Exhibit No.: _____
Issue: Policy, Rate Base, Tariff Changes, Rate Design
Witness: Timothy R. Johnston
Exhibit Type: Direct
Sponsoring Party: Missouri Gas Utility, Inc.
Case No.: GR-2008-____
Date: _________

MISSOURI PUBLIC SERVICE COMMISSION

CASE NO. GR-2008-____

DIRECT TESTIMONY

OF

TIMOTHY R. JOHNSTON

ON BEHALF OF

MISSOURI GAS UTILITY, INC.

TABLE OF CONTENTS

DIRECT TESTIMONY
OF
TIMOTHY R. JOHNSTON

MISSOURI GAS UTILITY, INC.

CASE NO. GR-2008-____

DIRECT TESTIMONY
TIMOTHY R. JOHNSTON
MISSOURI GAS UTILITY, INC.

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. Timothy R. Johnston, 7810 Shaffer Parkway, STE 120, Littleton, CO 80127.

Q. **ON WHOSE BEHALF IS YOUR TESTIMONY PRESENTED?**

A. Missouri Gas Utility, Inc ("MGU" or the "Company").

Q. **BY WHOM AND IN WHAT CAPACITY ARE YOU EMPLOYED?**

A. I am the Executive Vice President of MGU, and also hold that position in CNG Holdings, Inc., of which MGU is a wholly-owned subsidiary.

Q. **PLEASE STATE YOUR EDUCATIONAL BACKGROUND AND RELEVANT BUSINESS EXPERIENCE.**

A. Information responsive to this question is shown in the attached **Appendix 1**.

Q. **HAVE YOU TESTIFIED BEFORE OTHER REGULATORY BODIES?**

A. Yes. I have testified before the Colorado Public Utilities Commission.

Q. **IN WHAT CAPACITY?**

A. I have testified as a policy witness and as the representative for Colorado Natural Gas, Inc., an affiliate of MGU.

Q. **WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?**

A. I will describe MGU and give a brief history of the system, including a description of the municipal entities that originally operated the system and the derivation of the initial rates set in Case No. GO 2005-0120. I will lay out the rationale for filing this case as a formal case. I will address the three issues identified in that Case as issues to be settled in MGU's first rate case: corporate allocations, treatment of the acquisition costs and the valuation of the plant in service. I will present the rate increase request and describe the various parts of that request. I will also introduce new tariff provisions intended to normalize MGU's revenues with respect to variations in weather. Finally, I will present information on the on-going expansion and projected growth in the load on the MGU system, and the known and measurable changes these will bring to the Cost of Service Study.

Q. **ARE YOU SPONSORING ANY SCHEDULES?**

A. Yes, I am sponsoring Schedules TRJ-1, 2 and 3.

Q. **WERE THESE EXHIBITS PREPARED BY YOU OR UNDER YOUR DIRECTION?**

A. Yes.

Q. **PLEASE PROVIDE A BRIEF DESCRIPTION OF MISSOURI GAS UTILITY, INC.**

A. MGU was formed in October, 2004. Along with Colorado Natural Gas, Inc., Colorado Water Utility, Inc., Deer Creek Water, LLC and Wolf Creek Energy, LLC, MGU is a wholly owned subsidiary of CNG Holdings, Inc. Of the affiliates, Colorado Natural Gas, Inc. and Colorado Water Utility, Inc. are utilities regulated by the Colorado Public Utilities Commission. Deer Creek Water, LLC is an entity that holds water rights for use in present and future water utility projects, and Wolf Creek Energy is a natural gas broker that normally only sells gas to three transportation customers located in Teller County, CO. An organizational chart is attached as Schedule TRJ-1.

In the summer of 2004, we became aware that the towns of Gallatin and Hamilton, Missouri had elected not to appropriate funds for the payment of two separate lease/purchase contracts. The termination of the contracts by the non-appropriation of funds by the towns was permitted under the terms of the contracts that the towns had entered into to acquire the municipal natural gas systems located in their respective communities. The owner of the systems, a bank trust department, was attempting to sell the systems to retire the debt secured by the systems and had engaged an investment bank to find prospective buyers. A rapid assessment of the systems and an analysis of the financial records led to the formation of MGU and the submittal of a bid to purchase the systems from the owner. Once we were advised that our bid was accepted, MGU personnel contacted the MPSC Staff and set up a meeting to discuss a transfer application. The MPSC Staff and the Company worked closely together to expedite the transfer as neither the cities nor the systems' owner would commit to purchase any additional gas to cover the winter heating season, and a projection of the daily usage compared to the quantity of gas in storage revealed that the systems would be out of supply in early December, 2004. Subsequent analysis showed that this did indeed occur. The gas in storage that was owned by the cities was depleted on December 4, 2004, but by that time Wolf Creek Energy, LLC, an affiliate of MGU, had purchased additional gas into storage to cover system needs through the transfer period.

The result of the transfer application, Case No. GO 2005-0120, was that MGU became the owner of the two former municipal systems. MGU has operated these systems since January 1, 2005. During that time we have increased the service line count from 774 to 1023. Almost all of this growth has been in-fill on the existing systems,

The original municipal systems which constitute the current MGU system were constructed in 1995 and 1996. The system consists of 242,880 feet of 6" and 73,920 feet of 4" steel main line that run roughly north to south from Brooklyn, MO to Hamilton. This mainline provides gas to low pressure distribution systems in Jamison, Coffey, Gallatin and Hamilton, as well as service to numerous customers along the pipeline route. These distribution systems are comprised of 4" and 2" polyethylene pipe and ½" and ¾" service lines to the commercial and residential customers in those communities.

Q. PLEASE DESCRIBE THE CURRENT RATES AND THE PROCESS THAT LED TO THE ADOPTION OF THOSE RATES.

The Gallatin and Hamilton municipal systems had different rate structures, which had been established by the two City Councils. MGU examined these rates and proposed initial rates that met two criteria: the Monthly Customer Charge was to remain the same as the lower of the two municipal rate structures for each class of customer, and no customer would experience an initial increase in rates as a result of the acquisition.

The rates that were placed into effect as a result of this process serve customers in six rate classes. These six classes can be further divided into two broad categories: regular customers and institutional customers. The former Gallatin municipal rate structure included preferential rates for government and other "institutional" customers, which included all non-profit and not-for-profit entities, schools, nursing homes, and churches. The commodity rate for these customers has been only 71.57% of the commodity rate paid by the regular customers. Within each of the broad "regular" or "institutional" classes, MGU serves customers under three rate schedules. The first is the General Service schedule, which includes all residential customers and commercial customers with meters of less than 500 CF/hr capacity. The second is the Commercial Service schedule which includes all commercial customers with meters rated at capacities between 501 CF/hr and 1400 CF/hr at ½ inch water column pressure drop across the meter. Finally, a third group of customers with meters rated at capacities greater than 1401 CF/hr are served under the Large Volume Service schedule.

MGU would characterize the current rates as historically derived rather than set in accordance with the usual regulatory procedure. Correcting this situation was one of the factors considered in the decision to file this case.

Q. **WHY DID MGU FILE THIS REQUEST AS A "FORMAL" RATE CASE?**

A. The Nonunanimous Stipulation and Agreement in Case No. GO-2005-0120, which was ultimately approved by the Commission, required that MGU "not utilize the Gas Utility Small Company Rate Increase Procedure found in Commission Rule 4 CSR 240-3.240 for its first general rate case."

Q. **WAS THIS REQUIREMENT IMPORTANT TO THE COMMISSION STAFF?**

A. Yes. In its Memorandum in Support of the Nonunanimous Stipulation and Agreement, Staff stated as follows:

"This provision is important because several matters requiring a detailed audit will be determined in MGU's first rate case. Some of these matters to be determined include corporate allocation issues, treatment of acquisition costs and plant in service valuation. Detailed information must be available in order to let the parties produce evidence on these and other issues and for the Commission to be able to make an informed decision on these issues. Only a general rate case will provide this opportunity."

Q. **PRIOR TO FILING THIS CASE, DID MGU EXPLORE WHETHER STAFF STILL PREFERRED THAT MGU USE THE FORMAL RATE CASE PROCESS?**

A. Yes. MGU contacted Staff about this matter and after some discussion was informed that Staff's position on this issue had not changed.

Q. **MOVING ON TO THE ITEMS LISTED ABOVE AS REASONS FOR THIS CASE TO BE FILED AS A FORMAL CASE, PLEASE DESCRIBE THE CORPORATE ALLOCATION METHODOLOGY USED BY MGU AND ITS PARENT, CNG HOLDINGS, INC.**

A. CNG Holdings, Inc. and all its subsidiaries use the Distrigas Method for allocating operating costs from the holding company that are not directly charged to a specific subsidiary. The Distrigas Method allocates these costs by the average of three ratios: Direct Labor, Capital Investment, and Net Revenue. The use of this allocation method was suggested by the Colorado Public Utilities Commission Staff, and Colorado Natural Gas, Inc. agreed to this method in its 2006 rate case, which was ratified by Decision R06-0194. Colorado Natural Gas, Inc., along with all other regulated utilities in Colorado, was required by that Commission to file a Cost Assignment and Allocation Manual (CAAM) during the past year. The regulatory staff at CNG Holdings has also produced a version of this CAAM for MGU. This CAAM is provided as Schedule TRJ-2.

Q. **IS MGU PROPOSING TO RECOVER THE COSTS RELATED TO ITS SYSTEM ACQUISITION IN 2004?**

A. Yes. MGU has included the unamortized balance of start-up costs in rate base and included the annual amortization as an element of O&M.

Q. **PLEASE CITE THE RELEVANT PROVISIONS OF THE AGREEMENT ENTERED INTO BY THE PARTIES IN THE STIPULATION & AGREEMENT IN CASE NO GO-2005-0120.**

A. Condition #9 in the Stipulation and Agreement addresses the merger & acquisition costs. It requires MGU to: (1) to establish a twenty year amortization period for accounting purposes only: (2) isolate the costs in a specific FERC account: and, (3) disclose those costs under a protective order in its next general rate proceeding.

Q. **DOES CONDITION # 9 ASSURE MGU OF INTERVENOR SUPPORT SHOULD MGU REQUEST RECOVERY OF THE MERGER & ACQUISITION COSTS?**

A. It does not. In fact, it specifically cites the possibility that MGU may not be allowed to recover those costs in a subsequent general rate proceeding.

Q. **WHY SHOULD MGU BE ALLOWED TO RECOVER THOSE COSTS?**

A. The costs were prudently incurred and necessary to acquire and operate the system. The practical difference between this asset and other used and useful assets is nonexistent.

Q. **WHERE IN MGU'S FILING ARE THE COSTS AND AMORTIZATION SHOWN?**

A. Mr. Taylor's direct testimony will explain the details of MGU's request in this regard.

Q. **IS MGU PROPOSING A RATE BASE ADJUSTMENT RELATED TO ITS ACQUISITION OF THE SYSTEM IN DECEMBER 2004 TO REFLECT NET ORIGINAL COST?**

A. Yes.

Q. **PLEASE DESCRIBE THE REGULATORY BACKGROUND OF YOUR PROPOSAL.**

A. MGU purchased the distribution system for $1.9 million and began operations in January 2005. According to the accounting records acquired from Gallatin and Hamilton, the original construction cost of the system to the previous owners was approximately $6.8 million. (Because the lease/purchase financing contract was considered a "capital lease" under general accepted accounting principles, the systems were recorded as assets of the respective town and the present value of the lease obligations was recorded as debt of the respective town.) The original feasibility studies prepared by the previous ownership projected 1,718 customer connections and, presumably, that customer count would have supported the original investment. The customer count in January of 2005 was 774. MGU booked its original investment to Utility Plant in Service on the basis of that investment.

Q. **PLEASE STATE YOUR UNDERSTANDING OF THE COMMISSION'S POLICY RELATED TO NET ORIGINAL COST.**

A. In previous orders the Commission has adopted a default proposition that says, absent other influences, original cost, net of accumulated depreciation, should be the basis upon which rates will be established. Specifically, in Case No. EM-2000-292; Second Report and Order, issued February 26, 2004; page 6; "...ratepayers do not receive lower rates through a decreased rate base when the utility receives a negative acquisition adjustment. Even if a company acquires an asset at a bargain price, it is allowed to put the asset into its rate base at its net original cost. Similarly, ratepayers do not share in the gains a utility may realize from selling assets at prices above their original cost." Therefore, an acquisition premium would not be included in the net book value used to calculate rate base and, conversely, an acquisition discount or negative acquisition adjustment would not reduce net book value for rate making.

Q. **DID THE COMMISSION OFFER GUIDANCE IN ITS CASE NO. GO-2005-0120 ORDER APPROVING MGU'S ACQUISITION?**

A. No. The Commission accepted the Stipulation and Agreement that acknowledged the potential treatment of the acquisition adjustment in a future rate case. Condition #10 on p. 5 in the Stipulation and Agreement in that Case acknowledged the probable intent of MGU to seek rate treatment based on net original cost: "For any plant item transferred to MGU for which MGU seeks inclusion in rate base in future rate proceedings at a value in excess of the amount reflected in the purchase price for these properties, it shall be MGU's burden to demonstrate that these costs were prudently and reasonably incurred, and otherwise appropriate for inclusion [in] the establishment of just and reasonable rates."

Q. **DOES MGU PROPOSE TO INCLUDE THE DIFFERENCE BETWEEN ITS ACQUISITION COST AND THE NET BOOK VALUE RELATED TO ORIGINAL SYSTEM COST IN MGU'S RATE BASE IN THE CURRENT REQUEST?**

A. No. In this case MGU proposes a hybrid approach to the net original cost approach wherein a proportional amount of the discount from original cost-based net book value is added to Utility Plant in Service to acknowledge the additional customers brought on to the system since MGU acquired the system. MGU's proposal does not ask for immediate recognition of the net original cost in its used and useful investment but rather, requests permission to: (1) add $3,676,439 to Account 106: and, (2) transfer $899,637 of the Account 106 balance to Account 101 for the purpose of calculating rate base in this proceeding.

Q. **PLEASE EXPLAIN THE CONCEPT IN MORE DETAIL.**

A. MGU has calculated the difference between its acquisition cost and the net original cost of the utility plant in service at the time the system was acquired. That difference is $3,676,439. We propose that this amount be added to Account 106 – Plant Held for Future Use. Further, the balance of that account would not be included in rate base in this or subsequent rate cases. However, for each new customer brought on the system by MGU since acquisition, $3,894 would be transferred to Account 101 - Utility Plant in Service. The entire Account 106 balance would be completely transferred when MGU has added 944 customers.

Q. **WHAT IS THE SIGNIFICANCE OF 944 CUSTOMERS?**

A. 944 is the difference between the original projected customer count considered by the previous owners as the justification for the original investment and the number of customers on the system when MGU purchased the system. So, the additional net original cost would be added to Utility Plant in Service proportionately as MGU adds customers.

Q. **HOW DOES THIS APPROACH COMPLY WITH THE "USED AND USEFUL" RATE MAKING PRINCIPLE FOR DETERMINING INVESTMENT SUBJECT TO A RETURN?**

A. The six inch and four inch diameter steel main pipeline built to serve the current franchise areas was clearly underutilized prior to MGU's acquisition. Consequently, a party might argue that a portion of the capacity was not "used and useful." MGU's initial rate base included less than a third of the original investment. MGU's proposal acknowledges the value of increased capacity usage by allowing plant to increase only as MGU's customer expansion performance can be shown to increase the "used and useful" portion of the original investment.

Q. **HAS MGU PREPARED AN ANALYSIS SHOWING THE DESCRIBED CONCEPT?**

A. Yes, Mr. Taylor's testimony and Schedule KDT-4, Cost of Service Adjustments, provide the analytical detail to support the conceptual framework I have explained.

Q. **MOVING ON TO THE PRIMARY PURPOSE OF THIS APPLICATION, WHAT IS THE PROPOSED INCREASE IN REVENUES THAT MGU IS SEEKING THROUGH THIS APPLICATION, AND WHY IS THIS INCREASE NECESSARY?**

A. As shown in the Minimum Filing Requirements, (Appendix B to the cover letter for this filing and Schedule TRJ-3 attached hereto) MGU is seeking an overall increase in base revenues of $443,131. This is a 28.42% increase in the current revenues. Without this increase, MGU's return on common equity would be 1.26%, in a year that matched the heating degree-days of the 30-year normal. MGU's actual return on common equity has not reached even that figure during the time since acquisition, due to weather that has been significantly warmer than the 30-year average.

Q. REVIEWING THE REMAINDER OF SCHEDULE TRJ-3, MGU IS PROPOSING TO REALIZE THIS INCREASE BY INCREASES IN BOTH THE COMMODITY CHARGE AND THE MONTHLY CUSTOMER CHARGE. WHAT IS THE JUSTIFICATION FOR THE INCREASE IN THE MONTHLY CUSTOMER CHARGE?

A. MGU currently receives approximately 20% of its non-PGA revenues from the Monthly Customer Charges. The proposed increase in this charge will essentially maintain this ratio. Failure to keep this ratio at or above the current level would subject the company to additional risk associated with weather variations. MGU has chosen in this filing not to seek a straight fixed/variable rate design, as has been approved by this Commission in recent cases. While this type of rate design would help eliminate risk to the Company from weather variations, MGU does not believe that such a change would be well received by its customers at this time.

Q. **CONTINUING TO EXAMINE SCHEDULE TRJ-3, THE COMMODITY CHARGE INCREASES ARE NOT EQUAL FOR ALL RATE SCHEDULES. WHY ARE THERE DIFFERENCES?**

A. Except for the Interruptible Sales Schedule, the increases fall into two groups, the regular rate schedules and the institutional rate schedules. The difference is caused by bringing both groups up to a single Commodity Charge. MGU does not believe that continued preferential treatment of governmental and other institutional customers is fair to the regular residential and commercial customers on the system. These institutional customers generate the same costs for the Company to provide service as the regular customers, and the rate structure should reflect this fact. MGU, through this filing, is proposing to discontinue service under the GSI, CSI and LVSI Rate Schedules and to consolidate these customers into the GS, CS and LVSI Rate Schedules. The proposed new Commodity Rate would then be equal for all full-rate customers. MGU does not currently have any customers served on the Interruptible Sales Service Rate Schedule; the maximum Commodity Charge on that Schedule was set to the same as the remaining Schedules for consistency. The maximum Commodity Charge on the Transportation Service Rate Schedule was also set to the same as the proposed Commodity Charge for the sales Rate Schedules.

Q. **DOES MGU SERVE ANY CUSTOMERS UNDER THE TRANSPORTATION SERVICE RATE SCHEDULE?**

A. Yes. Premium Standard Farms (PSF) is MGU's only transportation customer, representing approximately 30% of MGU's annual throughput. The customer has five meters and pays five monthly customer charges.

Q. **DOES PSF PAY THE MAXIMUM COMMODITY CHARGE RATE UNDER THE TRANSPORTATION SERVICE RATE SCHEDULE?**

A. No. In 2002, prior to MGU's ownership of the distribution system, a contract was executed by the City of Gallatin and Premium Standard Farms wherein the municipal utility would provide transportation service for $2.70 per MMBtu. MGU inherited that contract and has honored its terms since January 2005 when MGU initiated operations. In this filing MGU proposes to increase both the monthly customer charges from $125 per meter per month to $200 per meter per month and the commodity charge from $2.70 per MMBtu to $3.50 per MMBtu. MGU has chosen to acknowledge the competitive environment with propane by maintaining a discount from the proposed maximum commodity charge of $5.557 per Mcf.

Q. **DOES PSF HAVE THE CURRENT ABILITY TO SWITCH TO PROPANE?**

A. Yes. PSF has on-site propane tanks and could switch fuels. In addition, PSF has hog production facilities elsewhere in the State of Missouri to which it could move the production currently accomplished at the sites connected to the MGU system.

Q. **HAS MGU PERFORMED ANY STUDIES TO JUSTIFY THE CONTINUED DISCOUNT?**

A. Yes. Based on the current NYMEX futures for propane and the historic usages for PSF, MGU estimates the annual total cost of this alternate fuel for this customer to be $646,000. Including the current MGU RPGA Charge, the proposed increased

Monthly Charges and the proposed increase in the discounted transportation rate, the total annual cost of natural gas will be $596,000.

Q. **DO THE TERMS OF THE CONTRACT ALLOW MGU TO INCREASE THE TRANSPORTATION RATE?**

A. Yes, the original term has expired and the Parties are operating on a month-to-month basis.

Q. **WHAT WOULD BE THE EFFECT ON MGU IF PSF WERE TO LEAVE THE SYSTEM?**

A. The annual revenue requirement requested in this case is $1,055,054. PSF's share is $191,708, or approximately 18%. The rate design deployed by MGU reduces the revenue requirement for retail sales customers by the amount anticipated from PSF. The loss of PSF would shift PSF's revenue responsibility to MGU's retail sales customers.

Q. **WOULD MGU AVOID ANY COSTS IF PREMIUM STANDARD WERE TO PERMANENTLY LEAVE THE SYSTEM?**

A. No.

Q. **ARE THERE ADDITIONAL CHANGES TO THE TARIFF THAT MGU IS PROPOSING IN THIS FILING?**

A. Yes. There are three additional tariff changes proposed in this filing. The first is an increase in the Company's prices for performing various service functions, as detailed on Sheets 54 and 55. The purpose of these changes is to fully recover the Company's costs for performing these service functions, and to also provide a disincentive for customers to discontinue service during the summer months. The second tariff change is an increase in the labor rates the Company charges for service and conversion work, as detailed on Sheet 82 of the tariff. This change is reflective of increased costs of labor for the Company. The third change is to introduce a new tariff that will help to lessen the impact on the revenues of the Company from weather-related variations in usage. This tariff, which would implement a Weather Equalization Revenue Adjustment Rider, is detailed on Sheets 53 through 53A.

Q. **WHY DOES MGU BELIEVE THAT A WEATHER EQUALIZATION REVENUE ADJUSTMENT RIDER IS NECESSARY?**

A. The practice of this Commission has been to set rates based on the thirty-year normal for the number of heating degree-days, as recorded by the National Weather Service for a weather reporting station located in the vicinity of the utility's service area. However, as detailed in Witness Taylor's testimony, this practice results in rates set that are not reflective of current weather trends, and which therefore result in actual revenues that are significantly deficient compared to the revenues that would result if Missouri actually experienced a thirty-year average winter. This Weather Equalization Revenue Adjustment Rider will correct for this discrepancy; it will provide the added value of providing some protection for MGU's customers in the event that a colder than normal winter occurs.

Q. **HAVE ANY SIGNIFICANT CHANGES OCCURRED IN MGU'S OPERATIONS OR**

REVENUES AND EXPENSES SINCE MARCH 31, 2007, THE DATE OF THE AUDITED FINANCIALS THAT FORMED THE BASIS FOR THIS FILING?

A. Yes. MGU recently completed a six-mile expansion of its system north of Gallatin which added several residential customers, one large commercial customer, and one very large industrial customer. An estimate of the cost of this expansion and the expected usage was reflected in the Cost of Service Study produced by Witness Taylor to determine the proposed Commodity Charge, but a "true-up" to actual costs and volumes should be made once these figures are known.

Q. **DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?**

A. Yes