

Company Witness: Michael R. Noack, Director of Pricing and Regulatory Affairs.

d. Depreciation Expense

What are the appropriate average service lives and net salvage values associated with MGE's plant to se the depreciation rates to be used in calculating MGE's cost of service?

As to the depreciation rates and related expense that are at issue in the current case, MGE's recommendations are based on a company-specific depreciation study that was conducted in 2005 by Black & Veatch Corporation. A summary of the accrual rates that resulted from that study, and which the Company is proposing for adoption in this case, are found in Revised Table 4-2 of Schedule TJS-2. The most significant changes that the Company is recommending are as follows:

- An increase in the depreciation rate for Account 380 (Services) from 2.70 to 3.41 percent and a reduction in the Average Service Life ("ASL") from 37 to 32 years with an annual net salvage value of $800,000. These changes account for approximately $2,017,349 of the total requested increase of $2,645,707;

- An increase in the depreciation rate for Account 376 (Mains) from 2.27 to 2.43 percent by amortizing the reserve deficiency. This increases annual depreciation expense by approximately $47,440; and

- An increase in the depreciation rate for Account 391 (Office Furniture and Equipment) from 8.06 to 9.09 percent and a change in the ASL from 12 to 11 years which increases annual depreciation rates by approximately $61,964

The depreciation study performed by Black & Veatch, and the recommended depreciation rates and ASLs that resulted from that study, are based on a combination of actual MGE experience and data, consideration of similar experience of ten other Midwestern local distribution gas companies, engineering judgment, and consideration of circumstances unique to MGE. The use of company-specific data as a first step in the process was critical because such data, alone, reflect the actual operating characteristics and history of MGE within its service territory. But because MGE's database of company-specific information is not as large as that of some other gas utilities, the Company's experts believed it was prudent, as a second step, to compare their MGE-specific results with data developed for ten comparable Midwestern gas distribution companies. This comparison provided a check as to the accuracy and reliability of the MGE-specific results. The results from the first two steps were then further analyzed and refined based on engineering experience and expertise derived from conducting numerous depreciation studies for other utilities as well as previous experience with MGE. A final check was then performed to make sure the results accurately reflected circumstances that are unique to MGE, such as the Company's Safety Line Replacement Program ("SLRP").[2] The results of this process are ASLs and depreciation rates that reasonably and accurately reflect the actual experience of

[2] The SLRP is the Company's effort to respond to the Commission's requirement that MGE replace bare steel, residential gas service lines and other facilities that were installed prior to 1970. Because of their age, these lines are prone to failure and may, therefore, pose a significant threat to MGE's customers and properties nearby. The Company's aggressive replacement program – which has been much more significant that those of other gas distribution companies in Missouri – coupled with the demographic characteristics of the residences whose lines are being replaced, have impacted the ASLs for Account 380 (Services) and, accordingly, the depreciation rates for that account.

MGE and its customers.

As it determines what depreciation rates should be prescribed for MGE and what amount of depreciation expense should be recognized for ratemaking purposes, the Commission also should consider several concerns the Company has regarding how Staff, both in the past and in this case, addresses issues of depreciation with respect to MGE. For example, although the Company has dutifully complied with the Commission's rule requiring natural gas distribution utilities to conduct company-specific depreciation studies and to file those studies as part of a general rate increase request,[3] Staff routinely has disregarded those studies in the depreciation recommendations it makes for MGE. And, when MGE has tried to address this situation by seeking Staff's input prior to conducting its depreciation studies and/or by soliciting Staff's comments when the studies were completed, the Company has received little in the way of a constructive response to its entreaties.

Another example is the inconsistent manner in which Staff has dealt with the issue of depreciation from one MGE rate case to the next. Over the past decade, the Company's depreciation rates have been reviewed by ***four different Staff witnesses*** who have used ***three different methodologies to determine the ASL of MGE's plant*** and ***four different methodologies to determine net salvage***. Depreciation rates are supposed to be relatively stable, and although MGE's approach to depreciation and the methodologies it has employed to determine ASLs, depreciation rates, and salvage have remained consistent over time, Staff's approach has changed from case to case. Such wide fluctuations in Staff's position

[3] 4 CSR 240-2.235 (1)(A).

on depreciation issues from case to case make it impossible for the Company to know: 1) what Staff's standards and expectations are with respect to depreciation, and 2) what MGE needs to do to comply.

Finally, MGE is concerned about the inconsistent manner in which Staff treats issues related to depreciation from one Missouri gas company to another. For example, in Atmos Energy Corporation's pending general rate case, Case No. GR-2006-0387, Staff has accepted the rates called for by Atmos's company-specific depreciation study, whereas in MGE's current case Staff has rejected MGE's company specific depreciation study, opting, instead, to use an average of the ASLs from three surrogate companies. The main difference between the depreciation studies conducted by the two companies appears to be that Atmos' study resulted in a reduction in its annual depreciation accrual of approximately $591,000, while MGE's study resulted in a recommended increase of $2,645,707. It thus appears to the Company that Staff's decision to endorse or reject company-specific depreciation studies is based not on the quality of the study, but, instead, on whether the study results in an increase or decrease in a company's current depreciation rates.

Company Witness: Thomas J. Sullivan, Vice President, Enterprise Management Division of Black & Veatch Corporation.

e. Low Income Weatherization/Natural Gas Conservation

What is the appropriate level of low-income weatherization funding to be used in calculating MGE's cost of service and how should such funding be allocated among the geographic regions of MGE's service territory?

Should funding for natural gas conservation programs be included in MGE's cost of service?

In its testimony in this case, MGE describes several gas conservation initiatives that the Company is willing to undertake if the Commission: 1) approves a residential rate design that neutralizes the financial affect on MGE of fluctuating customer usage, and 2) includes the cost of the conservation initiatives in rates to be set in this case. The Company's initiatives recognize energy efficiency as a high-priority; make a strong and sustainable commitment to implement cost-effective energy efficiency efforts; promote broad communication of the benefits of and opportunities for energy efficiency; and promote timely and stable funding for a program designed to deliver cost-effective energy efficiency. The details of these initiatives are set out in Schedule DH-1.

Broadly, the natural gas conservation initiatives proposed by MGE focus on two main elements. The first is communication and education regarding natural gas conservation and energy efficiency. The second is a water heater rebate program that is designed to encourage customers to install energy efficient water heaters, thereby potentially reducing a substantial portion of the usage within MGE's residential service class. In developing its program, the Company considered an additional element – a furnace rebate program – but concluded that adding a third element at this time might compromise the success of the first two. A furnace rebate program can be added later after satisfactory progress has been made in the communication/education and water heater rebate elements. Staff endorses MGE's proposed natural gas conservation initiatives, which would add $750,000 in revenue requirement to the cases of both MGE and the Staff.

With respect to low-income weatherization program funding, Staff also

recommends that: 1) the Commission increase the allowed level of expense for the Company's low-income weatherization program from $500,000 to $620,000 annually; and 2) that MGE participate in the evaluation of low-income weatherization that is currently being undertaken by Kansas City Power & Light Company ("KCPL") at an annual cost to the Company of $20,000. MGE agrees with Staff's recommendations, provided funds to cover the cost of those recommendations are included in rates set in this case.

The City of Kansas City ("City") proposes that MGE be ordered to increase its annual contribution to the City's weatherization program from $250,000 to $617,000. Although the Company fully supports the City's program and what it has accomplished, MGE believes the program should be expanded more gradually, and related funding increased more modestly, than the City has proposed. Should the Commission conclude otherwise, however, the Company is willing to support the degree of expansion that the City proposes, provided funding to support that expansion is included in rates set in this case.

Company Witnesses: Michael R. Noack, Director of Pricing and Regulatory Affairs.

David T. Hendershot, Manager, Business Support Services for Missouri Gas Energy

Russell A. Feingold, Managing Director of Navigant Consulting, Inc.

f. Environmental Response Fund

Should the environmental response fund proposed by MGE be adopted and what, if any, level of environmental costs should be used in calculating MGE's cost of service?

In 1994, Southern Union, MGE's corporate parent, completed its acquisition

of the Missouri natural gas operations of Western Resources, Inc. ("WRI") in a transaction that, after thorough review, was approved by the Commission in its Report and Order, dated December 29, 2003, in Case No. GM-94-40. Because the property that Southern Union acquired included several Manufactured Gas Plant ("MGP") sites that were subject to environmental investigation and/or remediation actions being conducted by and under the authority of federal and state regulators, Southern Union and WRI, as part of their transaction, entered into an "Environmental Liability Agreement" ("ELA") to "provide a framework for the liability of the parties for Environmental Claims[4] and for the sharing of Environmental Costs[5] . . .." Generally, the purpose of the ELA was to assign responsibility among insurance carriers, other "Potentially Responsible Parties" ("PRP"), ratepayers, Southern Union, and WRI for costs related to the environmental investigation and remediation activities that would be incurred after the closing of the acquisition transaction.

In the current case, MGE seeks authority to establish and fund an "Environmental Response Fund" ("ERF") that would be used to pay the Company's ongoing costs related to the investigation and remediation of the former MGP sites.

[4] As defined by the parties in the ELA, the term "Environmental Claim" means "any and all administrative or judicial actions, suits, demands, demand letters, directives, claims, liens or notices of noncompliance or violation by any Person alleging potential liability to pay removal, response, remediation or cleanup costs, damages or penalties (including, without limitation, potential liability for investigating costs, cleanup costs, governmental or other response costs, property damage or personal injuries) or to undertake compliance actions arising out of (a) the release or threatened release into the environment of any Hazardous Materials; or (b) circumstances forming the basis of an alleged violation of any Environmental Law; or (c) any and all claims by any third Person seeking damages, contribution, indemnification, cost recovery, compensation or injunctive relief arising out of the release or threatened release of any Hazardous Materials."

[5] As defined by the parties in the ELA, the term "Environmental Costs" means "all out of pocket costs and expenses (including reasonable attorneys' fees and expenses, but excluding consequential damages) actually incurred to respond to and remediate an Environmental Claim."

The terms and conditions governing the proposed ERF are set out on the second page of Schedule H-25. As specified there, costs payable from amounts accrued in the ERF are:

> All the reasonable and prudently incurred costs associated with evaluation, remedial and clean-up obligations of Missouri Gas Energy arising out of utility-related ownership and/or operation of manufactured gas plants and sites associated with the operation and disposal activities from such gas plants. In addition to the actual remedial and clean-up costs, "Environmental Response Costs" also include costs of acquiring property associated with the clean up of such sites as well as litigation costs, claims, judgments, expenditures made in efforts to obtain insurance reimbursements, and settlements – including the costs of obtaining such settlements – associated with such sites.

For each year the ERF remains in effect, MGE will file an annual report with the Commission, with copies provided to other interested parties, that provides a summary and accounting of all expenditures made from the fund. The Commission and each party receiving a copy of the annual report will then have the right to review and challenge any expenditures that are believed to be unjustified, excessive, or otherwise improper.

The types and size of the expenditures that MGE has made and can expect to make in the future include, but are not limited to: records and historical maps research; excavation test trenching; soil borings; installation of groundwater monitoring wells; laboratory analysis of soil and groundwater samples; evaluation of field and laboratory data; excavation and hauling of contaminated soil and debris; report preparation and submission; risk evaluation; and legal costs. From February 1994 through June 2006, MGE incurred approximately $9.9 million in costs related to MGP sites in the Kansas City area. Still more expenditures will be

required for the Kansas City sites, with additional remediation costs likely to fall within a range of $1 million – $10 million. In addition, Southern Union also has MGP sites, for which MGE may be responsible, in Joplin and Independence that also will require expenditures in the future.

Initially, MGE seeks to fund the ERF with an annual target amount of $500,000, to be collected from customers through a discrete rate element included in the basic service charge. Ongoing funding levels, however, will be determined in each subsequent MGE rate case during the life of the ERF. All amounts collected will be retained in an interest-bearing trust account. In addition, the ERF will receive: 1) a credit of what remains from a $3 million accrued liability that Southern Union established shortly after the closing of its acquisition transaction with WRI, and 2) one-half of any applicable insurance proceeds or contributions that are received in the future from other PRPs, net of costs incurred to obtain those proceeds or contributions.

The purpose of the ERF is twofold. First, it will provide a fund from which the Company can timely recover at least a portion of the substantial costs that will be incurred in the future as a result of the environmental investigation, any remediation liability that is imposed on MGE, and to pursue contributions from insurance carriers and other PRPs. Second, it will avoid the possibility of rate shock that likely will occur in the future if the Company is required to defer and accrue all of the aforementioned costs until such time as all of the activities related to the MGP sites are concluded.

Although MGE's proposed ERF is not a traditional ratemaking mechanism

employed in Missouri, several other jurisdictions have seen fit to adopt similar mechanisms that allow the tracking and payment of costs related to MGP remediation sites. As shown on Schedule MRN-1, the list of states that have either approved mechanisms similar to the ERF or included remediation costs in rates through a surcharge or other form of recovery includes California, New York, Illinois, Iowa, and Massachusetts. These states, and others, have recognized that for regulators, who are forced to deal with the lengthy and oftentimes costly problems that attend the environmental remediation of former MGP sites, a fund like the ERF offers significant advantages to both the Company and its customers while disadvantaging neither.

The amount and type of costs to be reimbursed from the ERF, although not currently known, will be fully known and measurable at the time disbursements are made from the fund. Moreover, those costs and will be subject to review as to reasonableness and prudence. In addition, the true-up and refund provisions of MGE's proposal assure that any funds that remain in the ERF when all remediation activities have been concluded will be returned to ratepayers.

The Company's proposal does not constitute "single issue ratemaking." MGE is presenting the ERF in the context of a general rate case where the Commission will consider and decide all aspects of the Company's cost of service, including the rate of return. If approved by the Commission, the funds in the ERF will be held in trust pending conclusion of all MGP-related remediation activities, so even if the ERF is over-funded from time to time that fact will not affect the Company's earnings in any way. Moreover, the Commission has a history of

approving cost recovery mechanisms, like the PGA, that are akin to the ERF in that they provide for controlled, carefully scrutinized, and audited recovery of future costs that will be incurred in amounts that are currently unknown. Just as those mechanisms do not constitute single-issue ratemaking, neither does the proposed ERF.

The proposed ERF also does not compensate the Company's shareholders for risks for which they have already been compensated through depreciation expense or rate of return. Depreciation rates, which theoretically provide for a return *of* investment made for the public service, do not include costs of potential environmental liabilities in their asset valuations. So even plant that is fully depreciated returns to shareholders only the value of the asset itself and not the costs of any environmental liability that may be related to that asset. And this Commission has never adjusted the rate of return that it has authorized for MGE to compensate the Company and its shareholders for the increased risks associated with MGP-related liability and remediation costs.

MGE's proposal to establish and fund an ERF to pay the ongoing costs associated with environmental remediation of MGP sites in Missouri reasonably and responsibly balances the interests of both the Company and its customers. By providing a pool of funds that the Company can use to help defray future costs related to remediation, the Commission will help safeguard MGE's financial integrity. At the same time, it will avoid future rate shock to customers that will likely result if MGE is forced to accumulate all costs related to its liability for MGP remediation and then pass on those costs to customers at one time.

Company Witnesses: Michael R. Noack, Director of Pricing and Regulatory Affairs;

Thomas J. Helfrich, Program Manager, Burns & McDonnell Engineering Company, Inc.

g. Infinium Software Amortization

Should the unrecovered cost associated with MGE's Infinium software be included in rates through an amortization and, if so, over what period should this cost be amortized?

In 2005, MGE discontinued use of certain general ledger and related financial reporting capabilities of the Infinium software system, which it had employed for several years. The Company, however, continues to use various of the other capabilities of that system. Although MGE has fully recovered through rates the original cost of the Infinium software, $1,225,756 in costs, which relate to updating and maintaining the capabilities of the system that continue to be used, remain on the Company's books. MGE proposees to amortize this balance over three years. But, in response to the Staff's suggestion that the balance be amortized over five years instead of three, the Company has elected to change its position to that of the Staff. Both MGE and Staff, therefore, now recommend a five-year amortization of the remaining Infinium costs.

The kind of regulatory treatment that MGE and Staff are requesting for the costs associated with the Infinium software is something the Commission has endorsed in the past. During the 1980s and 1990s, when telephone switching equipment changed from mechanical to digital, the Commission often faced the situation where the cost of mechanical equipment that was being replaced had not been fully recovered. The only way to rectify that situation was to authorize the telephone company to set up an amortization to recover the balance of its

investment. One example of a case where the Commission approved such a recovery was the Report and Order issued in Case No. TR-98-343, Mid Missouri Telephone, where a five-year amortization of the unrecovered switching investment was authorized.

Company Witness: Michael R. Noack, Director of Pricing and Regulatory Affairs.

h. Emergency Cold Weather Rule AAO Recovery Mechanism

What is the proper rate treatment for costs deferred under the Emergency Cold Weather Rule AAO Recovery Mechanism?

By its order dated December 21, 2005, in Case No. GX-2006-0181, the Commission approved an emergency amendment to the Cold Weather Rule, 4 CSR 240-13.055, which contained special provisions applicable only to providers of natural gas service to residential customers. Specifically, the emergency rule provided for additional repayment plans for customers who used natural gas for home heating but were unable to pay up to eighty percent of their pre-existing bills under the previous rule.

The more liberal payment and reconnection provisions of the emergency rule raised the specter of increased levels of bad debt for Missouri's natural gas utilities. In recognition of this fact, On September 21, 2006, the Commission issued an order granting MGE's request for an Accounting Authority Order ("AAO") that authorized the Company to maintain a regulatory asset on its books for costs related to complying with the emergency cold weather rule. In accordance with that AAO, MGE accumulated a balance of $901,331 on its books as of June 30, 2006, which represents the difference between what it would have collected and what it actually collected from 2,976 customers whose service was reconnected under the

emergency rule but was later disconnected for non-payment of bills.

Staff has audited and verified the amount of the regulatory asset related to the emergency cold weather rule that MGE has recorded on its books, and Staff is proposing that the full amount of that asset be amortized and collected from customers over a period of three-years.

Company Witness: Michael R. Noack, Director of Pricing and Regulatory Affairs.

IV. CCOS, RATE DESIGN AND MISCELLANEOUS TARIFF LANGUAGE

Class Cost of Service

With regard to the allocation of any revenue increase, MGE considered various criteria in order to recommend an appropriate apportionment of revenues among the rate classes, thereby deriving a reasonable balance between competing interests. Cost of service, class contribution to present revenue levels, and customer impact considerations were all taken into account, and these criteria were evaluated for each rate class. Ultimately, MGE proposed adjustments to class revenue levels so that the proposed rates would move class revenues closer to the costs of serving those customers.

MGE, Staff, MGUA, Central Missouri State University, the University of Missouri, Kansas City and Jackson County have agreed and jointly recommend that any revenue increase authorized by the Commission should be spread among the rate classes on the basis of an equal percentage of current non-gas revenues. This agreement has been presented to the Commission in the form of a "Partial Nonunanimous Stipulation and Agreement," which was filed on December 8, 2006. Although MGE does not accept the cost of service studies presented by Staff or

the Office of the Public Counsel ("OPC"), MGE agrees, for purposes of settlement, with the equal percentage revenue spread as a fair disposition of this issue for purposes of this case.

Rate Design

In this case, MGE has set out two rate design proposals for the Commission's consideration. The Company's primary and preferred rate design proposal establishes a Straight Fixed-Variable ("SFV") rate structure for the residential class and the continuation of the "traditional" rate structures for the SGS, LGS, and LVS rate classes. The alternate proposal consists of a Weather Normalization Adjustment ("WNA") mechanism applicable to the Company's residential, SGS, and LGS rate classes. This alternate proposal is designed to adjust the Company's volumetric rates on a monthly basis to account for changes in weather from the normal levels established in the Company's current rate case and to make more modest changes in the levels of the Company's fixed monthly rate elements for the residential and SGS rate classes compared to the levels reflected in the Company's primary proposal.

Under the SFV rate structure, residential customers will simply pay a flat monthly fee for the delivery services provided by MGE and will continue to pay for the amount of gas commodity used each month on a volumetric basis through the PGA. The SFV rate structure is characterized as such because all fixed costs incurred by the utility are recovered from customers through fixed charges, while all variable costs are recovered through variable charges. This pricing concept is new to Missouri LDCs, but it has been used in the interstate gas pipeline industry

for many years. More recently, it has been adapted for use by gas distribution utilities. An SFV rate structure helps to achieve a fundamental objective of ratemaking – the proper alignment of costs with revenues and rates.

The Company is proposing a rate design change at this time because the current "traditional" rate structure in effect for MGE has been proven to be inadequate to address major business challenges gas utilities such as MGE: weather variability, declining use per customer, high and volatile wholesale natural gas prices and resulting increases and volatility in customer bills. These factors challenge the ability of customers to manage their energy needs and result in serious challenges to the financial integrity of the Company. In order for MGE to have a reasonable opportunity to achieve its Commission-authorized return and to compete, with some meaningful likelihood of success, for the capital it needs to continue operating its distribution system for the benefit of its customers, MGE must be given a meaningful ability to address these challenges.

MGE has experienced chronic and continuing earnings shortfalls. For example, Schedule H-21 demonstrates the volumetric revenue shortfall suffered in January, February, and March of 2006 due to the shortfall in actual average usage per customer when compared to the average usage as determined in the Company's prior rate case. Additionally, Schedule G-4 demonstrates that in each fiscal year from 1996 through 2005, the Company's achieved rate of return was well below the Commission-authorized rate of return. The fixed cost nature of the gas distribution business and a consistent track record of volumetric revenue-driven earnings shortfalls demands a new approach to the ratemaking process so

that MGE will have a reasonable opportunity to recover its costs of providing gas service and of achieving its Commission-authorized earnings level.

The rate design proposed by MGE in this case is fully cost-based, equitable, and beneficial to the Company and its customers. Under the SFV rate structure, when it is colder than normal, customers do not overpay for the fixed costs, and the Company does not over-recover the approved margin. When it is warmer than normal, customers do not underpay, and the Company does not under-recover the margin. Under the SFV rate design for the residential class, the Basic Service Charge will be $27.50/month (based on a number of assumptions, including an overall revenue increase of $41.7 million). The Commodity Charge is eliminated, and the Company's fixed costs of natural gas delivery service will be recovered from these customers through a single, fixed monthly charge. (Feingold Direct, p. 36)

In addition to affording benefits to MGE, this fixed monthly charge results in numerous benefits for MGE's customers. For example, although the rate design will increase the average customer's bills in the summer months, the rate design will decrease or moderate the increase in a customer's bills in the winter months – the time period when customers' usage and gas bills are highest and, accordingly, when most difficulties in paying gas bills arise. The practical effect of the SFV rate design is to moderate seasonal variability in the amount of a customer's bill. Accordingly, MGE expects many of its customers will react favorably to this change. The pricing of the Company's gas delivery services using the proposed SFV rate design properly portrays to MGE's customers the fixed nature of the

costs, the delivery-only characteristics of the service MGE provides, and the fact that natural gas is the real commodity being purchased. Additionally, if the Commission adopts the SFV rate design recommended by MGE, and endorsed by the Staff, for the residential class, MGE's recommended return on equity would be reduced by 25 basis points, producing a revenue deficiency of $36,449,902 instead of the $37,533,421 which is the case in the absence of any meaningful protections from the weather variations.

The Company and the Staff are in conceptual agreement on the rate design that is most appropriate for MGE's residential customers – an SFV type of rate structure. Staff has not, however, applied the principle of recovering fixed costs through a fixed charge for the SGS class. The failure to include the substantial fixed costs attributable to the SGS class is a significant shortcoming in Staff's SFV proposal and, consequently, does not fully address MGE's chronic and continuing volumetric revenue shortfalls.

In the event the Commission does not adopt a SFV type rate design as proposed by the Company and Staff, MGE has provided the Commission with an alternative. Under the Company's alternate rate design proposal (use of a WNA mechanism), the current rate structure for the residential class was maintained with the proposed Customer Charge set at $15.50/month, and a Delivery Charge designed to recover the balance of the assigned revenue increase for that class. The proposed Customer Charge for the SGS class is set at $20.50/month. For both of these classes, the primary objective is to move the monthly customer

charges toward the fixed costs of delivery service – consistent with the results of MGE's cost of service study discussed above.

The proposed WNA mechanism will remedy some of the same problems the Company would like to address with its proposed SFV rate design proposal, although it will not address the problem of declining use per customer caused by factors other than weather.

It is time to implement a proposal in the nature of MGE's proposed SFV rate design or alternate WNA rate design. ***The traditional gas utility ratemaking process – a static process that relies on historically based assumptions of customer gas usage and weather – is simply no longer doing its job.*** With today's highly uncertain and volatile gas commodity pricing – an environment of which the commissioners are well aware – historically-based assumptions seldom reflect the actual gas usage levels and weather patterns experienced by a utility in any subsequent twelve-month period. The traditional approach of heavy reliance on volumetric rate elements to recover fixed costs is counterproductive in an environment wherein ***reduced*** natural gas use should be a priority to MGE and its customers. A more dynamic process is required in order for MGE to actually recover the Commission-approved cost of service and have a reasonable opportunity to achieve its authorized earnings level.

There are two key assumptions inherent in the use of a test year for purposes of establishing a gas utility's base rates: 1) that a test year represents a snap shot in time that reflects a level of plant and expenses which will be representative of the period the new rates will be in effect; and 2) that the utility's

costs in a future period can in fact reasonably be represented by its historical costs or, as in this case, its forecast of future costs. In reality, however, many of a utility's costs are unpredictable, unstable, and uncontrollable.

For example, so-called normal temperatures seldom, if ever, occur. Yet, with traditional ratemaking, a utility only has a reasonable opportunity to fully recover its fixed costs of service at established levels if actual temperatures are "normal." Additionally, MGE has experienced a substantial decline in gas use per customer.

Looking to past rate cases, the Company's baseline use per customer levels have not been representative of the actual use per customer experienced in subsequent years. The baseline use per customer level for MGE's residential class has always been high relative to the actual usage amounts. Accordingly, MGE's collection of margin revenues was low relative to the levels approved by this Commission. If this trend continues, base rates will never allow MGE to properly recover the fixed costs incurred to provide its customers with gas delivery service. ***Total volumetric revenue shortfalls during the last seven years amount to almost $42 million,*** and this type of under-recovery of fixed costs is not unique to MGE. This problem has been solved or mitigated for a growing number of gas utilities, as is discussed below, but this serious problem continues to impact MGE's financial performance and the natural gas bills of its customers.

This revenue shortfall problem has received much attention from state utility regulators over the last five or six years. To mitigate the variability in revenues caused primarily by weather and declining use per customers, the following

ratemaking solutions have been implemented: 1) revenue decoupling mechanisms that adjust for changes in usage caused primarily by weather and energy conservation; 2) weather normalization adjustment mechanisms that adjust rates for changes in usage caused by weather; 3) monthly customer charges that more fully reflect the gas utility's fixed costs of providing delivery service (including SFV rate structures); and 4) a measure of "normal weather" that is an accurate predictor of the weather expected in future years and a reasonable basis for deriving a gas utility's normalized sales volume in its rate case.

As virtually all of MGE's margin consists of fixed costs, and because the Basic Service Charge under the Company's proposed SFV rate structure for residential customers is designed to recover 100 percent of those fixed costs, the Company's ability to recover its Commission-approved level of margin through base revenues no longer will be subject to the ongoing fluctuations in customer usage caused by weather, energy conservation, and energy efficiency activities. MGE's customers will benefit as well by less seasonal variability in their gas bills and, in many instances, by lower yearly gas service costs. Rates should be more stable as well because MGE will not be forced to file for frequent rate increases to address systemic margin losses. Severing revenues from usage also will encourage gas conservation initiatives which will further benefit MGE's customers.

In summary, the benefits of implementing a SFV rate design for MGE are many and compelling.

- There will be less seasonal variability in customers' bills.In particular, it will lower winter bills.

- It removes the disincentive for MGE to actively promote natural gas conservation and the Company's PGA will retain the incentive for customers to conserve on natural gas usage.

- The overall revenue requirement will be over $1M lower with the SFV rate design than in a "traditional" rate design.

- MGE's customers will find their bills easier to understand.

- MGE will be able to file fewer rate cases and thereby lower costs to its customers and free Company management to focus on its principal mission, which is to provide safe and reliable gas service to its customers.

- The SFV rate design will send the correct price signals to customers because it is anchored in the actual cost of providing service.

Company Witnesses: Ronald J. Amen, Director with Navigant Consulting, Inc.

Russell A. Feingold, Managing Director of Navigant Consulting, Inc.

Philip B. Thompson, RT Associates

e. Seasonal Disconnects

Should the seasonal disconnect tariff language proposed by MGE (on Sheet No. R-31) be approved?

MGE initially proposed that any customer who voluntarily requests a disconnection of service, and then subsequently requests a reconnection of service at the same address or premise within the next seven (7) months, be charged a reconnection charge equal to the greater of the current $45 reconnection charge or a charge equal to the number of months the service was disconnected, up to seven (7) months, times the basic service charge.

In response to a suggestion from Staff, MGE has changed its original proposal slightly in order to institute a two-component reconnection charge. First, MGE would charge the traditional reconnection charge plus the monthly Customer

charge (in today's environment) or, secondly, the Delivery Charge (in the proposed environment) that was foregone during the disconnection period.

MGE is not advocating an increase in the reconnection charge for customers who have been disconnected involuntarily. MGE does not wish to increase charges for customers who have been disconnected for non-payment or are otherwise having trouble paying their utility bills. For that reason, MGE does not agree with Staff's proposal to apply the disconnection fee with no exceptions. This proposed new charge is to allow MGE to recover its costs associated with voluntary disconnections and to provide a disincentive to customers who disconnect during the non-heating months simply to avoid paying the Basic Service Charge during those months.

Company Witness: Michael R. Noack, Director of Pricing and Regulatory Affairs.

V. MISCELLANEOUS

a. Should the Commission order Staff's proposed PGA language put in MGE's Tariffs?

Staff has recommended that language be added to MGE's PGA tariff requiring the Company to provide documentation to Staff which supports its gas procurement activity applicable to each ACA period. The tariff language would require that all documentation concerning the Company's gas purchasing decisions for the ACA period be submitted to Staff.

MGE does not agree with this proposal. MGE currently provides the workpapers used to prepare the annual ACA filing to the Staff at the time it makes that filing. Other information requested by Staff customarily is supplied in response to data requests on a timely basis. Staff has not alleged that the documentation

currently provided by MGE is inadequate, that the annual filings MGE makes to true-up its gas costs and revenues is insufficient, or that MGE is not properly planning for its future gas needs. If the Staff believes that MGE should be required to provide additional information with its ACA filing – whether this requirement is to be documented through a tariff sheet or in some other fashion – MGE believes that the Staff should initiate a rulemaking for that purpose, which would apply to all LDCs in Missouri, and not through a proposal that burdens only MGE. This rate case is not the appropriate forum in which to impose this type of requirement.

Company Witness: Michael R. Noack, Director of Pricing and Regulatory Affairs.

b. Should the Kansas Property Tax AAO be continued past the expiration date ordered by the Commission in Case No. GU-2005-0095?

Pursuant to the AAO authorized in Case No. GU-2005-0095, MGE has deferred a total of $3,422,206 of Kansas property taxes for the years 2004 and 2005. The issue of whether property taxes should be assessed on stored gas has been appealed and is still pending in the Kansas Supreme Court. The Company does not expect a decision from the Kansas court anytime in the near future. Based on the prior order of the Commission, MGE will only be allowed to defer property taxes on gas in storage until the end of 2006 before amortization of the balance must begin. MGE does not expect a final court decision to be issued before the end of the current year; therefore, MGE is requesting that the Commission continue the deferral until such time as MGE concludes its next general rate proceeding before having to begin amortization.

Staff recommends that the Commission grant MGE the authority to continue deferring these costs through the end of an additional year (2007), or until a final decision is issued by the Kansas courts, whichever occurs first and suggests that this authority be included in the Commission's final order issued in this proceeding. MGE concurs with Staff's recommendation.

Company Witness: Michael R. Noack, Director of Pricing and Regulatory Affairs.

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CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the above and foregoing document was electronically transmitted, sent by U.S. Mail, postage prepaid, or hand-delivered, on this 21st day of December, 2006, to:

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