

Exhibit No.:

Issue(s):

Service Line Replacement Program/
Manufactured Gas Plant Remediation/
Landbase Digitized Mapping Sytem/
Alternative Regulation "Incentive" Plan

Witness/Type of Exhibit:

Robertson/Rebuttal

Sponsoring Party:

Public Counsel

Case No.:

GR-2001-292

REBUTTAL TESTIMONY

OF

TED ROBERTSON

FILED

MAY 22 2001

**Missouri Public
Service Commission**

Submitted on Behalf of
the Office of the Public Counsel

MISSOURI GAS ENERGY

Case No. GR-2001-292

May 22, 2001

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

In the Matter of Missouri Gas Energy's
Tariff filing for General Rate Increase.

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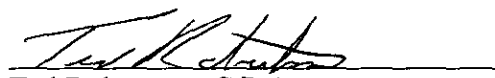
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AFFIDAVIT OF TED ROBERTSON

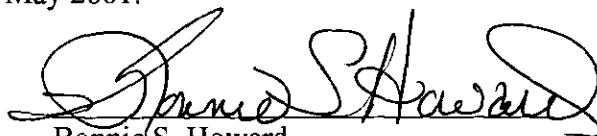
STATE OF MISSOURI)
) ss
COUNTY OF COLE)

Ted Robertson, of lawful age and being first duly sworn, deposes and states:

1. My name is Ted Robertson. I am a Public Utility Accountant for the Office of the Public Counsel.
2. Attached hereto and made a part hereof for all purposes is my rebuttal testimony consisting of pages 1 through 79, Schedule TJR-1.
3. I hereby swear and affirm that my statements contained in the attached testimony are true and correct to the best of my knowledge and belief.


Ted Robertson, C.P.A.
Public Utility Accountant III

Subscribed and sworn to me this 22nd day of May 2001.


Bonnie S. Howard
Notary Public



Commission Expires May 3, 2005.

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REBUTTAL TESTIMONY

OF

TED ROBERTSON

MISSOURI GAS ENERGY

CASE NO. GR-2001-292

INTRODUCTION

1

2

3

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

4

A. Ted Robertson, P. O. Box 7800, Jefferson City, Missouri 65102.

5

6

Q. ARE YOU THE SAME TED ROBERTSON THAT HAS PREVIOUSLY TESTIFIED IN
THIS CASE?

7

8

A. Yes, I am.

9

10

Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

11

A. I will present testimony rebutting the Company's positions regarding the ratemaking
treatment of costs associated with its on-going Service Line Replacement Program
("SLRP"), Manufactured Gas Plant Remediation ("MGP"), Landbase Digitized Mapping
System ("LDMS"), and the new Incentive Plan being proposed by the Company.

12

13

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18

SERVICE LINE REPLACEMENT PROGRAM

Q. WHAT IS THE ISSUE?

A. Pursuant to Commission order the Company is authorized to defer carrying costs, property tax, and depreciation expense on projects related to its service line replacement program. At issue is the calculation of the deferral costs, the length of the amortization period for the deferred costs and whether or not the deferred cost balances should be afforded rate base treatment. Thus, the main issues associated with the SLRP are:

1. Technical calculation differences for the deferred costs, and
2. Regulatory treatment differences of the deferred costs balances.

Q. WHAT IS THE MEANING OF THE TERM "DEFER" AS USED IN THE CONTEXT OF THIS ACCOUNTING ISSUE?

A. When a cost (expense) has been deferred, it is either removed from the income statement and entered on the balance sheet or directly entered to the balance sheet (e.g., Account 182.3, Other Regulatory Assets), pending the final disposition of these costs at some future point, usually a rate case. The Federal Energy Regulatory Commission ("FERC") Uniform System of Accounts ("USOA") Account No. 182.3, Other Regulatory Assets, states:

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1 A. This account shall include the amounts of regulatory-created assets,
2 not includible in other accounts, resulting from the ratemaking actions of
3 regulatory agencies. (See Definition No. 31.)
4

5 B. The amounts include in this account are to be established by those
6 charges which would have been included in net income determinations in
7 the current period under the general requirements of the Uniform System
8 of Accounts but for it being probable that such items will be included in a
9 different period(s) for purposes of developing the rates that the utility is
10 authorized to charge for its utility services. Where specific identification
11 of the particular source of the regulatory asset cannot be made, such as in
12 plant phase-ins, rate moderation plans, or rate levelization plans, Account
13 407.4, Regulatory Credits, shall be credited. The amounts recorded in this
14 account are generally to be charged, concurrently with the recovery of the
15 amounts in rates, to the same account that would have been charged if
16 included in income when incurred, except all regulatory assets established
17 through the use of Account 407.4 shall be charged to Account 407.3,
18 Regulatory Debits, concurrent with the recovery of the amounts in rates.
19

20 C. If rate recovery of all or part of an amount included in this account is
21 disallowed, the disallowed amount shall be charged to Account 426.5,
22 Other Deductions, or Account 435, Extraordinary Deductions, in the year
23 of disallowance.
24

25 D. The records supporting the entries to this account shall be so kept that
26 the utility can furnish full information as to the nature and amount of each
27 regulatory asset included in this account, including justification for
28 inclusion of such amounts in this account.
29
30

31 Q. HAS THIS COMMISSION ADOPTED THE FERC SYSTEM OF ACCOUNTS FOR
32 USE BY REGULATED GAS UTILITIES?

33 A. Yes. 4 CSR 240-40.040 directs natural gas companies within the Commission's
34 jurisdiction to use the FERC System of Accounts.
35

1 Q. DOES THE FACT THAT A GAS COMPANY HAS ACCOUNTED FOR A CERTAIN
2 ITEM IN A PARTICULAR FERC ACCOUNT GUARANTEE ITS RECOVERY IN
3 RATES?

4 A. No. 4 CSR 240-40.040 (4) provides:

5
6 (4) In prescribing this system of accounts the commission does not
7 commit itself to the approval or acceptance of any item set out in any
8 account, for the purpose of fixing rates in determining other matters before
9 the commission.
10
11

12 1. Technical Calculation Differences

13
14 Q. PLEASE EXPLAIN THE TECHNICAL CALCULATION DIFFERENCES THAT EXIST
15 BETWEEN THE COMPANY AND THE PUBLIC COUNSEL.

16 A. There are three issues regarding the SLRP calculation differences that exist between the
17 Company and the Public Counsel. They are:
18

- 19 1. The Company, without Commission authorization, calculated and deferred
20 costs associated with the 5th Accounting Authority Order ("AAO") SLRP
21 plant that was installed during the months of June, July and August of
22 1998 ("Gap Period").
23
24 2. The annual SLRP amortization amount Company calculated contains
25 errors regarding the 2nd and 3rd AAO's monthly amortization and the
26 Commission's order in Case No. GR-98-140 regarding the number of
27 years over which the deferred costs are to be amortized to expense.
28

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1 3. The deferred income tax balances associated with the SLRP deferred costs
2 do not match.
3
4

5 Q. WHAT IS THE VALUE OF THE DIFFERENCE IN THE DEFERRED COSTS
6 ASSOCIATED WITH THE 5th SLRP AAO?

7 A. Company's Workpapers B-1-8a and B-1-8b identify a total SLRP deferral of \$6,180,888 for
8 the 5th AAO authorized in Case No. GR-98-140. Exclusion of the SLRP deferrals
9 associated with the plant installed during the gap period reduces the deferral amount to
10 \$5,426,127 or a difference of \$754,761 (\$6,180,888 less \$5,426,127 equals \$754,761).
11

12 Q. PLEASE EXPLAIN THE COMPANY'S DEFERRAL OF SLRP COSTS DURING THE
13 "GAP PERIOD."

14 A. Company deferred SLRP costs for three months worth of plant installed between the
15 period designated as the Case No. GR-98-140 end of true-up and the September order
16 date for the case (the gap period includes the months of June, July and August of 1998).
17 The deferral of SLRP costs on plant installed during the gap period was not authorized by
18 the Commission. The Commission's Report and Order in Case No. GR-98-140, page 21,
19 states:
20

21 The Commission shall issue an AAO authorizing MGE to defer and book
22 costs relating to SLRP deferral carrying costs, property taxes and
23 depreciation expenses. The balance of the account for the deferral period
24 beginning the day after the effective date of this Report and Order shall
25 begin with a zero balance.

(emphasis added by OPC)

Thus, it is the Public Counsel's belief that the SLRP costs that the Company has deferred that is associated with the gap period should not be recovered in rates.

Q. ABSENT AN EFFECTIVE ACCOUNTING AUTHORITY ORDER AUTHORIZING MGE TO DEFER SUCH COSTS, IS DEFERRAL APPROPRIATE PURSUANT TO THE FERC ACCOUNTS AND REGULATORY ACCOUNTING?

A. No. As I will describe in more detail later in this testimony, the costs that the Company requests to defer that is associated with the Gap Period is far below the 5% threshold of materiality described in the FERC Uniform System of Accounts adopted by this Commission. The USOA definition of "extraordinary items" which are defined in the USOA General Instructions, paragraph 15,017, states:

7. Extraordinary items. It is the intent that net income shall reflect all items of profit and loss during the period with the exception of prior period adjustments as described in paragraph 7.1 in long-term debt as described in paragraph 17 below. Those items relate to the effect of events and transactions which have occurred during the current period and which are not typical or customary business activities of the company shall be considered extraordinary items. Accordingly, they will not be events and transactions of significant effect which would not be expected to recur frequently and which would not be considered as recurring factors in any evaluation of the ordinary operating process of business. (In determining significance, items of similar nature should be considered in the aggregate. Dissimilar items should be considered individually; however, if they are few in number, they may be considered in the aggregate.) To be considered as extraordinary under the above guidelines, an item should be

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1 more than approximately five percent of income computed before
2 extraordinary items. Commission approval must be obtained to treat an
3 item of less than five percent as extraordinary.
4

5 (emphasis added by OPC)
6
7

8 Since the Company did not receive Commission authorization to defer costs associated with
9 the SLRP plant during the gap period, it is the Public Counsel's opinion that it would be a
10 violation of both FERC and regulatory accounting procedures to allow it recovery of the
11 disputed costs.
12

13 Q. WHEN DID THE COMMISSION'S AUTHORIZATION FOR THE COMPANY TO
14 DEFER SLRP COSTS ASSOCIATED WITH THE 4TH AAO, CASE NO. GO-97-301,
15 TERMINATE?

16 A. The Commission's Accounting Authority Order, Case No. GO-97-301, states:
17

18 IT IS THEREFORE ORDERED:
19

20 1. That Missouri Gas Energy is authorized to defer and book to Account
21 182.3, beginning February 1, 1997 and continuing through the last date of
22 the Commission's test year, including any update or true-up period, in
23 Missouri Gas Energy's next rate case...
24
25

26 The Company's next rate case was Case No. GR-98-140 and the true-up for that case ended
27 in May 1998.

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1 Q. WHEN DID THE DEFERRAL PERIOD FOR THE COMPANYS 5TH AAO BECOME
2 EFFECTIVE?

3 A. The Commission's Report and Order in Case No. GR-98-140, page 66, states:
4

5 9. That this Report and Order shall become effective on September 2,
6 1998.
7
8

9 Q. DID THE COMMISSION'S ORDER IN CASE NO. GR-98-140 AUTHORIZE THE
10 COMPANY TO DEFER ANY SLRP COSTS ASSOCIATED WITH PLANT
11 INSTALLED DURING THE GAP PERIOD?

12 A. No. Normally, SLRP costs are accumulated monthly on installed plant. Company's
13 position is it followed the Commission's order by not deferring any SLRP costs in the
14 month that the plant was placed in service. Instead, it accumulated the SLRP plant in the
15 Gap Period and deferred SLRP costs on this plant beginning in September 1998.
16

17 Q. DID THE COMPANY ALSO CALCULATE THE ANNUAL SLRP AMORTIZATION
18 FOR THE 2ND AND 3RD AAO INCORRECTLY?

19 A. Yes. As shown on the Company's workpaper B-1-4, the balances for those AAO's that
20 existed at the end of August 1998 were amortized over 118 months rather than the 120
21 months as ordered by the Commission in its Report and Order in Case No. GR-98-140.
22 Until the Commission's order in Case No. GR-98-140 became effective (i.e., September 2,

1 1998) the tariffs then in existence determined the amortization period and amount for the
2 deferrals associated with these AAO's. Prior to the Report and Order of Case No. GR-98-
3 140 becoming effective the amortization period was set at 20 years. The difference in the
4 annual amortization expense authorized is approximately \$25,992 or \$9,384 for the 2nd
5 AAO (\$48,136 less \$47,354 multiplied by 12 months) and \$16,608 for the 3rd AAO
6 (\$103,326 less \$101,942 multiplied by 12 months). Though the dollar amount of the
7 amortization error is not large, it does result from an obvious violation of the Commission's
8 order.

9
10 Q. PLEASE EXPLAIN THE DIFFERENCES IN THE DEFERRED INCOME TAXES
11 ASSOCIATED WITH THE SLRP.

12 A. It's my understanding that the Company, Staff and the OPC have all calculated different
13 amounts for the deferred income taxes associated with the SLRP AAOs. OPC currently
14 has outstanding a data request that should be of assistance in resolving the reasons that
15 the amounts differ. Therefore, we request that the Commission allow us to postpone our
16 discussion on this issue to later testimony.

17
18 2. Regulatory Treatment Differences

19
20 Q. WHAT ARE THE REGULATORY DIFFERENCES BETWEEN THE COMPANY'S
21 POSITION AND THAT TAKEN BY THE PUBLIC COUNSEL?

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1 A. There are two issues regarding the SLRP regulatory treatment differences that exist
2 between the Company and the Public Counsel. They are:

3
4 2a. The number of years (amortization period) over which the SLRP deferred
5 costs balances are to be amortized to expense, and

6
7 2b. The regulatory rate base treatment of the deferred costs unamortized
8 balances and associated deferred income taxes.
9
10

11 2a. Amortization Period
12

13 Q. DID THE COMPANY UTILIZE A TEN YEAR AMORTIZATION PERIOD IN THE
14 INSTANT CASE FOR THE UNAMORTIZED SLRP DEFERRED BALANCES?

15 A. Yes, the Company proposes that the deferral balances be amortized to expense over ten
16 years; however, as I described earlier in this testimony, the Company's calculation of the
17 annual amortization amount is incorrect.
18

19 Q. IS THE TEN YEAR AMORTIZATION PERIOD UTILIZED BY THE COMPANY THE
20 APPROPRIATE PERIOD TO USE IN DETERMINING THE ANNUAL AMORTIZATION
21 OF THE AAO DEFERRED BALANCES?

22 A. No, a ten year amortization period of the deferred balances is not a reasonable time period
23 for the AAO deferred balances. For example, in the Commission's Order in MGE Case No.
24 GR-96-285, page 39, it found:

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1 The Commission finds that a 20-year amortization is appropriate because the
2 line replacements should last at least 20 years.
3
4

5 The Public Counsel continues to believe that the SLRP deferred balance should be
6 amortized over a period of time that is more representative of the plant lives to which the
7 deferred costs are related. Since the associated plant is expected to have a service life far
8 exceeding the ten year amortization proposed by the Company, it is irrational (based on
9 the depreciation rates shown on the Company's workpaper Schedule D, page 2 of 2, main
10 lives approximate 48 years and services lives approximate 22 years) to amortize the
11 deferred balances over the shortened period of ten years. Public Counsel continues to
12 believe that the amortization period should bear a direct correlation to the lives of the
13 plant upon which the deferred costs are based.
14

15 Q. DIDN'T THE COMMISSION RECENTLY RENDER A DECISION THAT ORDERED
16 A TEN YEAR AMORTIZATION OF COSTS DEFERRED PURSUANT TO THE
17 COMPANY'S SAFETY REPLACEMENT PROGRAM ACCOUNTING AUTHORITY
18 ORDERS?

19 A. Yes, in Missouri Gas Energy, Case No. GR-98-140, the Commission approved a ten year
20 amortization of the deferred balances associated with the Company's gas service line
21 replacement program. The Commission also ordered that the deferred costs balances

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1 would not be included in the determination of the Company's rate base and that the
2 deferred income taxes related to the SLRP would be included as a reduction to rate base.
3

4 Q. PRIOR TO THE COMMISSION'S ORDER IN CASE NO. GR-98-140 WAS MGE
5 REQUIRED TO AMORTIZE THE ACCUMULATED UNAMORTIZED SLRP
6 DEFERRAL OVER TWENTY YEARS?

7 A. Yes. Prior to the Commission's order in Case No. GR-98-140, the Company was
8 authorized to amortize the accumulated SLRP deferral over twenty years. In Case No. GR-
9 98-140 the Commission decided that a ten year amortization period was appropriate.
10

11 Q. DOES THE PUBLIC COUNSEL BELIEVE THAT THE COMMISSION ERRED IN
12 ALLOWING THE COMPANY A TEN YEAR AMORTIZATION OF THE SLRP
13 DEFERRED BALANCES?

14 A. Yes. Public Counsel believes that the twenty year amortization of the deferred costs
15 balances, as recommended by both the MPSC Staff and the OPC in the prior MGE rate
16 case, would have resulted in a more equitable sharing of regulatory lag effects between
17 shareholders and ratepayers. The twenty year amortization period was viewed as a
18 compromise to the position taken by the Company and the likely timeframe that the
19 associated plant, upon which the AAO deferrals were calculated, would remain in service.
20 If the assumption that the plant associated with the safety replacement program will
21 remain in service for twenty-two to forty-eight years or more is correct, then allowing the

1 Company the opportunity to amortize the deferred costs balances over ten years does not
2 appear to be a reasonable conclusion to the issue.

3
4 Q. PLEASE CONTINUE.

5 A. Intrinsic to the Public Counsel's position that the deferred balances should be amortized
6 over a period no less than twenty years is the fact that the costs are the result of a
7 Commission ordered aberration or accounting variance from normal regulatory
8 ratemaking. Absent the AAO procedure, the Company may never have been allowed to
9 even aggregate the SLRP deferred costs for later Commission review. The SLRP
10 deferred costs are solely a product of the accounting authority order and the accounting
11 authority order is solely related to investment in the replacement, for safety reasons, of
12 gas lines and appurtenances.

13
14 In fact, many of the same costs (i.e., interest and property taxes) are directly charged to
15 the plant investment during the period it is accounted for as construction work in
16 progress. These same costs are then depreciated in their entirety over the lives of the
17 respective plant investments. To separate the lives of the plant investment from the AAO
18 deferred costs (which are interest, depreciation and property taxes aggregated between the
19 period the plant is placed in service and the plant investment is included in rates) is
20 illogical.
21

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1 All the AAO process does is extend the period upon which the Company is allowed to
2 capitalize various direct and non-direct costs associated with the construction of the new
3 plant. Under normal accounting practices this capitalization process is denied once the
4 plant is placed in service. Prior to being placed in service the carrying costs and property
5 taxes are capitalized directly to the cost of the plant. These costs, along with the actual
6 construction costs, are then depreciated over the life of the plant after it is built into rates.
7 Depreciation under normal circumstances does not begin to accrue until the plant is
8 actually placed in service thus, under the AAO process the Commission has seen fit to
9 give depreciation the same capitalization status as that normally reserved for carrying
10 costs and property taxes.

11
12 Q. DIDN'T THE COMMISSION RULE IN A PRIOR MGE CASE THAT DEFERRAL
13 COSTS SHOULD NOT AMORTIZED OVER THE LIFE OF THE PROPERTY
14 CONSTRUCTED BUT OVER THE PERIOD IN WHICH THE BENEFITS WILL BE
15 REALIZED?

16 A. Yes. On page 17 of the Report and Order in Case No. GR-98-140 it states:

17
18 ...the Commission finds that it is not necessary to relate the amortization
19 period for the deferral or carrying costs to the life of the property
20 constructed but rather to the deferral period or the period during which it is
21 anticipated the benefits will be realized.
22
23

1 Q. ARE THE BENEFITS ASSOCIATED WITH THE SLRP DEFERRED COSTS
2 ACTUALLY REALIZED OVER THE SHORTER AMORTIZATION PERIOD?

3 A. No. The Commission's order created an accounting hybrid which treats the costs as if the
4 SLRP plant were in service and its costs were already included in rates but extends the
5 recovery period of the return, depreciation and property tax costs out to ten years rather
6 than including them in the period in which the costs are actually incurred. Theoretically,
7 the AAO methodology mirrors the accounting benefits that would occur had the
8 representative plant been placed in service on or at the date of the change in the tariff
9 rates. That being the various costs are capitalized (in this case to a deferral account rather
10 than the actual plant account) just as the carrying costs (return) and property taxes would
11 have been treated under normal accounting rules. Then the Commission does an about
12 face and determines that a shorter amortization period is more appropriate. Even though
13 under normal accounting practices the capitalized carrying costs and property taxes, and
14 even the depreciation expense, associated with the plant would normally be recovered
15 over the life of the plant placed in service and not a randomly chose lesser time.

16
17 Q. IS THE NORMAL RECOVERY OF DEPRECIATION EXPENSE DIFFERENT FROM
18 CARRYING COSTS AND PROPERTY TAXES?

19 A. Yes, the normal accounting for depreciation expense is somewhat different than that for the
20 carrying costs and property taxes. It is different because it, unlike the other two costs, does
21 not occur while the plant is being constructed. It only comes into play after the plant is

1 placed in service. If the in service date is prior to the plant's costs being built into rates, the
2 Company runs the risk of nonrecovery of the depreciation expense. However, this risk is
3 mitigated by the Company's current earnings level. That is, if the Company is earning at or
4 above its authorized return, the nonrecovery of the depreciation expense is a moot point.
5 Thus, the regulatory risk that the Company faces with regard to the depreciation expense is
6 that if it is not earning its authorized return, it will not recover the depreciation expense
7 incurred during the period from when the plant is placed in service and its costs are built
8 into rates. However, the AAO process eliminates the risk of the Company's recovery of the
9 depreciation expense. That occurs because the depreciation expense is capitalized just as
10 the carrying costs and property taxes are, and except for time value of money associated
11 with a later recovery from ratepayers, the Company's regulatory lag risk associated with the
12 depreciation expense is eliminated.

13
14 Q. IS THE PUBLIC COUNSEL'S RECOMMENDATIONS REGARDING THE AAO
15 DEFERRED BALANCES AND THEIR AMORTIZATION BASED ON THE
16 UTILIZATION OF A TEN YEAR AMORTIZATION?

17 A. Yes, it is.

18
19 Q. WHY DID PUBLIC COUNSEL DEVELOP A TEN YEAR AMORTIZATION OF THE
20 DEFERRED COSTS BALANCES VERSES A TWENTY YEAR AMORTIZATION?

1 A. Public Counsel developed the ten year amortization in order to enhance the comparability of
2 the results with those proposed by the Company. If the Commission subsequently decides
3 that the amortization period for the deferred costs balances should be amortized over twenty
4 years, the development of the annual amortization would require only a few simple
5 modifications to the workpapers already developed.
6

7 2b. Rate Base Treatment
8

9 Q. HAS THE COMPANY COMPLIED WITH THE COMMISSION'S CASE NO. GR-98-
10 140 ORDER IN THIS CASE REGARDING RATE BASE TREATMENT OF THE SLRP
11 DEFERRED COSTS BALANCES?

12 A. No. Company has included the unamortized deferred costs balances in its rate base for the
13 instant case. On page 9, lines 10-13, of Mr. Noack's Direct Testimony, he states that he
14 has included the unamortized SLRP deferrals as an addition to the Company's rate base.
15 The Company proposal adds a SRLP deferred costs balance of \$22,202,142 to rate base.
16

17 Q. YOU STATED IN THE PREVIOUS ANSWER THAT THE COMPANY HAS
18 INCLUDED THE SLRP DEFERRED COSTS BALANCES IN RATE BASE, DID
19 PUBLIC COUNSEL ALSO MAKE THIS ADJUSTMENT?

20 A. No, it is the Public Counsel's position that the SLRP deferred costs balances should not
21 be included in the determination of the Company's rate base. The rationale for this

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1 position is based on the view that the Company is being given the opportunity for an
2 effective guaranteed "return of" the deferred costs associated with the safety replacement
3 program; therefore, it should not be also provided with an opportunity for a guaranteed
4 "return on" those same amounts. The Commission's order in Case No. GR-98-140
5 clearly denied this type of regulatory treatment for the SLRP deferred costs.

6
7 In MGE's last general rate increase case, Case No. GR-98-140, the Commission ordered
8 that guaranteeing the Company a "return of" and "return on" the unamortized SLRP
9 deferral is not a fair allocation of regulatory lag resulting from the on-going construction
10 project. In order to comply with that Commission decision, the Public Counsel has not
11 adjusted the Company's rate base so that it can earn a "return on" the current unamortized
12 SLRP deferred costs balances. The rationale for this position is based on the view that the
13 Company is being given a guaranteed "return of" the deferrals associated with the service
14 line replacement program; therefore, it should not be also provided with a guaranteed
15 "return on" those same amounts.

16
17 Public Counsel believes that the Commission's Order in Case No. GR-98-140 regarding
18 this issue was a fair and equitable allocation of the risk and costs associated with the
19 SLRP project. While we continue to believe that an amortization period of twenty years
20 or longer is more appropriate, we are firmly committed to and in agreement with the
21 Commission's decision to disallow any addition to rate base of the unamortized SLRP

1 deferred costs. This view is based on the fact that OPC believes management is
2 responsible for planning and operating the activities of the Company. If management is
3 unable to or chooses not to implement the programs and procedures which would limit
4 the effect of regulatory lag on the its finances, the Company should not be protected by
5 the Commission with an effective guarantee of earnings. Therefore, in order that
6 ratepayers and shareholders both share in the effect of regulatory lag, the Public Counsel
7 is recommending that Company be allowed to earn a "return of" the unamortized SLRP
8 deferred costs balances, but not a "return on" the SLRP deferred costs balances.
9

10 Q. WHAT IS THE TRUE PURPOSE OF THE COMPANY'S SERVICE LINE
11 REPLACEMENT PROGRAM ACCOUNTING AUTHORITY ORDER?

12 A. The Commission's authorization of AAO treatment for the Company's SLRP insulates
13 MGE shareholders from some of the risks associated with regulatory lag that occurs if the
14 SLRP construction projects are completed, and placed in service, before the operational
15 law date of a general rate increase case.
16

17 Q. PLEASE EXPLAIN THE CONCEPT OF REGULATORY LAG.

18 A. This concept is based on a difference in timing of a decision by management and the
19 Commission's recognition of that decision and its effect on the rate base rate of return
20 relationship in the determination of a company's revenue requirement. Management
21 decisions that reduce or increase the cost of service without changing rates result in a

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1 change in the rate base rate of return relationship. This change either increases or
2 decreases the profitability of the company in the short-run until such time as the
3 Commission reestablishes rates to properly match the new level of service cost.
4 Companies are allowed to retain cost savings (i.e., excess profits during the lag period
5 between rate cases) and are forced to absorb cost increases. When faced with escalating
6 costs regulatory lag places pressure on management to minimize the change in the
7 relationship because it cannot be recognized in a rate increase until the Commission
8 approves such in a general rate proceeding.

9
10 Q. HAS THIS COMMISSION RULED THAT IT IS NOT REASONABLE TO PROVIDE
11 SUCH PROTECTION TO SHAREHOLDERS?

12 A. Yes, it has. In Missouri Public Service Co., Case Nos. EO-91-358 & EO-91-360, the
13 Commission stated:

14
15 Lessening the effect of regulatory lag by deferring costs is beneficial to a
16 company but not particularly beneficial to ratepayers. Companies do not
17 propose to defer profits to subsequent rate cases to lessen the effects of
18 regulatory lag, but insist it is a benefit to defer costs. Regulatory lag is a
19 part of the regulatory process and can be a benefit as well as a detriment.
20 Lessening regulatory lag by deferring costs is not a reasonable goal unless
21 the costs are associated with an extraordinary event.

22
23 Maintaining the financial integrity of a utility is also a reasonable goal.
24 The deferral of costs to maintain current financial integrity, though, is of
25 questionable benefit. If a utility's financial integrity is threatened by high
26 costs so that its ability to provide service is threatened, then it should seek
27 interim rate relief. If maintaining financial integrity means sustaining a
28 specific return on equity, this is not the purpose of regulation. It is not

1 reasonable to defer costs to insulate shareholders from any risks. 1 Mo.
2 P.S.C. 3d 200, 207 (1991).
3
4

5 Q. ARE THERE ANY OTHER CASES WHEREIN THE COMMISSION RULED THAT
6 IT IS NOT REASONABLE TO PROVIDE REGULATORY LAG PROTECTION TO
7 SHAREHOLDERS?

8 A. Yes. Public Counsel is aware of at least two cases where the Commission has stated that
9 it will not violate the cost of service rules and procedures in order to protect a utility from
10 the effects of regulatory lag. Beginning on page 19 of the Commission's Report and
11 Order in Missouri Gas Energy, Case No. GR-98-140, it states:

12
13 The Commission finds that the unamortized balance of SLRP deferrals
14 should not be included in the rate base for MGE. The AAOs issued by
15 the Commission authorize the Company to book and defer the amount
16 requested but do not approve any ratemaking treatment of amounts from
17 the deferred and booked balances. AAOs are not intended to eliminate
18 regulatory lag but are intended to mitigate the cost incurred by the
19 Company because of regulatory lag. Given that the Company will
20 recover the amortized amount of the SLRP deferral at the AFUDC rate in
21 ten years, instead of the previous 20 years' amortization period, it is
22 proper for the ratepayers and shareholders to share the effect of regulatory
23 lag by allowing the Company to earn a return of the SLRP deferred
24 balance but not a return on the SLRP deferred balance. The Commission
25 has noted previously in the consolidated cases entitled In The Application
26 of Missouri Public Service for the Issuance of an Accounting Order
27 Relating to Its Electrical Operation, and In the Matter of the Application
28 of Missouri Public Service for the Issuance of an Accounting Order
29 Relating to its Purchase Power Commitments, 1 Mo. P. S.C. 3rd 200, that
30 "the Court upheld the Commission's decision to place the initial risk of
31 cancellation on the shareholders since to do otherwise would be to make
32 the investment practically risk-free." State ex rel. Union Electric
33 Company v. PSC (UE), 765 S.W.2d 618, 622 (Mo. App. 1988); State ex

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1 rel Hotel Continental v. Burton, 334 S.w.2d 75, 80 (Mo. 1960). Most
2 recently, the Western District Court found that "AAOs are not a
3 guarantee of an ultimate recovery of a certain amount by the utility."
4 Missouri Gas Energy v. P.S.C., 1998 W.D. 54710 (Mo. App. Aug. 18,
5 1998). All of the parties agree that it is the purpose of the AAO to lessen
6 the effect of the regulatory lag, not to eliminate it nor to protect the
7 Company completely from risk. Without the inclusion of the
8 unamortized balance of the AAO account included in the rate base, MGE
9 will still recover the amounts booked and deferred, including the cost of
10 carrying these SLRP deferral costs, property taxes and depreciation
11 expenses through the true-up period ending May 31, 1998. The
12 Commission finds that OPC's position on this issue is just and reasonable
13 and is supported by competent and substantial evidence in the record.
14
15

16 Also, beginning on page 23, of Commission's Report and Order in St. Louis County
17 Water Company, Case No. WR-2000-844, it states:

18
19 In Case No. GR-98-140, a Missouri Gas Energy (MGE) rate case, the
20 Commission adopted a position advocated by Public Counsel that
21 "guaranteeing the Company a 'return of' and 'return on' the . . . deferred
22 balance [of an ongoing construction project] is not a fair allocation of
23 regulatory lag. . . ." The Commission concluded that, for ratepayers and
24 shareholders to share in the effect of regulatory lag, MGE should be
25 allowed to earn a return of the deferred balance, but not a return on the
26 deferred balance.
27
28

29 And on continuing on page 24, it states:

30
31 Nothing binds the Commission to particular ratemaking treatment of
32 deferrals made pursuant to an AAO:
33

34 In the Public Counsel case [State ex rel. Office of Public
35 Counsel v. Public Service Com'n of Missouri, 858
36 S.W.2d 806, Mo. App. W.D. (1993)], the court made it

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1 clear that AAOs are not the same as ratemaking
2 decisions, and that AAOs create no expectation that
3 deferral terms within them would be incorporated or
4 followed in rate application proceedings. Missouri Gas
5 Energy v. Public Service Com'n, State of Mo., 978
6 S.W.2d 434, (Mo. App. W.D. 1998), at 438.
7

8 The Commission, based on the same reasoning it used in Case No. GR-98-
9 140, will allow the Company to recover the deferred balances over ten
10 years, but will not allow a return on the unamortized balance.
11
12

13 Q. HAS THE COMMISSION MADE A DETERMINATION THAT THE SAFETY
14 REPLACEMENT PROGRAM IS AN EXTRAORDINARY EVENT?

15 A. Yes, it has. The Commission, however, qualified what an extraordinary event is when it
16 stated on page 13 of its Report and Order in St. Louis County Water Company, Case No.
17 WR-96-263:
18

19 As both the OPC and the Staff point out, the Commission has to date,
20 granted AAO accounting treatment exclusively for one-time outlays or
21 capital caused by unpredictable events, acts of government, and other
22 matters outside the control of the utility or the Commission. It is also
23 pointed out that the terms "infrequent, unusual and extraordinary"
24 connote occurrences which are unpredictable in nature.
25

26 (emphasis added by OPC)
27
28

29 Q. PLEASE EXPLAIN THE TERMS "RETURN OF" AND "RETURN ON."

30 A. When an expenditure is recorded on the income statement as an expense it is compared
31 dollar for dollar to revenues. This comparison is referred to as a "return of" because a

1 dollar of expense is matched by a dollar of revenue. A "return on" occurs when an
2 expenditure is capitalized on the balance sheet and then included in the calculation of rate
3 base. This calculation is a preliminary step in determining the earnings a company
4 achieves on its total regulatory investment.

5
6 Q. ISN'T IT TRUE THAT THE SLRP DEFERRED CARRYING COSTS AND
7 DEPRECIATION EXPENSE ARE NOT ACTUALLY FUNDED BY THE COMPANY?

8 A. Yes, that is a true statement. **The carrying costs and depreciation expense associated**
9 **with the SLRP deferral are not actual dollars of investment funded by the**
10 **Company, they are merely accounting entries on the financial books. Neither the**
11 **carrying costs nor the depreciation expense causes the Company to forego any**
12 **actual outlay of cash. However, the dollars associated with these book entries will**
13 **be recovered from ratepayers through the SLRP amortization included in the**
14 **Company's cost of service.**

15
16 Q. IF THE SLRP DEFERRAL BALANCE IS INCLUDED IN RATE BASE WOULDN'T
17 THAT PERMIT THE COMPANY TO EARN A RETURN ON FICTITIOUS
18 INVESTMENTS FOR WHICH THERE WAS NO ACTUAL INVESTMENT MADE
19 BY THE COMPANY?

20 A. Yes, it would. **In fact, allowing the Company to earn a "return on" the SLRP**
21 **deferrals has the same effect of allowing it to earn a "return on" a "return of."**

1 **Stated another way, the Company will recover (receive a "return of") the deferred**
2 **carrying cost, depreciation and property tax expense by way of the amortization**
3 **included in rates and then will earn a "return on" those same amounts.**
4

5 Q. DOES DISALLOWING THE SLRP DEFERRAL RATE BASE TREATMENT FORCE
6 SHAREHOLDERS TO MAKE AN INTEREST FREE LOAN TO RATEPAYERS?

7 A. No. Pursuant to the terms of the AAOs, the Company is authorized to defer three types
8 of costs; carrying cost, depreciation expense and property tax expense. These costs are
9 deferred during the time period from when the constructed plant is actually placed in
10 service until such time as the plant balances are recognized in rates (i.e., during a rate
11 case). The carrying costs and depreciation expense that are deferred do not represent any
12 actual dollars expended or incurred by the Company. Property taxes, though similar to
13 the carrying costs and depreciation expense, differ only slightly. In the case of property
14 taxes, the Company may actually incur expenditures to pay property taxes owed on the
15 constructed plant but only if the plant is in service for a period greater than one year
16 before the Company's rates are changed to recognize the construction costs. Any actual
17 expenditures for property taxes, in most cases, would only occur at the end of the year
18 after the year that the plant is actually placed in service (unless, of course, the plant was
19 placed in service on January 1 of the first year).
20

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1 The carrying cost represents nothing more than an imputed dollar amount (i.e., interest)
2 that acts as a surrogate for the return that Company would receive if the SLRP plant was
3 actually placed in service and immediately included in the determination of the tariffed
4 rates the Company charges. It is an actual dollar amount that is calculated by multiplying
5 the SLPR plant placed in service by the Company's Allowance For Funds Used During
6 Construction ("AFUDC") rate. It is an amount that is imputed only for the benefit of
7 shareholders. Common sense and reasoning belie any assertion that the denial of a
8 "return on" the carrying costs somehow correlates into an interest free "phantom" loan to
9 ratepayers. The implication being that the "phantom" loan consists completely of the
10 denied "return on" the imputed carrying cost amount which is itself, as stated earlier, an
11 imputed return. In essence, those who argue the loudest for the "return on the return" fail
12 to recognize that were it not for the AAO process, the Company would not receive the
13 benefit of any carrying cost (i.e., return) on the SLRP plant construction placed in service
14 during the period before its costs are included in rates.

15
16 No loan, phantom or otherwise, from shareholders to ratepayers, is created by the AAO
17 process. In reality, the exact reverse of the position argued by the "loan" supporters is
18 actually true. It appears that those supporting the loan position do not completely
19 understand or have not taken the time to appreciate the entire AAO process and the
20 benefits it provides to the Company's shareholders. The truth of the matter is that the
21 AAO process forces ratepayers to "give" the Company and its shareholders a carrying

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1 cost return, depreciation expense and property tax expense recognition on constructed
2 plant which under normal regulatory accounting they would never have received. That
3 recognition translates directly into dollars authorized for collection from ratepayers. The
4 carrying cost (along with depreciation expense and property tax expense) is no more or
5 less than a gift from the Commission to shareholders the purpose of which is to mitigate
6 the effect of regulatory lag associated with the SLRP construction. In fact, it enhances
7 the return on equity to the stockholders. Disallowance of rate base inclusion for the
8 deferred costs does not penalize the Company, it merely does not allow the Company to
9 be completely shielded from all the financial risk that occurs during the regulatory lag
10 period. In essence, it forces ratepayers to share the responsibility for costs associated
11 with SLRP construction during a period when, under normal regulatory ratemaking, the
12 Company and shareholders would own 100% of the liability. How anyone argue that the
13 Company and shareholders are being treated unfairly, when in fact, the Company and its
14 shareholders are the only benefactors of the AAO process, continues to amaze me.

15
16 Q. ARE THE SERVICE LINE REPLACEMENT PROGRAM COSTS UNPREDICTABLE
17 IN NATURE?

18 A. No, they are not. The SLRP project is a continuing construction project that has existed
19 for many years and it is my understanding that it is expected to last for another two years
20 or more. It would be unrealistic to believe that a construction project that has lasted as

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1 long as the SLRP could not be predicted and planned for by management with a
2 minimum of error in their results.
3

4 Q. SHOULD RATEPAYERS BE REQUIRED TO PROVIDE MGE WITH A
5 GUARANTEED RETURN ON THE SERVICE LINE REPLACEMENT PROGRAM
6 EXPENDITURES JUST BECAUSE THE COMPANY'S MANAGEMENT CHOOSES
7 NOT TO EXERCISE ITS PLANNING AND OPERATING RESPONSIBILITIES?

8 A. No, ratepayers should not be required to fund such a return. Planning and operation of
9 the Company's construction projects are a fundamental responsibility of MGE's
10 management. Only management has complete access to the data and resources necessary
11 to fulfill these responsibilities, and as such, management should be able to implement a
12 SLRP construction program that minimizes the effects of regulatory lag on the Company
13 finances. To the extent regulatory lag moves against the Company, the Commission has
14 already decided, as mentioned earlier, that lessening regulatory lag by deferring costs is
15 not a reasonable goal.
16

17 Q. PLEASE CONTINUE.

18 A. The purpose of the accounting variance is to protect MGE from adverse financial impact
19 caused by regulatory lag by providing it with a vehicle that allows it the opportunity to
20 capture and recover costs it normally would not have explicitly received. The accounting
21 variance should not be used to place the Company in a better position than it would have

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1 been in had plant investment and rate synchronization been achieved. Just as it would be
2 unfair to deny MGE recovery of its reasonable and prudent investment due to regulatory
3 delays which the Company could not control, it would be unfair if MGE were allowed to
4 reap a windfall, at ratepayer expense, due to a regulatory delay that MGE could control.
5 Public Counsel's position is that issues caused by regulatory lag must be treated in a fair
6 manner for both ratepayers and the Company.

7
8 Q. WHO HAS THE INITIAL RESPONSIBILITY TO ENSURE THAT THE MGE
9 OPERATING SYSTEM IS OPERATING SAFELY AND IS NOT A DANGER TO
10 RATEPAYERS?

11 A. The management and shareholders (as owners) are the primary persons responsible for the
12 safe operation of the Company.

13
14 Q. WHY WAS THE SLRP CONSTRUCTION IMPLEMENTED?

15 A. It's my understanding, in the late 1980's, a series of natural gas explosions occurred in
16 Missouri, a number of them in western Missouri. A number of people were killed, others
17 were injured and substantial property damage resulted. Because the Commission regulates
18 the safety of natural gas providers in Missouri, it was heavily involved in the investigation
19 of these matters. Largely as a result of these occurrences, the ensuing investigation and the
20 companies obvious shortcomings regarding their responsibility for oversight and
21 replacement of dangerous aging gas systems, the Commission in 1989 promulgated the

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1 extensive gas safety rules now found in Chapter 40 of the Commission's rules. A part of
2 these gas safety rules requires the change out of service lines and mains within certain time
3 frames according to various factors, including age and construction material.
4

5 Q. SHOULDN'T THEN THE MANAGEMENT AND SHAREHOLDERS OF THE
6 COMPANY ALSO SHARE IN SOME OF THE FINANCIAL RISK ASSOCIATED
7 WITH SLRP CONSTRUCTION?

8 A. Yes. Defective and/or dangerous gas transfer situations have occurred on their watch. It is
9 their responsibility to know whether or not the gas transfer system is operating as designed.
10 It is their responsibility to survey the adequacy and safety of the entire system at all times.
11 Past and present management people were responsible for the identification, selection,
12 installation and operation of the current gas transfer system. Only the Company has the
13 knowledge and resources to continually access and monitor the reliability of the its gas
14 transfer system. The explosions that occurred only reinforce the Public Counsel's belief
15 that management did not take these responsibilities seriously. Rather than update the gas
16 transfer system over the years management chose instead to ignore the problems until the
17 Commission was forced to address the issue for the benefit of consumers.
18

19 Q. ISN'T THE SOLE PURPOSE FOR THE COMMISSION'S AUTHORIZATION OF THE
20 SLRP DEFERRAL TO MITIGATE OR LIMIT THE COMPANY'S FINANCIAL

1 EXPOSURE TO THE REGULATORY LAG ASSOCIATED WITH THE SLRP
2 CONSTRUCTION?

3 A. Yes, it is.
4

5 Q. DOES THE COMPANY AGREE THAT REGULATORY LAG IS THE REASON FOR
6 THE COMMISSION'S AUTHORIZATION OF THE SLRP DEFERRAL?

7 A. I believe that it does. On page 6, lines 16-18, of Mr. Noack's Direct Testimony, he states:
8

9 ...the Commission has consistently approved AAOs to allow MGE to defer
10 certain SLRP costs between rate cases. These costs consist of depreciation ,
11 property taxes, and carrying costs.
12
13

14 Q. DOES THE COMPANY ARGUE THAT IT DOES NOT HAVE THE ABILITY TO
15 IMPLEMENT A CONSTRUCTION PROGRAM WHICH WOULD MITIGATE ITS
16 EXPOSURE TO REGULATORY LAG?

17 A. Yes, Company alleges if it did attempt to schedule its SLRP construction around rate filings
18 that it would not be in compliance with the safety plan filed with the Commission. On page
19 8, line 22, of the Direct Testimony of Company witness, Mr. Michael R. Noack, he states
20 that the Company does not enjoy such freedom because it must continue the replacement
21 program as mandated by 4 CSR 240-40.030, within the time required by the Commission.

22 Q. DOES THE PUBLIC COUNSEL AGREE WITH THE COMPANY'S ASSERTION
23 THAT IT CANNOT MODIFY ITS SLRP CONSTRUCTION PROJECTS?

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1 A. No.

2
3 Q. HAS THE COMPANY EVER MODIFIED THE SLRP CONSTRUCTION TIME
4 PERIOD?

5 A. Yes. On or about January 12, 1999, the Company filed an application with the
6 Commission, Case No. GO-99-302, to modify the SLRP order. On page three of that
7 application the Company stated:

8
9 10. MGE proposes to modify the currently-approved plan by : 1)
10 replacing all customer-installed unprotected steel service lines by October
11 31, 2000, (rather than year-end 1999 as called for under the currently-
12 approved plan); and 2) replacing all yard lines and Company-owned and –
13 installed unprotected steel service lines by year end 2004 (rather than year-
14 end 2009 as called for under the currently-approved plan).

15
16
17 Q. IS IT CORRECT THAT THE COMPANY'S APPLICATION SOUGHT TO
18 ACCELERATE THE SERVICE LINE REPLACEMENT PROGRAM?

19 A. Yes, that is correct.

20
21 Q. DID THE COMMISSION AUTHORIZE THE COMPANY'S REQUESTED
22 ACCELERATION OF THE SERVICE LINE REPLACEMENT PROGRAM?

23 A. Yes, it did. On pages 3 and 4 of its Order Granting Application to Modify Order, Case No.
24 GO-99-302, the Commission stated:

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1
2 IT IS THEREFORE ORDERED:
3

4 1. That the modified service line replacement schedule set forth in
5 Attachment B to Missouri Gas Energy's Application is approved. A copy
6 of that attachment is also attached to this order as Attachment B.
7

8 2. That Missouri Gas Energy is granted a partial waiver from the
9 requirements of 4 CSR 24—40.030 (15) (C) to extend the replacement
10 deadline for customer-owned unprotected steel service lines to October 31,
11 2000. This partial waiver is conditioned upon Missouri Gas Energy
12 accelerating the replacement of other unprotected steel service and yard
13 lines as shown in Attachment B.
14

15 3. That this order shall become effective on March 15, 1999.
16
17

18 Q. IS IT YOUR UNDERSTANDING THAT THE COMPANY IS CURRENTLY IN
19 TALKS WITH THE MPSC STAFF TO MODIFY THE SLRP ORDER ONCE AGAIN?

20 A. Yes, it is.
21

22 Q. DOES THE ISSUE OF MODIFICATION OF THE SLRP CONSTRUCTION TIME
23 FRAME HINDER IN ANY WAY THE COMPANY'S ABILITY TO FILE FOR A
24 GENERAL RATE INCREASE?

25 A. No.
26

27 Q. DOES THE COMPANY HAVE THE RIGHT TO FILE FOR A GENERAL RATE
28 INCREASE AT ANY TIME IT CHOOSES?

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1 A. Yes, it does.

2
3 Q. IS THE PUBLIC COUNSEL SUGGESTING THAT THE COMPANY ATTEMPT TO
4 SCHEDULE ITS SLRP CONSTRUCTION AROUND RATE FILINGS?

5 A. No. Public Counsel believes that it is the Company that has immediate or near immediate
6 access to the data that identifies its current and projected financial situation. We are
7 suggesting that the Company manage its operations and if necessary file for rate relief upon
8 such time as it becomes evident that it will not earn its Commission authorized return.

9
10 Q. IS THE PUBLIC COUNSEL SUGGESTING THAT THE COMPANY ASK THE
11 COMMISSION TO GRANT IT RATE INCREASES ON THE BASIS OF FUTURE
12 TEST YEAR PLANT BALANCES?

13 A. No. Basing rate increases on future test year plant balances is not a reasonable or
14 appropriate method for determining the cost of service of a regulated utility company such
15 as MGE. However, should the Company be able to manage its SLRP construction with
16 sufficient expertise, it is not inconceivable that it would also be able to project the point in
17 time that it will not be earning its Commissioned authorized return. Public Counsel
18 believes that the Company's management has the responsibility to manage the MGE
19 operations thus, they should or could have prepared and scheduled general rate increase
20 cases to be completed or coincide with the time period in which it expects its earnings
21 shortfall to occur.

1
2 Q. ISN'T IT A COMMON BUSINESS PRACTICE FOR A COMPANY TO PREPARE A
3 THREE TO FIVE YEAR FINANCIAL AND OPERATING BUDGET?

4 A. Yes, it is. Many companies prepare a three to five year budget as a quantitative expression
5 of a plan of action and an aid to coordination and implementation.
6

7 Q. ISN'T IT CONCEIVABLE THAT A THREE TO FIVE YEAR FINANCIAL AND
8 OPERATING BUDGET WOULD HELP MGE IN IDENTIFYING AND PLANNING
9 FOR ANY GENERAL RATES INCREASES THAT MIGHT BE REQUIRED.

10 A. Yes.
11

12 Q. DOES MGE PREPARE BUDGET INFORMATION ON A REGULAR INTERVAL?

13 A. Yes. According to the Company's response to MPSC Data Request No. 3 budget
14 information is created on a regular basis. In addition, variances from actual results and
15 budgeted results are also developed and reviewed by the Company's senior management.
16 These documents allow the Company to monitor changes in the financial and operating
17 results expected.
18

19 Q. IF THE COMPANY HAD ADVANCE KNOWLEDGE THAT THE SLRP
20 CONSTRUCTION WAS CAUSING IT TO NOT EARN ITS COMMISSIONED

1 ORDERED RETURN COULD IT FILE FOR A GENERAL RATE INCREASE IN TIME
2 TO MITIGATE THE ASSOCIATED REGULATORY LAG?

3 A. Yes, it could.

4
5 Q. IF MGE WAS NOT EARNING ITS AUTHORIZED RETURN DUE TO THE SLRP
6 CONSTRUCTION PROGRAM, OR OTHER FACTORS, WOULD MORE FREQUENT
7 RATE FILINGS BE APPROPRIATE?

8 A. Yes. All parties would potentially benefit from increased rate case filings by MGE if, in
9 fact, the Company is not actually earning its Commission authorized cost of service.
10 Shareholders and ratepayers alike would benefit from the re-basing of rates. Shareholders
11 would benefit because the re-based rates would almost certainly be set at a level that is more
12 in line with the Company's current actual cost of service. Similarly, ratepayers would
13 benefit due to the fact that the rates they would pay would more accurately reflect the actual
14 costs of the services that they receive from the Company.

15
16 MGE is not a charity, it is a business, it cannot be expected to provide a service to
17 customers and not be adequately compensated for its efforts thus, it must recover its costs to
18 serve the ratepayers in addition to earning a return upon its investments in the Company. If
19 MGE determines that it is not collecting enough revenues to cover its cost of service, the
20 Public Counsel would encourage it to come before the Commission so that its operations
21 and conclusions can be reviewed. If, after an investigation and audit is concluded, it

1 becomes evident that a rate increase is necessary then Public Counsel would naturally
2 support the Company increasing its rates to achieve its cost of service. Otherwise, the
3 Commission has no other choice but to determine that the Company is earning its
4 authorized cost of service and that the SLRP construction is not a detriment to its financial
5 requirements.

6
7 Q. DOES THE PUBLIC COUNSEL BELIEVE THAT THE DEFERRED INCOME TAXES
8 ASSOCIATED WITH THE SLRP AAOs SHOULD ALWAYS BE UTILIZED TO
9 REDUCE THAT COMPANY'S RATE BASE?

10 A. Yes. The Staff and Public Counsel both agree that the deferred income taxes associated
11 with the SLRP AAOs should continue to be utilized to reduce the Company's rate base.
12 It's the Company's opinion that rate base reduction of the deferred income taxes is only
13 appropriate if the SLRP deferred return, depreciation and property taxes are treated as an
14 addition to rate base. Company's position is not reasonable because the deferred income
15 taxes are a creation of the federal income tax laws and are a cost free source of capital to
16 the Company. This characterization of the deferred income taxes does not change. It
17 does not matter whether or not the SLRP deferred costs are included or excluded from the
18 rate base. Either way the deferred income taxes remain a cost free source of capital that,
19 to my knowledge, all prior Commission orders and regulatory theory does not allow the
20 Company to earn a return on.
21

1 Q. PLEASE SUMMARIZE THE PUBLIC COUNSEL'S RECOMMENDATION
2 REGARDING MGE'S SERVICE LINE REPLACEMENT PROGRAM ACCOUNTING
3 AUTHORITY ORDER DEFERRALS.

4 A. Public Counsel calculated the SLRP deferred costs balances, annual amortization and
5 deferred income taxes associated with Company's four accounting authority orders
6 pursuant to the terms ordered by the Commission in MGE Case No. GR-98-140 and it is
7 our recommendation that the Company's rate base determination exclude the SLRP
8 balances so that MGE does not earn a "return on" the deferred balances. Guaranteeing
9 the Company a "return of" and "return on" the SLRP deferred balance is not a fair
10 allocation of regulatory lag resulting from the Company's on-going construction project.
11 This view is based on the fact that management is responsible for planning and operating
12 the activities of the Company. If management is unable to or chooses not to implement
13 processes and procedures which would limit the effect of regulatory lag on its finances,
14 the Company should not be protected by the Commission with a guaranteed earnings
15 opportunity. Therefore, in order that ratepayers and shareholders both share in the effect
16 of regulatory lag, the Public Counsel is recommending that the Commission allow the
17 Company to earn a "return of" the SLRP deferred balance over twenty years, a period
18 representative of the life of the plant to which the deferrals relate, but not a "return on"
19 the SLRP deferred balance. Furthermore, we recommend that in all situations the
20 deferred income taxes associated with the SLRP AAOs continue to be utilized as a
21 reduction to the Company's rate base.

MANUFACTURED GAS PLANT REMEDIATION

Q. WHAT IS THE ISSUE?

A. Company's response to OPC Data Request No. 1128 states that it has made an adjustment as part of the corporate joint and common cost model which directly assigns \$280,448 to the utility operating expenses of MGE for manufactured gas plant remediation. Public Counsel believes that the \$280,448 should not be allowed as an MGE operating expense. Our recommendation is that the Commission disallow all recovery of the MGP site remediation costs for the reasons discussed in the following testimony.

Q. WHAT ARE REMEDIATION COSTS?

A. As I stated in my instant case Direct Testimony, remediation costs can be defined as all investigations, testing, land acquisition if appropriate, remediation and/or litigation costs/expenses or other liabilities excluding personal injury claims and specifically relating to gas manufacturing facility sites, disposal sites, or sites to which material may have migrated, as a result of the operation or decommissioning of gas manufacturing facilities.

Q. WHY DOES THE PUBLIC COUNSEL OPPOSE THE INCLUSION OF THE
MANUFACTURED GAS SITE REMEDIATION COSTS IN MISSOURI GAS
ENERGY'S COST OF SERVICE?

1 A. The Public Counsel's opposition to the inclusion of the manufactured gas plant site
2 remediation costs in Missouri Gas Energy's instant case cost of service is based on a
3 plethora of reasons. For example, MGE (i.e., Southern Union Company) and Western
4 Resources Inc., ("WRI") have already recognized and accepted that they, their insurers
5 and other potentially responsible parties ("PRP") are responsible for the costs of the MGP
6 remediation (WRI is the former owner of the Missouri gas utility assets). Pursuant to the
7 terms of the *Environmental Liability Agreement* ("Agreement"), Exhibit 13.01 to the
8 *Agreement For Purchase Of Assets* between Southern Union Company ("SUC") and
9 Western Resources Inc., the two companies have agreed to share the liability for payment
10 of any costs associated with any MGP remediation that might occur subsequent to SUC
11 buying the Missouri gas utility assets. The *Environmental Liability Agreement* is
12 attached to this Rebuttal Testimony as Schedule TJR-1.

13
14 Additionally, Southern Union Company in recognition of the potential MGP remediation
15 liability it had taken on with its purchase of the Missouri gas utility assets, in conjunction
16 with the advice of its outside auditors, established an "Acquisition Adjustment" of
17 \$3,000,000 on its financial books of record. The \$3,000,000 represents, according to the
18 terms of the *Environmental Liability Agreement*, the buyer's initial sole liability amount
19 that must be incurred prior to WRI sharing in any costs to remediate the MGP sites.
20 Furthermore, the \$3,000,000 is described as occurring only after exhaustion of relief from

1 insurance, other potentially responsible parties and recovery of remediation costs through
2 regulated cost of service.

3
4 Furthermore, additional reasons that Public Counsel believes the costs should not be
5 included in customer's rates are: (1) to my knowledge none of the manufactured gas
6 plants are currently in operation. Therefore, they are not used and useful for providing
7 service to current customers, (2) if current customers are required to pay for the cost of
8 service not recovered from past customers (e.g., past rates were set too low), the result is
9 intergenerational inequity, and possibly retroactive ratemaking. Present customers should
10 not be required to pay for past deficits of the Company in future rates. Also, recovery of
11 these costs from ratepayers would guarantee the investments of stockholders rather than
12 present the Company with the opportunity to earn a return approved by the Commission,
13 (3) the investigation expenditures expensed by the Company are a non-recurring cost of
14 operations, (4) shareholders are compensated for this particular business risk through the
15 risk premium applied to the equity portion of the Company's weighted average rate of
16 return (WROR), (5) shareholders not ratepayers receive the benefits of gains or losses
17 (below-the-line treatment) of any sale or removal from service of Company-owned land
18 or investment. Since it is the shareholder who receives either the gain or the loss on an
19 investment's disposal, it is the shareholder who should shoulder the responsibility for any
20 legal liability that arises at a later date related to the investment, (6) the liability for the
21 remediation costs is not incurred because of the services Missouri Gas Energy currently

1 provides to its customers. Missouri Gas Energy is a potentially responsible party because
2 it either owns the property now or its predecessor owned the property at sometime in the
3 past, and (7) automatic recovery of the remediation costs from Missouri Gas Energy's
4 customers reduces the incentive for the Company to seek partial or complete recovery of
5 the costs from other past owners of the plant sites or Company's insurers.
6

7 Q. ACCORDING TO THE ENVIRONMENTAL LIABILITY AGREEMENT WHAT IS
8 WRI'S FINANCIAL RESPONSIBILITY?

9 A. Article 2(c) of the Environmental Liability Agreement states:

10
11 (v). Buyer/Seller Shared Liability Amount. Upon exhaustion of relief
12 contemplated under subparagraphs (c) (i) through (iv), Buyer and Seller
13 shall share equally in payment of costs incurred by Buyer in connection
14 with Covered Matters in excess of the amounts received by Buyer under
15 subparagraphs (c) (I) through (iii) (or paid by buyer under subparagraph
16 (c) (iv)) to a maximum aggregate amount of Fifteen Million Dollars
17 (\$15,000,000.00), without regard to the number of claims concerning
18 Covered Matters required to reach said amount. Notwithstanding anything
19 to the contrary herein, Seller's total liability for Covered Matters shall be
20 limited to the amount of Seven Million Five Hundred Thousand Dollars
21 (\$7,500,000.00), and Buyer shall indemnify and hold Seller harmless with
22 respect to all claims, costs, demands and liabilities with respect to all other
23 Covered Matters.
24
25

26 Furthermore, in Article 2(d) the Agreement states:
27

28 Limitation on Seller's Liability. Seller's liability under Subparagraph (c)
29 above shall terminate upon that date (the "Termination Date") which is
30 fifteen (15) years after the Closing Date. From and after the Termination

1 Date, Seller shall have no further obligation or responsibilities with respect
2 to all other Covered Matters.
3
4

5 Q. DID SUC WILLINGLY ASSUME RESPONSIBILITY FOR THE POTENTIAL
6 LIABILITY ASSOCIATED WITH THE MGP REMEDIATION?

7 A. Yes, it did. On page one of the Environmental Liability Agreement it states:
8

9 Article 1. ASSUMPTION OF LIABILITY. Except as hereinafter
10 provided, Buyer hereby (a) assumes and agrees to be responsible for all
11 Environmental Claims now pending or that may hereafter arise with
12 respect to the Assets and the Business and (b) agrees to pay, perform and
13 discharge, as and when due and payable, all Environmental Costs with
14 respect to such Environmental Claims. Buyer hereby agrees, except as
15 herein provided, to indemnify and hold Seller harmless from and against
16 all Environmental Claims and Environmental Costs which Buyer has
17 assumed or agreed to be responsible for pursuant to this Article 1.
18
19

20 Q. WHAT EXACTLY WAS THE LIABILITY THAT SUC ASSUMED?

21 A. Covered matters are defined on page 2 of the Environmental Liability Agreement as:
22

23 Article 2. DEFINITION OF COVERED MATTERS. (a) Definition. As
24 used herein, the term "Covered Matters" shall mean and refer to all
25 Environmental Claims and Environmental Costs related to the Assets or
26 the Business which (i) arise out of or are based upon Environmental Laws,
27 and (ii) are not included in Assumed Liabilities.
28

29 (b) Newly Discovered Matters. Covered Matters that are
30 discovered by Buyer prior to the date which is two (2) years following the
31 date of this Agreement shall be subject to the cost sharing provisions
32 contained herein. All Covered Matters discovered by Buyer more than

1 two (2) years following the date of this Agreement shall be the sole
2 responsibility of Buyer.
3
4

5 Q. IS IT THE PUBLIC COUNSEL'S ASSERTION THAT SUC WILLINGLY AND WITH
6 FULL KNOWLEDGE OF ITS ACTIONS AGREED TO ACCEPT, AS PART OF THE
7 PURCHASE OF THE MISSOURI ASSETS, THE RESPONSIBILITY FOR THE
8 POTENTIAL LIABILITY ASSOCIATED WITH THE REMEDIATION OF THE MGP
9 SITES?

10 A. Yes, it did.
11

12 Q. HOW DID THE COMPANY INITIALLY RECOGNIZE ITS ASSUMED LIABILITY?

13 A. According to the Company's response to MPSC Staff Data Request No. 275, effective
14 September 1, 1994, the Company booked a \$3,000,000 adjusting entry to its financial
15 records to recognize the initial liability it had assumed pursuant to the terms of the
16 Environmental Liability Agreement discussed in the prior Q & A. The adjusting entry
17 debited USOA Account No. 114, Gas Plant Acquisition Adjustments for \$3,000,000 and
18 credited USOA Account No. 253, Other Deferred Credits for \$3,000,000. The
19 Company's description for the accrual was that the adjusting entry was for "possible
20 environmental liabilities."
21

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1 Further corroboration of this position is provided in the Company's response to OPC
2 Data Request No. 1150. It states:

3
4 1. Missouri Gas Energy was required by our third party auditors
5 (PricewaterhouseCoopers) to record a reserve of \$3,000,000 at June of
6 1994 for certain environmental costs that may arise at MGE. The
7 acquisition of MGE occurred on January 31, 1994. This amount was not
8 an attempt to quantify all potential environmental obligations, only a
9 specific portion of initial costs that would be excluded from any potential
10 sharing arrangement with Western Resources.
11
12

13 In essence, the Company, and apparently its outside accountants, recognized that pursuant
14 to the terms of the Environmental Liability Agreement recoveries of MGP remediation
15 costs from insurers, other potentially responsible parties and ratepayers was exhausted, or
16 at least not forthcoming, so it booked the adjusting entry to recognize its "initial sole
17 liability amount" and it also recognized that the initial sole liability amount was part of
18 the excess purchase price over book value that SUC paid WRI for the assets.
19

20 Q. PLEASE EXPLAIN WHAT IS MEANT BY THE ACCOUNTING TERM
21 "ACQUISITION ADJUSTMENT?"

22 A. In traditional accounting, fixed assets, such as plant, are usually recorded at "original
23 cost." Original cost, as applied to utility plant, means the cost of property to the utility
24 first devoting it to public service. An acquisition adjustment results when utility property
25 is purchased or acquired for an amount either in excess of or below book value. Book

1 value relates to the value placed on utility property and recorded on the Company's
2 financial books and records at the time the utility property is first placed in public service.

3
4 If the utility property is purchased by another utility, the purchaser must record the
5 acquisition in the appropriate "plant and property" accounts at the selling utility's original
6 cost; similarly, the purchaser records the seller's accumulated depreciation, amortization,
7 and contributions in aid of construction ("CIAC") in the appropriate account(s). Any
8 difference between the original cost and the actual price paid by a subsequent purchaser is
9 recorded as the acquisition adjustment. An acquisition adjustment does not represent a
10 contribution of capital (i.e., neither cash or new investment) to the public service. It
11 merely represents a purchase of the legal interests in the properties that were possessed by
12 the seller.

13
14 Q. WHAT IS ORIGINAL COST?

15 A. The term "original cost," as defined by the 1976 Uniform System of Accounts ("USOA")
16 for Class A and B Water Utilities, page 18, relates to:

17
18 All amounts included in the accounts for utility plant, acquired as an operating
19 unit or system, shall be stated at the cost incurred by the person who first devoted
20 the property to utility service and all other utility plant shall be included in the
21 accounts at the cost incurred by the utility.
22
23

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1 The deduction of depreciation, amortization, and CIAC from the original cost results in a
2 net original cost recorded on the seller's financial books and records. Thus, any property
3 acquired is valued on the books and records of the purchaser at the same value that the
4 seller placed on it. This principle is referred to as the "original cost first devoted to public
5 service concept."

6
7 Q. IS IT THE PUBLIC COUNSEL'S BELIEF THE MGE IS REQUESTING COST OF
8 SERVICE RECOVERY FOR AN ACQUISITION ADJUSTMENT RELATED TO ITS
9 PURCHASE OF THE WRI ASSETS?

10 A. Yes, it is. The Company's response to MPSC Staff Data Request No. 275 provided a
11 listing of the total MGP remediation costs it has incurred as of March 2001. These costs
12 are identified as reducing the \$3,000,000 acquisition adjustment credit amount booked to
13 USOA Account No. 253, Other Deferred Credits. Furthermore, the Company's proposal
14 to include remediation costs of \$280,444 (costs which are included in the listing provided
15 with Staff Data Request No. 275) in its cost of service as an expense would result in an
16 offsetting reduction in the \$3,000,000 acquisition adjustment debit amount recorded in
17 USOA Account No. 114, Gas Plant Acquisition Adjustments. The Company's proposal
18 clearly seeks recovery of an acquisition adjustment it has booked in its financial records
19 that pertains to its purchase of the WRI assets.
20

1 Q. SHOULD THIS COMMISSION CONTINUE ITS PAST PRACTICE OF ENDORSING
2 THE "ORIGINAL COST" CONCEPT?

3 A. Yes, we believe that it should endorse the concept. This Commission has the duty to
4 ascertain the reasonable value of all property of any regulated public utility within its
5 jurisdiction whenever such value becomes necessary to ascertain fair and reasonable
6 rates. The rate base of a public utility represents the reasonable value of all property
7 which is in service and devoted to the public use. Because the value of a utility's
8 property remains unchanged as its stock is bought and sold, the transfer of stock, the
9 indicia of ownership in a corporate entity whose stockholders are separate and distinct
10 from the entity itself, does not affect the value of its property in service and devoted to
11 the public use. Thus, no recalculation of the utility's property, or rate base, is
12 appropriate.

13
14 Q. IS USE OF NET "ORIGINAL COST" FOR VALUING RATE BASE THE
15 PREDOMINANT FORM OF REGULATION IN THE STATE OF MISSOURI?

16 A. Yes, it is. The use of "original cost" to set rates is not only the predominant form of
17 regulation, but the only form which has been employed by the Missouri Public Service
18 Commission. I know of no other time that this Commission has deviated from the
19 concept of using net "original cost" in setting rates.
20

1 Q. IS THE USE OF ORIGINAL COST FOR VALUING RATE BASE CONSISTENT
2 WITH GENERALLY ACCEPTED ACCOUNTING PRINCIPLES ("GAAP")?

3 A. Yes, it is. The accounting profession's "cost principle" specifies that cash-equivalent cost
4 is the most useful basis for initial accounting recognition of the elements recorded in the
5 accounts and reported on the financial statements. It is important to note that the cost
6 principle applies to the initial recording of transactions and events. Financial Accounting
7 Standards Board Concepts Statement 5, paragraph 67, explains that the initial cost is
8 commonly adjusted for depreciation, amortization or other allocations. The "accounting
9 constant" is the starting point, which is the historical (i.e., original) cost of the property
10 being purchased.

11
12 Q. WHAT IS THE HISTORICAL BACKGROUND FOR THE POSITION THAT NET
13 ORIGINAL COST SHOULD BE THE BASIS FOR SETTING RATES?

14 A. Abuses occurred in the 1920's and 1930's that created the need to adopt the original cost
15 method for valuing rate base and setting rates. Utilities were acquiring other utility
16 properties for amounts in excess of net book value. The valuation and transfer of
17 properties in excess of their book value (i.e., positive acquisition adjustment) created
18 inflated rate bases which resulted in higher rates to existing customers. The customers
19 were paying higher rates based on services provided by the exact same property that had
20 been providing them utility service prior to the acquisition when, in fact, nothing had
21 changed except for the valuation of the properties transferred. Regulators and legislators

1 determined it was unreasonable to charge customers higher rates for the utilization of
2 same utility property simply because the utility providing the service was acquired by
3 another company. Thus, the concept of using the original cost of the property when first
4 devoted to public service came to be widely accepted. This principle has served to
5 protect ratepayers from utilities who would buy properties at inflated prices and then seek
6 revaluation of the properties at higher levels in order to produce greater profits. Absent
7 this protection, the potential for abuse through acquisitions and mergers **is the same**
8 **today** as it was prior to implementation of the original cost concept.

9
10 Q. HOW IS AN ACQUISITION ADJUSTMENT RECORDED IN THE FINANCIAL
11 BOOKS AND RECORDS?

12 A. As I discussed previously in this testimony, an acquisition adjustment results when utility
13 property is purchased or acquired for an amount either in excess of or below book value.
14 If the purchase price exceeds book cost, a "premium" has been paid to the seller. If the
15 purchase price is less than book cost, a "discount" has been paid to the seller. The
16 premium or discount would be classified and booked on the purchasing company's (i.e.,
17 SUC's) financial records as an acquisition adjustment.

18
19 When utility property is purchased from another utility, the buyer is allowed to capitalize
20 the cost of the property when it was originally dedicated to utility service. This means
21 that any excess or discount paid from original cost for the property cannot be recorded in

1 the USOA Account No. 101, Gas Plant In Service. The difference (the premium or
2 discount) is recorded in USOA Account No. 114, Gas Plant Acquisition Adjustments, and
3 any amortization of the balance is booked to USOA Account No. 115, Accumulated
4 Provision For Amortization Of Gas Plant Acquisition Adjustments. The USOA account
5 descriptions for the three accounts are as follows:

6
7 1. 101. Gas Plant in Service.

8
9 A. This account shall include the original cost of gas plant, included
10 in accounts 301 to 399 prescribed herein, owned and used by the
11 utility in its gas operations, and having an expectation of life in
12 service of more than one year from date of installation. Including
13 such property owned by the utility but held by nominees. (See also
14 account 106 for unclassified construction costs of completed plant
15 actually in service.)

16
17 B. The costs of additions to and betterments of property leased from
18 others which are includible in this account, shall be recorded in
19 subdivisions separate and distinct from those relating to owned
20 property. (See gas plant instruction 6.)

21
22 2. 114. Gas Plant Acquisition Adjustments.

23
24 A. This account shall include the difference between (a) the cost to the
25 accounting utility of gas plant acquired as an operating unit or
26 system by purchase, merger, consolidation, liquidation, or
27 otherwise, and (b) the original cost, estimated, if not known, of
28 such property, less the amount or amounts credited by the
29 accounting utility at the time of acquisition to accumulated
30 provisions for depreciation and amortization and contributions in
31 aid of construction with respect to such property.

32
33 B. With respect to acquisitions after the effective date of this system
34 of accounts, this account shall be subdivided so as to show the
35 amounts included herein for each property acquisition and to gas

1 plant in service, gas plant held for future use and gas plant leased
2 to others. (See gas plant instruction 5.)
3

- 4 C. Debit amount recorded in this account related to plant and land acquisition
5 may be amortized to account 425, Miscellaneous Amortization,
6 over a period not longer than the estimated remaining life of the
7 properties to which such amounts relate. Amounts related to the
8 acquisition of land only may be amortized to account 425 over a
9 period of not more than 15 years. Should a utility wish to account
10 for debit amounts in this account in any other manner, it shall
11 petition the Commission for authority to do so. Credit amount
12 recorded in this account shall be accounted for as directed by the
13 Commission.
14

15 3. 115. Accum. Provision for Amort. of Gas Plant Acquisition Adjustments.
16

17 This account shall be credited or debited with amounts which are
18 includible in account 406, Amortization of Gas Plant Acquisition
19 Adjustments, or account 425, Miscellaneous Amortization, for the
20 purpose of providing for the extinguishment of amounts in account
21 114, Gas Plant Acquisition Adjustments, in instances where the
22 amortization of account 114 is not being made by direct write-off
23 of the account.
24
25

26 The amortization of the acquisition adjustment is made to USOA Account 406,
27 Amortization of Gas Plant Acquisitions Adjustments, if authorization is granted by the
28 Commission for "above-the-line" treatment. If Commission authorization is not given to
29 include the amortization for ratemaking purposes, the utility must account for the
30 purchase price difference "below-the-line" in USOA Account 425, Miscellaneous
31 Amortization. The USOA account description for these two accounts is as follows:
32

- 33 1. 406. Amortization of Gas Plant Acquisition Adjustments.
34

1 This account shall be debited or credited, as the case may be, with
2 amounts includible in operating expenses, pursuant to approval or order of
3 the Commission, for the purpose of providing for the extinguishment of
4 the amount in account 114, Gas Plant Acquisition Adjustments.
5

6
7 2. 425. Miscellaneous Amortization.
8

9 This account shall include amortization charges not includible in other
10 accounts which are properly deductible in determining the income of the
11 utility before interest charges. Charges includible herein, if significant in
12 amount, must be in accordance with an orderly and systemic amortization
13 program.
14

15 ITEMS
16

- 17 1. Amortization of gas plant acquisition adjustments, or of
18 intangibles included in gas plant in service when not
19 authorized to be included in utility operating expenses by
20 the Commission.
21
22 2. Amortization of amounts in account 182, Extraordinary
23 Property Losses, when not authorized to be included in
24 utility operating expenses by the Commission.
25
26 3. Amortization of capital stock expenses when in accordance
27 with a systematic amortization program.
28
29

30 Q. WHAT DOES AN ACQUISITION PREMIUM ACTUALLY REPRESENT?

31 A. An acquisition premium merely represents a financial transaction among shareholders. A
32 portion of the acquisition premium actually represents the procurement of additional
33 shareholder value (a control premium) that exceeds the book price of properties
34 purchased. From the perspective of WRI shareholders, the excess acquisition purchase
35 price merely represents nothing more than a financial gain on their investment. That

1 financial gain has nothing to do with the determination of the value of the actual plant
2 and service investments utilized in the operation and provision of services to utility
3 customers. As far as those investments are concerned the purchase transaction itself
4 changes nothing and they will remain fixed until the new owners implement changes.

5
6 Q. DO UTILITIES BENEFIT FROM THIS COMMISSION'S PRACTICE OF NOT
7 ALLOWING RECOVERY OF AN ACQUISITION PREMIUM IN RATES?

8 A. Yes, they do. Based on the ratemaking treatment afforded utilities in the past, if there is
9 an asset acquired at less than net book value, utility shareholders reap any benefits
10 associated with the acquisition of that asset. This occurs because the buyer records the
11 asset on its financial books at net book value (i.e., that is the asset's "original cost"
12 instead of the below book purchase price).

13
14 Furthermore, based on past Commission practice, utilities expect that any gain on a sale
15 of an asset (i.e., any sale of an asset in excess of its net book value) will go to the utilities
16 shareholders, and not to the ratepayers. To my knowledge no Missouri utilities have
17 come forward proposing to share gains from the sale of assets with ratepayers. It's
18 inconsistent to expect ratepayers to pay for an acquisition premium while shareholders
19 reap the benefits of any gains when a company disposes of utility properties.
20

1 For example, as it relates to the instant case, the former owners of the properties have at a
2 minimum reaped a gain commensurate with the stock value paid by SUC above the net
3 original cost of the Company, but those same owners did not come forward offering to
4 share their gains with Missouri customers. It is quite apparent that the ratepayers in
5 Missouri did not share in any of the gains from the sale.
6

7 Q. DO UTILITIES BENEFIT FROM CONSISTENT TREATMENT OF ACQUISITION
8 ADJUSTMENTS?

9 A. Yes, they do. Utilities that purchase property below book value resulting in negative
10 acquisition adjustments benefit because those same utilities receive a return on property
11 valued at its net "original cost," not the purchase price. Since these utilities would be
12 receiving a return on the net "original cost" rate base, their return component would be
13 computed on a rate base greater than that which these utilities actually had invested. If
14 the Commission then decides to allow utilities to recover positive acquisition premiums,
15 it creates a situation whereby utilities are put in the position of arguing for net "original
16 cost" ratemaking whenever a negative acquisition premium occurs, while at the same
17 time advocating that positive acquisition premiums be treated above net "original cost."
18 Under either scenario, the utility would benefit to the detriment of the ratepayers.
19

1 Q. ARE YOU AWARE OF ANY CASE IN MISSOURI WHEREBY A NEGATIVE
2 ACQUISITION ADJUSTMENT WAS AFFORDED "ORIGINAL COST" RATE
3 TREATMENT?

4 A. Yes, I am. In the U.S. Water/Lexington, Missouri ("U.S. Water") general rate case, Case
5 No. WR-88-255, the Commission rejected a negative acquisition adjustment which was
6 proposed by this Office. The negative acquisition adjustment was not used by the
7 Commission to reduce U.S. Water's rate base or to reflect a negative amortization to the
8 cost of service. This Commission determined that the reasonable value of property
9 purchased from other utilities was not its purchase price but rather the higher original cost
10 to the first entity which devoted the property to public.

11
12 The Commission did not recognize the negative acquisition adjustment associated with
13 the purchase nor, did it "write down" the value of the assets transferred; therefore, it
14 would be inconsistent to "write up" the assets, by whatever means, either through the
15 recovery of an acquisition premium or acceptance of any sharing of acquisition-related
16 savings. Acceptance of a recovery of an acquisition premium would be a reversal of the
17 Commission precedent set in the U.S. Water rate case.

18
19 Q. DOES USING NET "ORIGINAL COST" VALUATION FOR RATEMAKING
20 PURPOSES GIVE CONSISTENT TREATMENT TO UTILITIES?

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1 A. Yes, it does. Using net "original cost" to determine rate base valuation for ratemaking
2 purposes provides utilities consistency in establishing their rates. It also provides utilities
3 with the incentive to acquire utility properties termed "troubled utilities" where it would
4 be in the public interest for these troubled utilities to be acquired by another utility. For
5 example, if the Commission was confronted with a troubled property, and there was a
6 buyer willing to purchase that troubled property for less than original cost, the difference
7 between the original cost and the lower purchase price would be part of the incentive for
8 the buyer to consummate the transaction. Without the incentive associated with this
9 opportunity, the property may never change hands and improvements wouldn't even have
10 been contemplated.

11
12 Q. HOW HAVE GAINS ON SALE OF UTILITY PROPERTY BEEN TREATED FOR
13 RATEMAKING PURPOSES?

14 A. To my knowledge, the Commission has never allowed ratepayers to share in any gains
15 resulting from the sale of a utility's property. The selling utility's shareholders have
16 always realized the entire benefit of any gains received.

17 The Commission's position on this issue is illustrated by its decision in Kansas City
18 Power & Light, Case No., ER-77-118. On page 42 of its Report and Order, the
19 Commission stated:

20
21 It is the Commission's position that ratepayers do not acquire any
22 right, title and interest to Company's property simply by paying their

1 electric bills. It should be pointed out that Company investors
2 finance Company while Company's ratepayers pay the cost of
3 financing and do not thereby acquire an ownership position.
4 Therefore, the Commission finds that the disposal of Company
5 property at a gain does not entitle its ratepayers to benefit from that
6 gain nor does the disposal of Company property at a loss require that
7 Company's ratepayers absorb that loss.
8
9

10 Furthermore, in decisions reached by the Commission in rate cases involving Missouri
11 Cities Water Company, Case No. WR-83-14, and Kansas City Power & Light, Case No.
12 EO-85-185, the Commission found that gains of utility property sold by those utilities
13 would be treated "below-the-line."
14

15 The Commission has consistently followed this practice of not allowing any gains
16 resulting from sales of utility property to flow to ratepayers. It would be inequitable for
17 the shareholders of a seller of utility property to receive the benefit of any gain, while at
18 the same time, the buyer of utility property is be permitted to recover from its ratepayers
19 any "premium" above net book value. It would also be unfair to ratepayers if the seller's
20 gain were be taken below-the-line while the buyer's premium is provided recovery
21 above-the-line.
22

23 Q. HAS THE COMMISSION BEEN CONSISTENT IN ITS TREATMENT OF
24 ACQUISITION PREMIUMS AND GAINS ON SALE OF UTILITY PROPERTY?

1 A. Yes, it has. To my knowledge, this Commission has accorded acquisition premiums and
2 gains on sale of utility property consistent treatment in the ratemaking process. It has
3 consistently valued utilities rate bases utilizing net "original cost" valuation methods, and
4 it has consistently ignored the positive as well as the negative acquisition adjustments
5 that have resulted from utility acquisitions and mergers under its jurisdiction. It has also
6 disregarded the concept of flowing any gains derived from the sale of utility property to
7 ratepayers. It has taken the position, as noted previously, that gains from the disposal of
8 utility property belong to the utility's shareholders.

9
10 Q. WOULD THE CONTINUED DISALLOWANCE OF THE RECOVERY OF ANY
11 ACQUISITION PREMIUM IN RATES CREATE A DISINCENTIVE FOR UTILITIES
12 TO ACQUIRE OTHER UTILITIES?

13 A. No. If the utility considering an acquisition believes that it is in its economic as well as
14 its business interest, it would still acquire the other company regardless of any recovery
15 of an acquisition premium from ratepayers. The prudent thing to do would be for the
16 utility to pursue the acquisition if it is considered to be in the best interest of the utility
17 and the public absent an acquisition premium recovery.

18
19 Q. IS IT APPROPRIATE FOR THE COMMISSION TO DENY MGE THE PARTIAL
20 RECOVERY OF THE ACQUISITION ADJUSTMENT RELATED TO
21 MANUFACTURED GAS PLANT IN THIS PROCEEDING?

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1 A. Yes, it is.

2
3 Q. IS MGE POTENTIALLY LIABLE FOR EXPENSES RELATED TO THE
4 INVESTIGATION AND CLEANUP OF THE FORMER MGP SITES?

5 A. Yes, it would appear that the Company is potentially, at least partially, liable for the
6 costs. Two federal statutes have the greatest environmental regulatory impact with respect
7 to former MGP. They are, the 1976 Resource Conservation and Recovery Act enacted to
8 address the treatment, storage, management and disposal of solid wastes and the 1980
9 Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA"
10 or "Superfund"). Under the provisions of CERCLA, the Company falls under one or
11 more of the identified potentially responsible parties categories and therefore may be held
12 strictly, jointly, and severally liable for all cleanup costs. CERCLA specifically includes
13 in its PRP classifications the present owner and operator of a site, past owners of a site
14 and transporter of hazardous substances disposed of at a site when the transporter selected
15 the site.

16
17 Q. HAS ANY ACTUAL CLEANUP ACTION ON ANY OF THE MGP SITES
18 OCCURRED TO DATE?

19 A. No. Expenditures, however, have been incurred relating to the MGP site identifications,
20 consultant investigations, attorney fees, etc. MGE's response to Public Counsel Data

1 Request No. 1070, which requested a listing of the MGP sites and the current status of
2 cleanup expenditures states:

3
4 No active remediation has been completed on any of the above-referenced
5 sites.
6
7

8 Public Counsel understands the Company's response to mean that no active cleanup of
9 any of the MGP sites has yet occurred; however, according to the Company's response to
10 MPSC Staff Data Request No. 275, it has incurred approximately \$752,642 of various
11 remediation costs since the beginning of calendar year 1998.

12
13 Q. IS THE MANUFACTURED GAS PLANT USED AND USEFUL IN PROVIDING
14 SERVICE TO CURRENT CUSTOMERS?

15 A. It's my understanding that the Company does not currently own or operate any
16 manufactured gas plants. Company does own some of the plant sites where manufactured
17 gas plant was formerly operated, but no coal gas is manufactured there now. Therefore,
18 current and future ratepayers did not and will not receive service from any MGP. The
19 actual MGPs are not and will not be used and useful.
20

21 Q. PLEASE EXPLAIN THE CONCEPT "USED AND USEFUL".

1 A. One of the Public Counsel's main objections to the Company proposed treatment of this
2 issue is that we believe that it violates the regulatory "used and useful" standard. The
3 general rule is that, "the rate base on which a return may be earned is the amount of
4 property used and useful, at the time of the rate inquiry, in rendering a designated utility
5 service." (A.J.G. Priest, Principles of Public Utility Regulation (1969), p. 139, vol. 1).
6 This principle is certainly grounded in common sense. In dividing the responsibility for a
7 utility's operations between ratepayers and stockholders, regulators have traditionally
8 required that stockholders rather than ratepayers be required to bear the costs of any
9 utility investment which is not used and useful to provide service to the ratepayers.

10
11 In a recent discussion of the policy in Missouri, State ex rel. Union Electric v. Public
12 Service of the State of Missouri, 765 S.W. 2d 618 (Mo. App. 1988), the Court of Appeals
13 for the Western District endorsed the used and useful policy. That case involved Union
14 Electric's appeal of the Commission's denial of the costs of cancellation of its Callaway II
15 nuclear unit. The Commission ruled that the risk of cancellation should be borne by the
16 shareholder, since if it was not, the shareholder's investment would be practically risk
17 free. The Court, in upholding the Commission's decision, stated:

18
19 The utility property upon which a rate of return can be earned must be
20 utilized to provide service to its customers. That is, it must be used and
21 useful. This used and useful concept provides a well-defined standard for
22 determining what properties of a utility can be included in its rate base.
23

1 Q. SHOULD RATEPAYERS BE HELD RESPONSIBLE FOR COSTS ASSOCIATED
2 WITH ASSETS THAT ARE NO LONGER IN SERVICE?

3 A. No. Current ratepayers should not be held responsible for additional costs that do not
4 increase service capabilities or provide cost benefits. The MGP site remediation costs
5 being incurred are associated with plant that is no longer in service and therefore no
6 longer used and useful. The Company is asking the Commission to have the customer
7 pay for plant that does not operate to provide current utility service. I don't believe this is
8 a normal practice of this Commission, and it is unreasonable to force a consumer to pay
9 for something they are not using. MGE is entitled to the opportunity to earn a fair rate of
10 return only upon monies prudently invested in property used and useful in rendering
11 utility service.

12
13 The purpose of the regulatory ratemaking process is to identify a reasonable monetary
14 return that the monopoly enterprise has the opportunity to earn. Regulation does not
15 guarantee that level of earnings, nor does it force a company to return any overearnings
16 retroactively, in the event overearnings occur. Even if the former MGPs are assumed to
17 have been used and useful utility property at the time the pollution of the land occurred,
18 and the cleanup costs had not been anticipated while the plant was in use, current
19 ratepayers should not be held captive to their recovery. In simplistic terms, the
20 ratepayers part of the regulatory bargain is to provide the company with a level of
21 revenues that allow it to earn the Commission approved rate of return on current used and

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1 useful investment along with the costs of operating and maintaining that investment, and
2 no more. Ratepayers do not assume, willing or implied, any risk assumed by the
3 stockholders.

4
5 MGE's proposal implicitly states that because federal statutes, unrelated to its provision
6 of utility service to customers, will cause the Company's expenditures to increase,
7 ratepayers and not stockholders should be held responsible for those costs. The Company
8 is attempting to pass the natural risks associated with a business that is a continuing
9 enterprise, a "going-concern", entirely from stockholders to ratepayers. Stockholders, not
10 ratepayers, are the actual risk-takers and for assumption of risk they receive a market
11 determined return on their investment. If an unexpected event occurs that affects the
12 Company either in a negative or positive manner then stockholders, not ratepayers,
13 should weather the effects.

14
15 Q. ARE THERE ANY OTHER REASONS WHY RATEPAYERS SHOULD NOT BE
16 FORCED TO COMPENSATE THE COMPANY FOR THE REMEDIATION COSTS
17 AT THIS TIME?

18 A. Yes, there are. Other reasons include:

- 19
20 1. It is likely that prior ratepayers have already provided the Company with a "return
21 on and a "return of" its investment in the MGP operations. This return of (i.e.,

1 depreciation) included costs to dismantle and decommission the plant, current and
2 future ratepayers bear no responsibility for the contamination which exists at the
3 sites.

4
5 2. Future costs espoused by the Company are not sufficiently fixed, or "known and
6 measurable," and should not be relied on for ratemaking purposes.

7
8 3. The costs to analyze, study, remediate, and litigate MGP contamination are not a
9 current or future cost of providing safe and adequate, and reliable gas service to
10 ratepayers.

11
12 4. Guaranteeing full recovery of the costs from ratepayers removes the incentive for
13 the Company to control costs and may lessen other PRPs willingness to contribute
14 to clean-up efforts.

15
16 5. The Company has not completed its pursuit of recovery of the costs incurred from
17 its insurers and other PRPs consequently full recovery of these costs from
18 ratepayers would likely lessen the incentive to aggressively pursue and maximize
19 recovery from insurers and PRPs.
20

1 6. Implicit in Company's rate of return is a risk factor for unknown and
2 unanticipated expenditures such as environmental compliance costs. The "return
3 on" component of prior rates included recognition of this risk factor. Company
4 stockholders have therefore already been compensated for the costs.

5
6 Q. ARE THE MGP REMEDIATION COSTS POTENTIALLY RECOVERABLE FROM
7 THE COMPANY'S INSURERS?

8 A. Yes, they are.

9
10 Q. ARE MANUFACTURE GAS PLANT REMEDIATION COSTS POTENTIALLY
11 RECOVERABLE FROM OTHER POTENTIALLY RESPONSIBLE PARTIES?

12 A. Yes, they are. As the former owners of the Missouri utility operations, Western
13 Resources Inc., is potentially liable for the payment of costs associated with the
14 remediation of the MGP sites. It is likely that WRI's potential liability will exceed that
15 agreed to by WRI and SUC in their Asset Purchase Agreement. This potential increase in
16 liability for WRI would likely occur due to the fact that if the EPA names WRI as a PRP
17 for the affected sites (which OPC believes is a likely outcome), the federal government
18 will not be inclined to view the terms of the Asset Purchase Agreement as a limitation on
19 either parties responsibility for MGP remediation or the payment of its costs.
20

1 Q. IS IT REASONABLE TO ASSUME THAT BASED ON CURRENT KNOWLEDGE
2 MGE CAN EXPECT TO ENTER INTO FUTURE COST SHARING AGREEMENTS
3 WITH THE FORMER OWNERS, OTHER POTENTIALLY RESPONSIBLE PARTY'S
4 AND/OR RECEIVE COST REIMBURSEMENTS FROM ITS INSURERS?

5 A. Yes, that is a possibility.
6

7 Q. WOULD IT BE APPROPRIATE TO ORDER RATEPAYERS TO REIMBURSE MGE
8 FOR THE REMEDIATION EXPENDITURES IT HAS INCURRED GIVEN THAT IN
9 TIME OTHER POTENTIALLY RESPONSIBLE PARTIES AND/OR COMPANY'S
10 INSURERS MAY TAKE RESPONSIBILITY FOR PAYING THE COSTS?

11 A. No, it is not appropriate that ratepayers be required to reimburse the Company for the
12 remediation expenditures. Until such time as the Commission can accurately gauge the
13 cost reimbursement or recovery MGE will receive from its insurers and other PRPs, it is
14 inappropriate to ask ratepayers to finance the Company's expenditures for these projects.
15 The lack of information for potential cost recovery from other PRPs and insurance claims
16 increases substantially the impossibility of accurately determining the level of MGP site
17 remediation costs MGE is or will eventually be responsible for.
18

19 Q. WHAT IS THE TRUE NATURE OF THE REMEDIATION COSTS?

20 A. The remediation and any future cleanup costs are in actuality a legal requirement that
21 must be met in order to satisfy federal statutes on the proper handling of hazardous

1 wastes in order to alleviate adverse environmental effects. The expenditures MGE has
2 incurred were to identify and assess MGP sites that may require further action. They are
3 not expenditures related to the providing of utility service to current or future MGE
4 ratepayers.

5
6 Q. HOW IS RISK DEFINED?

7 A. Business or investment risk can be defined as, "The probability that the expected return
8 will not be earned because of the impact of some risky (unplanned) event occurring."

9
10 Q. IS IT POSSIBLE THAT STOCKHOLDERS HAVE ALREADY BEEN
11 COMPENSATED FOR THIS PARTICULAR BUSINESS RISK?

12 A. Yes. It is a well accepted principle of regulation that common stockholders contribute
13 what is known as "risk capital" to the utility company for which they receive a
14 compensatory rate of return. Among the uncertainties that common stockholders accept
15 in return for this added compensation is the danger, for whatever reason, of earnings
16 shortfall.

17
18 Each year prior and subsequent to the acquisition, it is likely stockholders received the
19 benefit of a risk premium in the rates that the Company collected from ratepayers. The
20 stockholders have been rewarded with an additional return, above a risk free investment
21 such as U.S. government securities, on their investment for unplanned, unforeseeable and

1 unexpected events. Now, after receiving the benefit of the additional risk return, the
2 Company proposes that it is ratepayers, not stockholders, who should bear the financial
3 responsibility for the MGP site remediation costs.
4

5 Public Counsel believes that ratepayers have already satisfied the requirements imposed
6 upon them by past Commission orders. They provided the revenues to meet the
7 Company's Commission approved earnings level for each of the years that the MGP plant
8 was in service. It is the Company's stockholders that should bear total responsibility for
9 the remediation costs because the stockholders have already been remunerated for
10 assuming the risk of an event such as MGP site remediation occurring.
11

12 Q. WOULD INTERGENERATIONAL INEQUITY OCCUR SHOULD THE DEFERRED
13 COSTS BE ALLOWED IN THE COST OF SERVICE?

14 A. Yes, that is a distinct probability. The concept of intergenerational equity is that one
15 "generation" of utility customers should pay the current costs of providing service to
16 themselves. It is inequitable for those customers to pay for the costs of providing service
17 in the past or in the future.
18

19 The Company is demanding that current and future generations of ratepayers bear
20 responsibility for costs that does not relate to the provision of safe and reliable gas service
21 that they receive now or in the future. It is my opinion that the MGP site remediation

1 expenses Company is demanding relates to out of period service. Such costs are not
2 related to the provision of utility service to current customers. Also the quality, quantity,
3 and reliability of gas service is not likely to improve no matter how much MGP
4 remediation MGE conducts. Clearly, imposition of these costs on current and future
5 ratepayers would be unjust and should be denied.

6
7 A denial of recovery from present and future ratepayers is appropriate because past
8 generations of ratepayers, those that received the service from the manufactures gas
9 plants in question, provided MGE shareholders a "return on" their investments in the
10 MGPs. Those same shareholders were also provided a "return of" the MGP investment
11 through depreciation rates during the time such plant were in service. This depreciation
12 should have been sufficient for plant wear and tear, obsolescence, and complete and
13 prudent decommissioning of each MGP, less salvage value. Therefore, MGE is
14 attempting to charge ratepayers for costs its has already recovered.

15
16 Q. WERE RATEPAYERS AT FAULT FOR THE ENVIRONMENTAL
17 CONTAMINATION?

18 A. No. Ratepayers had no input as to the manner in which MGP sites were operated or
19 dismantled nor were they at fault for the contamination of the MGP sites.
20

1 Q. WHY IS IT SIGNIFICANT TO ESTABLISH THAT THE RATEPAYERS ARE NOT
2 AT FAULT FOR THE ENVIRONMENTAL CONTAMINATION?

3 A. It is significant to establish the ratepayers lack of fault in order to highlight the
4 impropriety of MGE's proposal. The proposal is a classic example of a public utility
5 trying to take advantage of the captive position of its customers. Essentially, it's the
6 Company's desire to shift the risk and financial burden of the MGP sites remediation
7 from its shareholders to its customers. Customers did not cause the contamination. In
8 fact, it is unlikely that current customers played any part in the management and
9 operation of the plant that is now being remediated. Any contamination that occurred
10 was done under the auspices of managers of the Company. To absolve them of this
11 responsibility, for whatever reason, is not appropriate. The Company's shareholders have
12 been reimbursed for the risk of events such as these through Commission approved rates
13 of return. Accordingly, the Company's shareholders should be held responsible for the
14 resulting liabilities and costs.

15
16 Q. IF THE COMMISSION DISALLOWS THE COMPANY'S REQUEST FOR
17 RECOVERY OF THE REMEDIATION EXPENDITURES WOULD THAT DECISION
18 MATERIALLY IMPACT THE COMPANY'S FINANCIAL POSITION?

19 A. It's the Public Counsel's opinion that MGE's financial position would not be materially
20 impacted if the Commission disallows the remediation expenditures from its cost of
21 service. The deferred balance the Company is requesting recovery of represents

1 approximately .0079% (approximately eight tenths on one percent) of the calendar year
2 2000 net operating income as shown on Schedule A-1 of Mr. Noack's Updated Test Year
3 Direct Testimony (i.e., \$280,448 divided by \$35,541,699). Public Counsel does not
4 believe that Commission disallowance of such a relatively small percentage of costs
5 would have a material impact on the Company's operations. This view is further
6 bolstered by our opinion that we believe ratepayers should not be held responsible for
7 reimbursement of any of the costs and that it is quite possible that the Company will
8 receive future reimbursement of some of the expenditures from WRI, its insurers and/or
9 other PRPs.
10

11 **LANDBASE DIGITIZED MAPPING SYSTEM**
12

13 Q. WHAT IS THE ISSUE?

14 A. Company has been leasing the LDMS to outside entities such as municipalities and
15 utilities. The revenues it received from the leasing activities have been booked to a
16 clearing account which is then allocated to various construction work in process
17 ("CWIP") projects. It's the Public Counsel's understanding that many of the CWIP
18 projects to which the revenues are being allocated are in no way related to the LDMS.
19 Furthermore, expenses associated with the enhancement of the LDMS have either been
20 booked to the same clearing account as the lease revenues or booked directly to a
21 construction work in process account specific to the miscellaneous intangible account

1 where the costs of the LDMS are recorded or to a miscellaneous/labor and overheads
2 account. Public Counsel believes that the Company's methodology for recording the
3 revenues and costs associated with the LDMS should be changed.

4
5 Public Counsel recommends that the Company book all valid costs associated with the
6 development, enhancement or implementation of the LDMS directly to USOA Account
7 303, Miscellaneous Intangibles. It is also our recommendation that any revenues received
8 in the future should either be booked as a direct reduction of the costs recorded in the
9 LDMS account until such time as the cost of the LDMS is completely amortized then,
10 any further revenues should be treated as a normal operating revenue.

11
12 Q. WHY DOES THE PUBLIC COUNSEL BELIEVE THAT THE COMPANY'S
13 METHODOLOGY FOR RECORDING THE REVENUES AND COSTS OF THE
14 LDMS NEEDS TO BE CHANGED?

15 A. Public Counsel believes the financial recording modification is needed because the
16 Company's methodology does not accurately represent the true costs of the LDMS. We
17 share this belief because booking the costs and revenues to the clearing account I
18 described earlier allows some of the costs and revenues to be ultimately booked to plant
19 accounts that have little or nothing to do with the LDMS. In addition, the Company, by
20 leasing the LDMS to outside parties, has created a non-regulated revenue center for the
21 selling of a product that is not included in its tariffs. Thus, the Company should be

1 required to track the costs of the LDMS as accurately as possible to insure that ratepayers
2 do not inappropriately subsidize Company's non-regulated operations. In addition,
3 because the LDMS was paid for in its entirety by ratepayers provided monies, we believe
4 that booking all revenues received from leasing the system with all costs for the
5 development, enhancement and implementation of the system is a logical methodology
6 that enhances the audibility and verification of the system's true cost.
7

8 Q. DID THE COMPANY RECEIVE ANY LEASE REVENUES DURING THE TEST
9 YEAR?

10 A. No. The Company's response to OPC Data Request No. 1137 identifies October 1999 as
11 being the last time it received any revenues associated with its leasing of the LDMS.
12

13 Q. IS THERE ANY RATE IMPACT TO THE PUBLIC COUNSEL'S PROPOSAL?

14 A. Any rate impact associated with the Public Counsel's proposal would be limited to the
15 rate base and depreciation impact of transferring any revenues and costs booked to the
16 clearing account that are not ultimately allocated to USOA Account 303, Miscellaneous
17 Intangibles. Public Counsel suspects the rate impact would be minimal.
18

19 ALTERNATIVE REGULATION (INCENTIVE) PLAN
20

21 Q. WHAT IS THE ISSUE?

1 A. Company has proposed the adoption of an Alternative Regulation Plan ("ARP") which it
2 deems to be an "Incentive Plan." Public Counsel believes that the ARP proposal is short-
3 sighted and too limited in its development and structure to be of any real or potential benefit
4 to ratepayers or shareholders. The plan as proposed by the Company is limited to two Call
5 Center customer service standards and recovery of the SLRP deferred costs. It doesn't
6 propose to include any other areas of the Company's operations. There is no mention of
7 costs savings or total revenue sharing procedures or tracking and reporting procedures or
8 increases in the efficiency of MGE's overall operations expected to occur if the ARP is
9 implemented. Public Counsel believes that because the Company's proposal lacks
10 discussion on these types of important items, which are usually identified and explained in
11 any ARP proposal presented to this Commission for authorization, it is not a completely
12 thought-out plan and as such it should not be approved.

13
14 Furthermore, Public Counsel believes that there exists absolutely no linkage between the
15 Call Center customer service standards proposed and the Service Line Replacement
16 Program that would justify such an odd aberration from the accepted regulatory procedures
17 and accounting for the SLRP deferred costs. To Public Counsel, tying the recovery of
18 SLRP deferred costs to the ARP the Company proposes makes no sense.

19
20 Q. WHAT IS THE PURPOSE OF THE ARP?

1 A. The purpose of the ARP, according to the Direct Testimony of Company witness Dr. Jay
2 Cummings, is to provide an alternative to the issuance of a new AAO upon completion of
3 this proceeding. Dr. Cummings goes on to add that in the event that the Commission does
4 not authorize the ARP, MGE requests that the Commission authorize a new SLRP AAO.

5
6 Q. DOES THE PUBLIC COUNSEL BELIEVE THAT AN ALTERNATIVE
7 REGULATORY PLAN IS NEEDED TO REPLACE THE CURRENT SLRP AAO
8 PROCESS?

9 A. No. The current AAO process sufficiently provides the Company with the opportunity to
10 identify and defer various costs associated with the SLRP which it would not be able to do
11 under normal regulatory ratemaking. It also provides intervening parties to the Company's
12 rate cases with the opportunity to review and/or audit the costs Company has deferred for
13 reasonableness and prudence. The intervening parties may then present their
14 recommendations for cost of service treatment for the deferred costs to the Commission.
15 All parties benefit by knowing exactly what the SLRP costs are and by having the ability, if
16 found necessary, to challenge the Company's proposed ratemaking treatment of the costs
17 deferred.

18
19 Also, It's my understanding that the Company's gas line safety program is winding down
20 and nearing completion. It is currently scheduled to expire on or about the year 2004.
21 Company has stated that it has replaced all its bare steel and cast iron mains and is in the

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1 process of finishing the replacement of the remaining service lines. Public Counsel believes
2 it short-sighted of the Company to propose a new, and potentially complicated, SLRP ARP
3 at a time when the safety program is very nearly finished.
4

5 Q. PLEASE EXPLAIN WHY THE PUBLIC COUNSEL BELIEVES THAT THE
6 PROPOSED ALTERNATIVE REGULATORY PLAN IS NOT A RATIONALE
7 SUBSTITUTE FOR THE CURRENT AAO PROCESS.

8 A. The Company's proposal is nothing more than an attempt to establish an abbreviated audit
9 and/or review process that would allow it to receive rate treatment for costs (i.e., return,
10 depreciation expense, and property taxes) associated with SLRP plant that has not been
11 recognized in rates. Public Counsel believes that the ARP, if authorized, would circumvent
12 the detailed analysis now performed when reviewing the reasonableness and prudence of
13 the SLRP costs deferred utilizing the current AAO process. The circumvention occurs due
14 to the fact that the Company's proposal would tie annual rate changes for the SLRP costs to
15 two Call Center standards that have absolutely nothing in common with the Service Line
16 Replacement Program. Company's proposal would also guarantee it rate base treatment of
17 the SLRP costs.
18

19 Q. HAS THIS COMMISSION ORDERED IN THE PAST THAT RATE BASE
20 TREATMENT OF DEFERRED SLRP COSTS IS NOT APPROPRIATE?

21 A. Yes, it has.

1 Q. DOES THE PUBLIC COUNSEL BELIEVE THAT THE PROPOSED ARP WOULD
2 COMPLICATE FURTHER AN ALREADY COMPLICATED SAFETY PROGRAM?

3 A. Yes. The structure of the ARP, as proposed, is extremely limited as it essentially consists of
4 reviewing only two standards associated within the Company's Call Center operations. If
5 those standards are met, it would allow the Company to make annual rate changes for SLRP
6 costs (which are not even remotely related to the Call Center's costs) without the
7 ratemaking aspect or methodology being challenged by any intervenor. Neither does the
8 ARP provide for the resolution of any potential conflicts. Company's claim is that conflicts
9 should not occur because if the customer service standards are met, the SLRP costs
10 automatically become authorized for recovery. Public Counsel believes that position to be
11 absurd. Rate allowance of the SLRP costs should be based on the audit and ratemaking
12 determination of the individual SLRP costs themselves and not some short-list of pre-
13 designed standards from an ambiguous Call Center. To the extent which the ARP does not
14 provide for a full review of the Company's entire operation and cost structure (which it
15 doesn't), the plan is incomplete and unworkable.

16
17 Q. DOES IT APPEAR THAT THE COMPANY BELIEVES THAT IN THE PAST IT HAS
18 SOMEHOW BEEN TREATED UNFAIRLY?

19 A. Apparently so. On page 12, lines 3 – 6, of Mr. Steven W. Cattron's Direct Testimony, he
20 states:
21

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1 My Company's experience also indicates that while the Commission is
2 willing to administer punishment for what it deems to be inappropriate
3 conduct, it is at the same time hesitant to administer rewards for what it
4 deems to be positive conduct.
5
6

7 Q. IS IT MGE'S BELIEF THAT THE COMMISSION OWES IT THE ARP BECAUSE THE
8 OPERATION OF THE COMPANY HAS IMPROVED?

9 A. It would appear so. On page 16, lines 12 - 15, of Mr. Cattron's Direct Testimony, he
10 states:
11

12 Finally, the Commission needs to bring symmetry to its treatment of MGE
13 by showing a willingness to reward positive conduct, through the adoption
14 of an upward rate of return adjustment and approval of the Customer Service
15 Effectiveness/Gas Safety Program Experimental Incentive Plan.
16
17

18 Q. IN YOUR OPINION WHAT IS THE REWARD THAT THE COMPANY IS SEEKING
19 WITH REGARD TO THIS ISSUE?

20 A. In my opinion, the Company wants the Commission to abstain from its statutory regulatory
21 oversight responsibility regarding the investigation and audit of the costs associated with
22 the SLRP, and their ultimate ratemaking treatment. Commission authorization of the
23 Company's proposed ARP would achieve that reward.
24

25 Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?

26 A. Yes, it does.

ENVIRONMENTAL LIABILITY AGREEMENT

FILE COPY

ENVIRONMENTAL LIABILITY AGREEMENT (the "Agreement"), dated as of _____, 199__ between WESTERN RESOURCES, INC., a Kansas corporation ("Seller") and SOUTHERN UNION COMPANY, a Delaware corporation ("Buyer").

WHEREAS, Seller and Buyer have entered into an Agreement for Purchase of Assets dated as of _____ 1993, (the "Asset Purchase Agreement"), in which this Agreement is incorporated by reference pursuant to Article XIII of the Asset Purchase Agreement; and

WHEREAS, Buyer and Seller desire to provide a framework for the liability of the parties for Environmental Claims and for the sharing of Environmental Costs;

NOW, THEREFORE, in consideration thereof and of the respective covenants, representations and warranties herein contained, the parties agree as follows:

Article 1. ASSUMPTION OF LIABILITY. Except as hereinafter provided, Buyer hereby (a) assumes and agrees to be responsible for all Environmental Claims now pending or that may hereafter arise with respect to the Assets and the Business and (b) agrees to pay, perform and discharge, as and when due and payable, all Environmental Costs with respect to such Environmental Claims. Buyer hereby agrees, except as herein provided, to indemnify and hold Seller harmless from and against all Environmental Claims and Environmental Costs which Buyer has assumed or agreed to be responsible for pursuant to this Article 1. The procedures set

forth in Section 12.02 of the Asset Purchase Agreement concerning recovery of costs for matters subject to indemnification are incorporated herein by reference and made a part hereof, and Seller and Buyer agree to comply with the procedures set forth in said Section 12.02 in making any claim relating to indemnification. For the purposes of Buyer's assumption of liability, agreement to pay, perform and discharge and to indemnify set forth in this Article 1, Article 2(c)(v) and Article 2(d) only, the term "Environmental Claim" shall include, in addition to those claims which are included within such term as defined in the Asset Purchase Agreement, any and all such claims and other matters hereafter arising which are based in whole or in part upon (A) any amendment or modification which occurs after the Closing Date of any Environmental Law which is extant on the Closing Date; (B) any law, statute, ordinance, rule, regulation, order or determination of any governmental authority or agency enacted or adopted after the Closing Date which would, if such law, statute, ordinance, rule, regulation, order or determination were in effect on the Closing Date, be an Environmental Law; or (C) any change in interpretation of any Environmental Law after the Closing Date by any court or by any governmental agencies having authority to enforce such Environmental Law.

Article 2. DEFINITION OF COVERED MATTERS. (a) Definition. As used herein, the term "Covered Matters" shall mean and refer to all Environmental Claims and Environmental Costs related to the Assets or the Business which (i) arise out of or are based upon

Environmental Laws, and (ii) are not included in Assumed Liabilities.

(b) Newly Discovered Matters. Covered Matters that are discovered by Buyer prior to the date which is two (2) years following the date of this Agreement shall be subject to the cost sharing provisions contained herein. All Covered Matters discovered by Buyer more than two (2) years following the date of this Agreement shall be the sole responsibility of Buyer.

(c) Shared Liability. (i) Insurance First Line of Recovery. Seller shall undertake, at its sole expense, to conduct an Environmental Insurance Archaeology Survey ("Survey") for all Plants and other locations identified on Schedule 6.18 of the Asset Purchase Agreement within thirty (30) days of the Closing Date and promptly thereafter provide Buyer with the results of the Survey. To the extent that Seller may lawfully do so without adversely affecting the insurance coverage disclosed by the Survey, Seller hereby agrees that the insurance coverage disclosed by that Survey shall constitute the first line of recovery. For any Covered Matter discovered by Buyer after Closing, Buyer shall as promptly as possible after the discovery of such Covered Matter provide notice of such discovery, together with all factual information and copies of all notices, environmental assessments, reports and other information, to Seller's Environmental Services Department so as to allow Seller to provide prompt and timely notice to the appropriate insurance carrier or carriers identified in the Survey. The parties thereafter agree to cooperate in the filing and prosecution of

claims with the appropriate insurance carrier(s) in a manner that the parties mutually agree so as to expeditiously prosecute such claims. Amounts recovered from such insurance carrier(s) from the prosecution of such claims shall, after allowance for Seller's post closing outside legal fees and other reasonable out of pocket expenses, be paid to Buyer. In the event insurance recovery is protracted, the parties shall accelerate the shared cost provisions of subparagraphs (c)(ii) through (v), crediting subsequent insurance or PRP contributions to the parties as their interests appear in subparagraphs (iv) and (v).

(ii) Potentially Responsible Party First Line of Recovery. In those instances where other Potentially Responsible Parties (PRPs) are identified for purposes of cost sharing in the remediation of any site, amounts recovered from such PRPs shall, after allowance for Buyer and Seller's post closing outside legal fees and other reasonable out of pocket expenses, be paid to Buyer and credited against the cost incurred with respect to such required remediation. In the event PRP recovery is protracted, the parties shall accelerate the sharing of cost as provided for in subparagraphs (c)(iii) through (v) hereof, crediting subsequent insurance or PRP contributions to the parties as their interests appear in subparagraphs (iv) and (v).. If Seller and Buyer agree to so accelerate the sharing of costs, then Seller shall, prior to the application of any subsequent insurance proceeds or PRP contributions, be entitled to receive reimbursement of amounts advanced under subparagraph (c)(v) for post-closing costs incurred

in connection with Covered Matters as provided herein pursuant to said subparagraph.

(iii) Recovery of Remediation Costs through Regulated Cost of Service. In addition to seeking the relief contemplated under subparagraphs (c)(i) or (ii), Buyer shall request from the appropriate regulatory agency having jurisdiction in the state where any remediation site is located for authority to include the cost incurred by Buyer in connection with the remediation of such site, above that recovered under subparagraphs (c)(i) or (ii), in its applicable rates or other charges for service. Notwithstanding anything to the contrary contained in this Agreement, Buyer shall retain complete discretion as to the timing of any filings with the appropriate regulatory agencies and may seek to recover such amount in rates either before or after the recovery of any amounts pursuant to any other provision of this agreement. Buyer shall be deemed to have recovered in its applicable rates or other charges for service an amount equal to the greater of (A) the amount actually authorized for inclusion in Buyer's applicable rate or other charges for service reflected in tariffs, or (B) the amount which would be recovered if Buyer would have been authorized to include in its applicable rate or other charges for service reflected in tariffs an amount which would have been authorized for such inclusion if Buyer's request for inclusion had been accorded the treatment accorded similar expenditures under similar facts and circumstances by the applicable regulatory agency.

(iv) Buyer's Initial Sole Liability Amount. Upon exhaustion

of relief contemplated under subparagraphs (c)(i), (ii) and (iii), Buyer shall thereafter be solely liable (as between Seller and Buyer) for the payment of costs incurred by Buyer or Seller in connection with Covered Matters in excess of the amounts received by Buyer under subparagraphs (c)(i), (ii) and (iii) in the aggregate amount of Three Million Dollars (\$3,000,000.00), without regard to the number of claims concerning Covered Matters required to reach said amount.

(v). Buyer/Seller Shared Liability Amount. Upon exhaustion of relief contemplated under subparagraphs (c)(i) through (iv), Buyer and Seller shall share equally in payment of costs incurred by Buyer in connection with Covered Matters in excess of the amounts received by Buyer under subparagraphs (c)(i) through (iii) (or paid by Buyer under subparagraph (c)(iv)) to a maximum aggregate amount of Fifteen Million Dollars (\$15,000,000.00), without regard to the number of claims concerning Covered Matters required to reach said amount. Notwithstanding anything to the contrary herein, Seller's total liability for Covered Matters shall be limited to the amount of Seven Million Five Hundred Thousand Dollars (\$7,500,000.00), and Buyer shall indemnify and hold Seller harmless with respect to all claims, costs, demands and liabilities with respect to all other Covered Matters.

(d) Limitation on Seller's Liability. Seller's liability under Subparagraph (c) above shall terminate upon that date (the "Termination Date") which is fifteen (15) years after the Closing Date. From and after the Termination Date, Seller shall have no

further obligations or responsibilities with respect to all other Covered Matters.

(e) Costs Incurred by Buyer and Seller. For the purposes of this Agreement, Seller and Buyer agree that the costs incurred by Buyer or Seller with respect to Covered Matters for which the other party is liable pursuant to Subparagraph (c) above shall include only costs and expenses actually paid to unrelated third parties, and in no event shall Buyer or Seller be responsible for nor shall either party receive credit for (i) pre-closing costs or expenses, or (ii) any costs or expenses paid with respect to any of either party's employees or any of either party's overhead. Each party hereby agrees to use its best reasonable efforts to control costs incurred for which the other party may be responsible and shall provide such other party with quarterly reports of costs incurred.

(f) Duty to Consult. Buyer and Seller shall at all times consult with and keep each other apprised of all activities and costs incurred in connection with Covered Matters, and Buyer and Seller shall indemnify and hold the other party harmless from any unreasonable expense incurred. Each party shall apprise the other party of those respective activities on a quarterly interval on all active Covered Matters.

(g) Standstill Agreement. In the event either Buyer or Seller is notified that they or either of them is asked to respond as a Potentially Responsible Party ("PRP") under any federal, state or local law or regulation with regard to a Covered Matter, the party receiving such notice shall notify the other party of the receipt

of such notice, and shall deliver a copy of all notices and documents received, within ten (10) business days after receipt. With regard to Covered Matters, Buyer and Seller each covenant and agree not to sue the other or attempt in any manner to avoid responsibility as a PRP by seeking or attempting to shift or allocate responsibility to the other. Buyer and Seller agree to cooperate in the identification of all other PRPs for purposes of participation, remediation cost sharing and liability to regulatory agencies.

Article 3. MISCELLANEOUS. (a) Dispute Resolution. No party to this Agreement shall be entitled to take legal action with respect to any dispute relating hereto until it has complied in good faith with the following alternative dispute resolution procedures, provided however, this Article shall not apply to the extent it is deemed necessary to take legal action immediately to preserve a party's adequate remedy.

(i) Negotiation. The parties shall attempt promptly and in good faith to resolve any dispute arising out of or relating to this Agreement, through negotiations between representatives who have authority to settle the controversy. Any party may give the other party written notice of any such dispute not resolved in the normal course of such negotiations. Within twenty (20) days after delivery of the notice, representatives of both parties shall meet at a mutually acceptable time and place, and thereafter as often as they reasonably deem necessary, to exchange information and to attempt to resolve the dispute, until the parties conclude that the

dispute cannot be resolved through unassisted negotiation. Negotiations extending sixty (60) days after notice shall be deemed at an impasse, unless otherwise agreed by the parties.

If a negotiator for a party hereto intends to be accompanied at a meeting by an attorney, the other negotiator(s) shall be given at least ten (10) business days' notice of such intention and may also be accompanied by an attorney. All negotiations pursuant to this Article are confidential and shall be treated as compromise and settlement negotiations for purposes of the Federal and state Rules of Evidence.

(ii) ADR Procedure. If a dispute with more than \$100,000.00 at issue has not been resolved within sixty (60) days of the disputing party's notice, a party wishing resolution of the dispute ("Claimant") shall initiate assisted Alternative Dispute Resolution (ADR) proceedings as described in this Article. Once the Claimant has notified the other ("Respondent") of a desire to initiate ADR proceedings, the proceedings shall be governed as follows: By mutual agreement, the parties shall select the ADR method they wish to use. That ADR method may include arbitration, mediation, mini-trial, or any other method which best suits the circumstances of the dispute. The parties shall agree in writing to the chosen ADR method and the procedural rules to be followed within thirty (30) days after receipt of notice of intent to initiate ADR proceedings. To the extent the parties are unable to agree on procedural rules in whole or in part, the current Center for Public Resources (CPR) Model Procedure for Mediation of Business Disputes, CPR Model Mini-

trial Procedure, or CPR Commercial Arbitration Rules--whichever applies to the chosen ADR method--shall control, to the extent such rules are consistent with the provisions of this Article. If the parties are unable to agree on an ADR method, the method shall be arbitration.

The parties shall select a single neutral third party (a "Neutral") to preside over the ADR proceedings, by the following procedure: Within fifteen (15) days after an ADR method is established, the Claimant shall submit a list of five (5) acceptable Neutrals to the Respondent. Each Neutral listed shall be sufficiently qualified, including demonstrated neutrality, experience and competence regarding the subject matter of the dispute. A Neutral shall be deemed to have adequate experience if an attorney or former judge. None of the Neutrals may be present or former employees, attorneys, or agents of either party. The list shall supply information about each Neutral, including address, and relevant background and experience (including education, employment history and prior ADR assignments). Within fifteen (15) days after receiving the Claimant's list of Neutrals, the Respondent shall select one Neutral from the list, if at least one individual on the list is acceptable to the Respondent. If none on the list are acceptable to the Respondent, the Respondent shall submit a list of five (5) Neutrals, together with the above background information, to the Claimant. Each of the Neutrals shall meet the conditions stated above regarding the Claimant's Neutrals. Within fifteen (15) days after receiving the

Respondent's list of Neutrals, the Claimant shall select one Neutral, if at least one individual on the list is acceptable to the Respondent. If none on the list are acceptable to the Claimant, then the parties shall request assistance from the Center for Public Resources, Inc., to select a Neutral.

The ADR proceeding shall take place within thirty (30) days after the Neutral has been selected. The Neutral shall issue a written decision within thirty (30) days after the ADR proceeding is complete. Each party shall be responsible for an equal share of the costs of the ADR proceeding. The parties agree that any applicable statute of limitations shall be tolled during the pendency of the ADR proceedings, and no legal action may be brought in connection with this agreement during the pendency of an ADR proceeding.

The Neutral's written decision shall become final and binding on the parties, unless a party objects in writing within thirty (30) days of receipt of the decision. The objecting party may then file a lawsuit in any court allowed by this Contract. The Neutral's written decision and the record of the proceeding shall be admissible in the objecting party's lawsuit.

(b) Incorporation By Reference. This Agreement constitutes a part of the Asset Purchase Agreement dated _____, 1993 between the parties.

(c) Savings Provision. This Agreement, and the terms, provisions, covenants and agreements contained herein, shall

survive the Closing.

(d) Defined Terms. All terms used herein as defined terms and not defined herein shall have the meaning set forth in the Asset Purchase Agreement.

Article 4. WARRANTIES AND REPRESENTATIONS CONTAINED IN THE ASSET PURCHASE AGREEMENT. Notwithstanding any provision that may be contained in this Agreement or the Asset Purchase Agreement to the contrary, the terms and the conditions of this Agreement shall not affect, or in any way limit, any claim for an Indemnifiable Loss that Buyer may have arising out of any breach of the Seller's warranties and representations contained in the Asset Purchase Agreement, including, but not limited to Section 6.18 thereof, and notwithstanding the provisions of Article XII, Loss in the event of a breach of the warranties and representations contained in Section 6.18 in the same manner as provided for other Indemnifiable Losses under Article XII of the Asset Purchase Agreement.

IN WITNESS WHEREOF, The parties hereto have duly executed this Agreement as of the date first above written.

THIS AGREEMENT CONTAINS A BINDING ARBITRATION PROVISION WHICH MAY BE ENFORCED BY THE PARTIES.

BUYER

By _____

SELLER

By _____

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