BEFORE THE PUBLIC SERVICE COMMISSION
STATE OF MISSOURI

In the Matter of Missouri Gas Energy's	)	
Tariff Sheets Designed to Increase	)	
Rates for Gas Service in the	)	Case No. GR-2009-0355
Company's Missouri Service Area	)	

INITIAL POST-HEARING BRIEF OF MISSOURI GAS ENERGY

COMES NOW Missouri Gas Energy, a division of Southern Union Company ("MGE" and/or "Company"), and for its Initial Post-Hearing Brief, respectfully states the following to the Missouri Public Service Commission (the "Commission"):

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I. Introduction

A. Procedural Background

MGE is a division of Southern Union Company. MGE provides residential, commercial and industrial natural gas service in those areas of the state certificated to it by the Commission. MGE currently provides natural gas distribution service to approximately 500,000 customers in 29 Missouri counties. On April 2, 2009, MGE filed proposed tariff sheets to implement a general rate increase in the amount of approximately $32.2 million, or approximately 4.7%, for natural gas services, including its transportation services. Pursuant to the Commission's Order Setting Procedural Schedule dated May 27, 2009, evidentiary hearings in this matter were held from October 26 through November 6, 2009.[1] On November 5, 2009, the parties filed a Stipulation and Agreement resolving all issues except rate design, energy efficiency programs and cost of capital. This brief will address those unresolved issues.

[1] On December 3, 2009, the Commission scheduled an additional hearing to address Commission Exhibit 106, such hearing to take place on December 23, 2009. The true-up hearing was held on December 8, 2009.

B. MGE, the Reason for Its Rate Increase Request and the Objective of this Case

MGE's focus is to be a low cost local distributor of natural gas with quality customer service. MGE's objective is to do so while appropriately balancing the interests of its primary stakeholder groups - customers, employees, and shareholders. (Ex. 10, Hack Dir., pp. 2-8) The record in this case demonstrates that while MGE provides the most cost effective service of any Missouri local distribution company (LDC), it has not been able to achieve its Commission-authorized rate of return. (Ex.10, Hack Dir., pp. 10, 16) MGE made the necessary decision to file this general rate increase request principally due to its inability to achieve its Commission-authorized return it needs to obtain a sufficient authorized rate of return, and the need for a ratemaking solution on former manufactured gas plant costs. (Ex.10, Hack Dir., p. 19)

The rates in this case should be set so as to provide MGE with a reasonable opportunity to recover its operational costs and to achieve a reasonable, authorized return on the capital it has devoted to public service. Achieving its authorized return involves choosing a capital structure that reflects a proper capital cost profile for MGE's business while setting a return on common equity at a level sufficient to compensate shareholders for the risk they bear while enabling the attraction of capital on reasonable terms. It also involves structuring rates that address the major business challenges faced by gas utilities such as MGE, including weather variability, declining use per customer, high and volatile wholesale natural gas prices and the resulting increases in volatility in customers' bills.

MGE recommends the use of a hypothetical capital structure based on peer companies and a 10.5% return on equity. Additionally, the straight fixed-variable (SFV) rate design authorized for its residential class of customers should be retained and expanded to a restructured small general service (SGS) class. The SFV rate design has been a success story for MGE and

its customers. This decoupled rate design has permitted MGE to offer expanded energy efficiency programs for its customers, provides effective price signals because the majority of customer bills are comprised of gas costs, and has eased bill spikes during winter months. As will be explained below, SFV rates have resulted in savings for residential customers over the last nine winter period months of 2007-2008 and 2008-2009. As promised, the SFV rate design has moderated the typical customer's bill over a year's time. It has been beneficial to MGE's low-income customers who tend to be higher than average users of natural gas. Also, its implementation was basically a non-event. Customer complaints to the Commission's Consumer Services Division have actually been lower on average over the three years since SFV rates were put into effect than over the four year period preceding that event. (Ex. 103, p. 1) Customers have largely become accustomed to the new rate design and to rescind it now would create unnecessary customer confusion, resulting in more inquiries and complaints.[2] Very few customers raised the issue at the local public hearings and, of those, a number are actually better off with SFV rates. (Ex. 9, Feingold Sur., p. 12) No compelling reason has been provided to move away from the *status quo* where residential rate design is concerned, particularly for a rate design that has had such a positive effect on MGE's customers.

C. Basic Regulatory Principles

The Commission's primary objective in a rate case is to balance the interests of the utility's owners (i.e., stockholders) and those of its customers. Section 386.610, RSMo., reads as follows:

> A substantial compliance with the requirements of this chapter shall be sufficient to give effect to all rules, orders, acts and regulations of the Commission, and they shall not be declared inoperative, illegal or void for any omission of a technical nature in respect thereto. The provisions of this chapter

[2] Staff witness Fred testified that to change back to a volumetric rate design after three years of SFV would likely cause a renewed round of inquiries and complaints from confused customers. (Tr. 821-822)

> shall be liberally construed with a view to the public welfare, efficient facilities and substantial justice between patrons and public utilities. (emphasis added)

The Missouri Supreme Court elaborated on this topic in *State ex rel. City of St. Louis v. Public Service Commission*, 73 S.W.2d 393 (banc 1934):

> [§ 393.190, RSMo] must be read together with other provisions of the Public Service Commission Act, so that the whole act may be construed to effect the purpose for which it was enacted. The whole purpose of the act is to protect the public. The public served by the utility is interested in the service rendered by the utility and the price charged therefore; investing public is interested in the value and stability of the securities issued by the utility. (citations omitted, emphasis added)

There can be no question that the Commission weighs the public interest by balancing the interests of the consuming public and the investing public.

Additionally, the Commission must provide a utility with a reasonable opportunity to earn a fair return on the assets it has devoted to the public service. *Utility Consumer's Council of Missouri v. Public Service Commission*, 585 S.W.2d 41, 49 (Mo. banc 1979). This is a constitutional right of the stockholders of the utility. *State ex rel. Missouri Public Service Company v. Fraas,* 627 S.W.2d 882 (Mo.App. 1981).[3] In this regard, the Commission must consider the 1925 opinion of the Missouri Supreme Court wherein it stated that:

> The enactment of the Public Service Act marks a new era in the history of public utilities. Its purpose is to require the general public not only to pay rates which will keep public utility plants in proper repair for effective public service, but to further insure to the investors a reasonable return upon funds invested. The police power of the state demands as much. We can never have efficient service, unless there is a reasonable guarantee of fair returns for capital invested. . . . These instrumentalities are a part of the very life blood of the state, and of its people, and a fair administration of the act is mandatory. When we say 'fair', we mean fair to the public, and fair to the investors.

State ex rel. Washington University v. Public Service Commission, 272 S.W. 971, 973 (Mo. banc).

[3] "There can be no argument but that the Company and its stockholders have a constitutional right to a fair and reasonable return upon their investment." 627 S.W.2d at 886.

II. Rate Design

A. SFV Rate Design and Its Primary Benefits

In 2007, the Commission approved as just and reasonable MGE's proposal to implement a SFV rate design for the Company's Residential Class (RS) of customers. Through subsequent appeals, the SFV rate design was also found to be just and reasonable by the Missouri Court of Appeals. After the Missouri Supreme Court denied a request to transfer the matter from the Court of Appeals on November 17, 2009, this appellate review is complete and the Commission's 2007 order is now final.[4]

The SFV name reflects the fact that the rate design includes all fixed non-gas costs of delivery service in a single, uniform, fixed monthly charge, whereas the actual gas commodity costs – the only MGE costs which vary directly with volumes consumed by customers – will be collected on a volumetric basis each month through the Purchased Gas Adjustment (PGA). It is a simple design with only two components. It is easily understood by MGE's customers.

SFV rates are cost-based, equitable and beneficial to the Company and its customers. In this case, the Company has proposed the continuation of the SFV rate design for the RS class and has proposed that it be extended to apply to a restructured SGS class.[5] The fixed costs to serve each of these classes are reasonably homogenous so a uniform delivery charge within each class is fair to all customers within the class.[6] The Company is proposing to expand SFV to a restructured SGS class at this time because the SFV rate design best addresses the major business challenges faced by gas utilities such as MGE, including weather variability, declining use per

[4] *See, State ex rel. Missouri Office of the Public Counsel v. Public Service Commission*, Case Nos. SD29278 and SD29308 (consolidated).

[5] MGE also filed rate design proposals for its restructured LGS and LVS rate classes. Those issues have been resolved by agreement and are set forth in the Stipulation and Agreement filed on November 5, 2009.

[6] By long tradition, the Commission has set rates based on an average cost of service within a defined group having common usage characteristics as opposed to pricing services on a per customer basis. It is not practical to determine cost for each individual customer. Service line costs, for example, can vary based on vintage and length. (Ex. 9, Feingold Sur., p. 9)

customer, high and volatile wholesale nature gas prices and the resulting increases in volatility in customers' bills. (Ex.7, Feingold Dir., p. 14) The implementation of SFV rates in early 2007 made substantial progress in addressing these difficulties, but the same challenges to the Company remain within its existing SGS rate class.

The objective with regard to the SGS class was to derive a new class that exhibits greater customer homogeneity than its existing SGS class in order to apply a SFV rate structure. To do this, MGE examined both its SGS class and its LGS class. This process resulted in an SGS class comprised of smaller customers with homogeneity similar to those in the RS class and a LGS class composed of larger sized commercial and industrial customers. The recommended result is an SGS rate class applicable to customers with annual gas usage less than or equal to 10,000 ccf and a LGS rate class with annual gas usage greater than 10,000 ccf. (Ex.7, Feingold Dir., pp. 5-8, Sch. RAF-2)

SFV rates offer a number of notable advantages:

1. SFV Rates Best Reflect Actual Cost Causation. The cost to provide distribution service to customers within these homogeneous customer classes does not vary based on the amount of gas consumed. To the contrary, the minimum installed size of distribution main will serve over 99 percent of the Company's residential customers taking into account the average density of the Company's gas distribution system, its standard operating pressures, and the design day load characteristics of the customers served under the RS rate class. (Ex. 8, Feingold Reb., p. 5). Similarly, the Company's cost of gas delivery service is the same for customers in the SGS class. A two inch main, the smallest size of main used by MGE, will serve 99 percent of the customers served under its new SGS rate class. (Ex. 8, Feingold Reb., pp.19-21) SFV rates are intended to recover fixed costs through fixed charges and variable costs (i.e., the cost of

the gas commodity) through variable charges. Accordingly, SFV rates properly reflect the nature of the costs incurred by MGE to serve its RS and SGS customers.

2. SFV Rate Design Reduces Spikes in Winter Bills and Moderates Bill Fluctuations Throughout the Year. A SFV rate design recovers fixed delivery charges more evenly through the year in a uniform, monthly charge. This is in contrast to a volumetric rate design whereby the vast majority of non-gas delivery costs are collected during the winter months when most gas usage occurs and when gas prices typically are at their highest. This doubling down on the recovery of non-gas delivery costs when customers are using the most gas (typically priced at its seasonal premium) for space heating causes a price spike on customers' bills. Loading of charges in the high heating bill months in this manner, as proposed by Public Counsel, is detrimental to the interests of all residential customers who use natural gas for space heating purposes, and visits a particular hardship on MGE's low income customers who are higher than average users of natural gas.

3. SFV Rates Represent Economically Efficient Pricing. When setting rates, it is important to send the proper price signal so that customers can make informed decisions concerning both demand conservation and energy efficiency. For the Company, the impact on the marginal cost of providing distribution service from increased gas use by existing RS and SGS customers is zero. Consequently, existing customers can add new loads without requiring new distribution investment or increased operation and maintenance expenses. The SFV rate provides an appropriate price signal for new customers related to the investment and delivery service. Under these circumstances, the right price signal to customers must be based only on the variable component of rates (in this case, the commodity cost of gas) since this represents the only additional costs the Company incurs to serve the new load of an existing customer. Under

SFV rates, the vast majority of a typical customer's bill – about 70% for a residential customer[7] – is tied to the amount of gas used so they have a strong economic incentive to control consumption.

4. SFV Rate Design Simplifies Customers' Bills. SFV rate design provides clear and meaningful information to the customer about the cost to serve them. The gas bill contains only two parts: (1) the fixed monthly delivery charge and (2) the amount charged for the cost of gas used. The fixed monthly delivery charge component informs the customer of the fixed costs associated with connecting them to the distribution network to receive natural gas service. The PGA, on the other hand, which represents the great majority of a typical residential customer's annual gas bill, is a direct dollar-for-dollar pass through of the cost of the gas consumed by the customer. A pricing structure of this nature is simple, direct and easy for the Company and the Commission's Customer Service Department to explain.

5. SFV Rate Design Stabilizes MGE's Revenues. SFV rates provide the Company with a more predictable and reliable revenue stream. Fixed distribution costs are recovered evenly throughout the year and recovery of those costs are not subject to the vagaries of weather. This allows the Company to better position itself to cover its costs of operation and to earn its authorized rate of return.[8]

[7] Ex. 11, Hack Reb., p. 2.

[8] Even with SFV rates, there is no certainty of revenue for the utility. For example, there is no guarantee under SFV that MGE's customer numbers will not decline. Moreover, MGE will continue to face pressure on earnings in the form of cost increases, infrastructure investments and an aging workforce. (Ex. 8, Feingold Reb., p. 11) As noted above in section I.B., a significant driver in the decision to file this rate case was to address the need to fashion a method to recover environmental remediation costs.

B. State and Federal Energy Policy Strongly Favors Revenue Decoupling Rate Designs

Revenue decoupling rate designs, such as SFV rates, are strongly endorsed by policy makers on both the state and federal levels. Such rate designs are gaining national acceptance for one reason: they are an important feature of a sound energy conservation policy.

SFV is a superior approach because it aligns the financial interests of MGE with those of its customers. Under SFV rate design, MGE no longer has an incentive to sell larger volumes of gas to meet its profit targets as was the case under the traditional volumetric rate design. Instead, MGE can work in concert with its customers to help them use finite natural gas resources more efficiently and cost-effectively. As noted above, the gas commodity cost is a dollar-for-dollar pass through expense so under SFV rates MGE has no financial incentive (1) to induce customers to consume more natural gas or, conversely, (2) to discourage their energy conservation efforts. In fact, SFV rates have ushered in innovative, Company-sponsored energy efficiency programs that provide incentives for the typical customer to conserve on the 70 percent of a typical annual bill attributable to natural gas used for space and water heating, as well as other household uses, as will be discussed in a subsequent section of the this brief.

1. Regulatory Policy in Missouri Overwhelmingly Favors SFV Rates. State regulatory policy supporting revenue decoupling rate design like SFV is manifold. In response to dramatic spikes in the commodity price of natural gas in the winter of 2000-2001, Governor Holden asked then-Attorney General Jeremiah J. Nixon to investigate the causes. Attorney General Nixon conducted an inquiry in early 2001 which included an examination of the mechanics of retail pricing of natural gas for residential and small businesses. His findings were summarized in an Attorney General's News Release dated February 27, 2001, which included as an area needing a long-term solution "allowing industry to recover fixed distribution costs on a monthly basis

rather than through volumetric charges. The current system requires customers to pay a substantial portion of those costs during high heating bill months." (Ex. 11, Hack Reb., p. 3, Sch. RJH-1)

Around the same time, the Commission established a Natural Gas Commodity Price Task Force to investigate the process for recovery of natural gas commodity cost increases by LDCs.[9] The members of the 2001 Task Force, *which included Public Counsel*, issued a Final Report in August of 2001 including a recommendation that there be a "redesign of base rates for fixed (non-commodity related) distribution charges placing more or all costs in a monthly service charge and less or none in the commodity charge." The Final Report also observed that an LDC "may have little incentive to facilitate programs designed to reduce energy use because in doing so the LDC may be reducing its revenue base." Thus, the Task Force recognized the fact that a revenue decoupling rate design is an essential component of meaningful natural gas conservation policy. (Ex.11, Hack Reb., p. 3, Sch. RJH-2)

Again, in 2004, the Commission established a Cold Weather Rule and Long-Term Energy Affordability Task Force to examine "possible programs to improve long-term energy affordability for persons who need help with their utility bills."[10] Members of the Task Force, *which included Public Counsel*, issued a Final Report that included the recommendation that the Commission consider implementing "rate designs that remove disincentives for utilities to pursue programs aimed at reducing usage" as part of the objective to improve long-term energy affordability. (Ex. 11, Hack Reb., p. 4, Sch. RJH-3)[11]

[9] Commission Case No. GW-2001-398.

[10] Commission Case No. GW-2004-0452.

[11] The inconsistency of Public Counsel's support for the 2004 Task Force Report, contrasted with its advocacy of a volumetric-based rate design in MGE's 2006 rate case, was specifically noted as a finding of fact by the Commission in its March 27, 2007 Report and Order at page 11. (Ex. 11, Hack Reb., p. 7) In other words, the Commission concluded in 2007 that Public Counsel lacked credibility on this topic and, certainly, there is nothing new where this topic is concerned that could reasonably cause the Commission to reach a different conclusion.

In 2005, the General Assembly passed, and the Governor signed into law, SB 179.[12] Among other things, it contains the following language:

> 3. Subject to the requirements of this section, any gas corporation may make an application to the commission to approve rate schedules authorizing periodic rate adjustments outside of general rate proceedings to reflect the nongas revenue effects of increases or decreases in residential and commercial customer usage due to variations in either weather, conservation, or both.

This authorization to seek a rate adjustment clause to address weather variability perfectly compliments the issue of revenue decoupling. The Commission will recall that in its 2006 rate case, MGE's suggested alternative to SFV rates was the implementation of a weather normalization rate adjustment mechanism. The Commission chose to address the issue by authorizing SFV rates.

This regulatory support for revenue decoupling rate design is echoed in the testimony of Missouri Department of Natural Resources (MDNR) witness John Buchanan. He noted a resolution of the National Associations of Regulatory Commissioners "strongly supporting the removal of disincentives for utilities to promote energy efficiency". He also pointed to the Commission's Report and Order in MGE's last rate case, GR-2006-0422, wherein the Commission observed that the Company "has an incentive to sell more gas to at least recover its cost. The current [volumetric-based] rate design therefore discourages natural gas conservation efforts on the part of the company." Mr. Buchanan observed, correctly, that rescinding the current SFV rate design would cause the company to stop offering energy efficiency initiatives. (Ex.88, Buchanan Reb., p. 15)

[12] This has been codified at §386.266 RSMo (Supp. 2008). Public Counsel complained in the 2006 MGE rate case that the Commission (inexplicably, in Public Counsel's view) authorized a new rate design after having ordered a volumetric-based rate design in the Company's 2004 rate case. The enactment of SB 179 in the interim, taken together with other developments bearing on the topic, provided more than enough justification for the Commission's decision to adopt a new approach and also supports continuation and expansion of SFV rates in this case.

2. Federal Energy Policy Strongly Favors SFV Rates. Developments at the federal level have been equally supportive of revenue decoupling rate designs, like SFV. The Energy Independence and Security Act of 2007 addresses revenue decoupling in conjunction with its directive that utilities develop energy efficiency programs. Section 532(b)(6)(A) of that law states that "the rates allowed to be charged by a natural gas utility shall align utility incentives with the deployment of cost-effective energy efficiency." The Act further directs each state utility regulatory authority to consider "separating fixed cost recovery from the volume of transportation or sales service provided to the customer." It is undisputed on the record of this case that SFV rate design achieves this objective. (Ex. 9, Feingold Sur., pp. 13-14)

Also, the American Recovery and Reinvestment Act of 2009 includes $3.1 billion in funding for the State Energy Program, including state level energy efficiency block grants. Those funds can be released only if the Governor of the recipient state certifies to the Secretary of the United States Department of Energy ("DOE") that he will take certain steps to insure that the state's regulatory agency implements a policy:

> that insures a utility's financial incentives are aligned with helping their customers use energy more efficiently and that provide timely cost recovery and a timely earnings opportunity for utilities associated with cost-effective measureable and verifiable energy savings, in a way that enhances utility customers' incentives to use energy more efficiently.

This is a strong endorsement of revenue decoupling rate designs, like SFV, in that LDCs would suffer a financial penalty for advocating energy efficiency efforts by its customers under a volumetric rate design where recovery of fixed costs is linked to attaining a certain level of sales of the gas commodity. (Ex. 11, Hack Reb., p. 8)

Where the "stimulus" bill is concerned, Governor Nixon endorsed this policy in a letter to Chairman Clayton and sent a confirming correspondence to Secretary Chu of the DOE as

recently as March of 2009. (Ex. 11, Hack Reb., p. 8, Sch. RJH-4 and RJH-5) It would be very troubling indeed for the State's Governor to urge the Commission to align the financial incentives of energy utilities and their customers in order to secure federal grant funding just to have the Commission - within a matter of months - take a ratemaking step that has precisely the opposite effect.

This litany of important policy guidance is conspicuously absent from the testimony of the rate design and energy efficiency witnesses for Public Counsel. (Kind, Tr. 857-858)[13] This is not surprising. It is simply not possible for Public Counsel to reconcile its antiquated rate design recommendation with the inexorable tide of energy conservation policy guidance from all quarters.

It cannot credibly be disputed that state and federal energy policy overwhelmingly supports revenue decoupling mechanisms like SFV for LDCs. Volumetric-based rate designs are being abandoned as counterproductive artifacts of history. Even Public Counsel's cost of capital witness, Mr. Lawson, testified to this trend.

> Q. Is straight fixed variable a common rate design?
>
> A. No. It's something that's starting to sweep the country. I'm seeing it all over the country, called different things. Some companies -- I have a litigation next week where the company just increased its customer charge and just charges a penny or two for the volume charge and has mentioned nothing about decoupling. But that's exactly what's going on, it's -- it's decoupling.
>
> And it's happening all over the country. It's been around for a while, but it's really picking up -- picking up steam in -- among regulatory authorities around the country.

[13] Public Counsel witness Ryan Kind made a perfunctory effort in this regard by pointing to a Missouri Energy Task Force Action Plan (Ex. 76, Kind Reb., p. 7) which contains a statement that the Commission "should consider rate designs that reward customers for conservation efforts." SFV does this by setting out in the variable component of the bill the 70% of a typical customer's cost that is directly related to gas usage. (Ex. 9, Feingold Sur., pp. 19-20) The Commission's rejection of Aquila's fixed bill tariff in Case No. EO-2007-0395, referenced by Public Counsel, is distinguishable in that Aquila proposed to flat rate both the fixed and variable elements of cost of service, thus providing a zero marginal price for each kWh of electricity. This needs to be contrasted with SFV rates that provide for a significant marginal price for additional consumption of gas. (Ex. 9, Feingold Sur., pp. 20-21)

(Tr. 358) The Commission took a forward-looking and principled step in 2007 when it authorized the use of SFV rates for MGE's residential class. It would be a giant and disruptive step[14] backward if it were in this case, a mere three years later, to completely reverse itself absent clear, compelling and credible evidence that SFV rates are no longer reasonable or supported by prevailing public policy.

C. The SFV Rate Design for MGE's RS Class Has Been a Success Story

MGE's actual experience with SFV rates has been a nearly unqualified success. The implementation of this rate design in 2007 has resulted in savings for MGE's residential customer class. Over the last nine winter period months (2007-2008 and 2008-2009), residential customers saved on average $81.00 or about $36.4 million in the aggregate. (Ex. 7, Feingold Dir., pp. 16-17, Sch. RAF-6) Staff witness Anne Ross testified that MGE's residential customers paid nearly $2,205,000 less during the test year with SFV than they would have under the old volumetric-based rate design. (Ex. 63, Ross Reb., p.9) At the same time, the Company's monthly margin revenue was stabilized.

SFV rates have eliminated weather risk for both the Company and its customers. Customers no longer bear the risk of colder than normal weather producing gas bills far in excess of the cost of the commodity. Conversely, MGE is no longer undercompensated if weather is warmer than normal during which time the customers pay less than the utility's underlying costs because volumetric rates produce lower than intended gas bills. (Ex. 7, Feingold Dir., p. 18) The fact that MGE gives up this upside potential – having the opportunity for substantially increased revenues in colder than normal winters with "traditional" rate design - is a point that is completely ignored by Public Counsel.

[14] *See*, ftnt. no. 2.

SFV rates serve to moderate gas bills because the 30 percent of a typical customer's non-commodity component of the bill is collected in a fixed delivery charge throughout the year. This is in contrast to the volumetric-based rate design proposed by Public Counsel which collects nearly half of the fixed costs in the volumetric charge which disproportionally inflates customer bills in the winter months when gas usage, and prices, are highest.

SFV rates have enabled the Company to initiate and administer energy efficiency programs to help customers control the 70 percent of the cost of a typical bill attributable to the cost of the gas used. Since the PGA component of the customer's bill is a dollar-for-dollar pass through, the Company is financially disinterested where gas sales are concerned and, consequently, is in a position to assist its customers with comprehensive demand side measures.

Finally, SFV rates are socially responsible. This rate design has been beneficial to MGE's low income customers who tend to be higher than average users of natural gas for space and water heating. Low income customers tend to live in older, less energy efficient housing equipped with less energy efficient or poorly maintained appliances and furnaces. (Ex. 36, Thompson Reb., p. 6) Low income customers also may be unemployed or under-employed which has the practical effect of causing them to spend more time at their residence where the thermostat may be set higher during winter daytime hours in order to achieve a desired level of comfort.

The evidence in this case demonstrates that there has been very little public opposition to the SFV rate design. Only 11 customers of the 438,000 customers in MGE's RS rate class appeared at the local public hearings to address the issue of rate design. This represents

0.00251% of the affected customers, a microscopic number.[15] MGE's records indicate that most of these 11 customers are low use customers, although some had higher than average gas usage in certain years. Importantly, those customers who had higher than average monthly gas usage were actually better off under the Company's current SFV rate design compared to billings under the Company's prior volumetric rate design. (Ex. 9 HC, Feingold Sur., p. *)

The data maintained by the Commission's Customer Service Department supports the conclusion that the implementation of SFV rates has been a non-event from the customers' perspective.[16]

Year	2003	2004	2005	2006	2007	2008	2009
Complaints	425	424	423	327	252	351	410
Rates	Volumetric	Volumetric	Volumetric	Volumetric	SFV	SFV	SFV

As can be seen from this table, there were more complaints received by the Commission on average during the four years preceding the implementation of the new SFV rate design when volumetric-based rates were in effect (i.e., 400 per year) than in the three years immediately following the implementation of the new SFV rate design (i.e., 319 per year).[17]

It is also clear that only a portion of the complaints to the Commission dealt with bills, rates or charges. Page 4 of Exhibit 103 shows that a wide variety of topics other than rates, such as the cold weather rule, delays in installation/restoration of service, customer deposit policy, gas

[15] It is significant that the local public hearing took place in September, a shoulder month when it is to be expected that the customer charge would be more apparent to customers than would have been the case in a winter month.

[16] The information provided by Staff at the hearing corresponds closely to the information contained in the direct testimony of Company witness Ron Crow at page 5. (Ex. 1) For purposes of this brief, MGE accepts the number of complaints as set forth in Staff exhibit 103.

[17] Even if one were to assume that all 319 complaints were critical of SFV rates (an assumption which is demonstrably wrong, as noted in the immediately following paragraph), this would still only represent 0.073% of the affected customers. This is hardly a reaction that justifies a major change to rate design for the whole residential class of customers.

leaks and service refusals, have been the subject matter of many customer calls. Even under the category of billing or rates, it cannot readily be discerned whether the call concerned rates generally or rate design.

The SFV rate design also has been a good thing for the investing public. As noted above, it has eliminated weather risk for MGE in its RS class of customers. This had been a huge issue for the Company. In 2006 before SFV rates went into effect, MGE fell short of its revenue budget by almost $16 million. This was due primarily to the effects of weather. (Hack, Tr. 77) It also has addressed the trend of declining use per customer due to the use of more energy efficient appliances, advances in home construction techniques and affirmative conservation efforts by customers. (Hack, Tr. 78) The new rate design has improved the Company's ability to timely recover fixed costs which are not connected to volumes of gas sold. Finally, as also noted above, the SFV rate design has addressed an important component of positioning the Company to earn its authorized rate of return on capital it has devoted to serving the public.

D. Continuing Objection to the Customer Comment Cards

On December 2, 2009, the Commission issued an Order Regarding Comment Cards (the "Record Order") which denied Public Counsel's request that official notice be taken of certain customer comment cards and admitted them into the record as direct evidence over MGE's objection. MGE renews, restates and confirms its objections to the admissibility of the comment cards in this case. Further, MGE does not waive, and specifically reserves, its objections notwithstanding any references that it may make to them as may be made necessary by the Commission's Record Order.

MGE will not address the comment cards in this brief because the record on this topic is still open. The Commission has scheduled a hearing for December 23rd for testimony concerning

the cards, five (5) days after the filing deadline for this brief, to address Exhibit 106. Consequently, MGE reserves the right to address this topic in its reply brief.

E. Public Counsel has not Shown that SFV Rates are Unreasonable

In this case, Public Counsel urges the Commission to take a step backward and revert to the old volumetric-based rate design that had been in effect for decades prior to 2007. This short-sighted recommendation subordinates important policies regarding energy efficiency, cost causality and the practical ability of the Company to actually achieve its authorized revenue levels to the parochial concerns of a small minority of the Company's customers, that is, its low-use customers. Public Counsel's response to the mountain of evidence for a decoupled rate design like SFV is to trot out the same tired arguments for a volumetric-based rate design that was shown in the 2006 rate case to have been a failure for the Company, its investors and customers.

Public Counsel has been little more than obstructive where this question is concerned. In MGE's 2001 rate case, Public Counsel resisted MGE's efforts to shift recovery of more of its fixed costs out of the volumetric component of traditional rates and into the customer charge. Public Counsel resisted MGE's attempt in its 2004 rate case to implement a weather mitigation rate design similar to that of Laclede Gas Company which would have allowed the Company to recover some greater level of fixed distribution costs from customers by having the rate design work in tandem with the its PGA factors that would vary by season and by rate block.[18] In MGE's 2006 rate case, Public Counsel objected to MGE's proposal to implement a weather normalization clause authorized by SB 179 (See §386.266.3, RSMo). In that same 2006 rate case, Public Counsel also objected to MGE's proposal to implement SFV rates. In complete denial of MGE's consistent and long-standing volumetric driven revenue shortfalls, Public

[18] Commission Case No. GR-2004-0209.

Counsel has stubbornly clung to its recommendation that a rate design that recovers 55 percent of fixed costs in a customer charge and 45 percent of fixed costs in a volumetric component be ordered by the Commission. Public Counsel again is urging this position upon the Commission despite the alarming spike in natural gas costs in the winter of 2000-2001 and a trend in higher gas costs from 2002 through the winter of 2004-2005 (and the resulting customer outcry) and heedless of the energy conservation policy pronouncements on both the state and federal levels addressed above. The Commission and MGE's customers deserve better than Public Counsel's "just say no" mindset.

Public Counsel's position appears to be based on nothing more than an article of faith. It is grounded on the demonstrably false assumption that higher income households are, on average, higher users of natural gas. (Meisenheimer, Tr. 464-465)[19] Consequently, Public Counsel suggests a direct relationship between usage and income. This is simply an incorrect premise.

MGE witness Dr. Philip Thompson studied the income-consumption relationship for MGE's customers and established that it is "U"-shaped, that is, usage increases as income falls. The income-consumption relationship becomes positively correlated at higher income levels, but usage at the lowest income levels is greater than the overall average usage. Dr. Thompson saw "no evidence whatsoever to indicate that low-income customers as a group use a lower than average quantity of natural gas." (Ex. 36, Reb., Sch. PBT-3, p. 8) His ultimate conclusion was that a volumetric charge would likely have a regressive impact on low income customers because low income customers in MGE's service territory consume higher than average volumes. (Ex.

[19] It is important to note that a low use customer of MGE may have a much higher than average income. (Meisenheimer, Tr. 465-466) The question the Commission must ask itself is whether the low income customer who uses a higher than average amount of natural gas for space and water heating should subsidize the high income customer who only uses natural gas in an ornamental fireplace.

36, Thompson Reb., p. 16) This conclusion is supported by an analysis of those MGE customers who receive low income energy assistance. Dr. Thompson concluded that approximately 82 percent of the MGE customers who received energy assistance would experience higher winter bills under Public Counsel's volumetric-based rate design proposal than they would under the current SFV charges. (Ex. 36, Thompson Reb., pp. 16-17)

Beyond that, Public Counsel's proposal to revert to an antiquated volumetric-based rate design for the Company's residential customers and to maintain a volumetric-based rate design for a restructured SGS class of customers is deficient in the following ways:

→A volumetric-based rate design is not reflective of the true costs of serving those customers. The cost to provide delivery service to RS and SGS customers does not vary based upon volumes consumed.

→A volumetric-based rate design will reinstate intra-class cross subsidies that had been abolished with SFV in 2007 in that high use customers will receive more than the fixed delivery costs they cause whereas low use customers will receive less than the fixed delivery costs they cause.

→A volumetric-based rate design will cause residential customers to overpay for service by a greater amount during colder than normal periods. (Ex. 8, Feingold Reb., p. 3)

→A volumetric-based rate design loads fixed delivery costs disproportionately onto the customers' bills in the winter months when fuel usage (and price) is highest. From a practical perspective, this has a much more adverse effect on customers in terms of budgeting and cost management than does a full revenue decoupling approach like SFV rates.

From a purely economic pricing perspective, including fixed costs in MGE's volumetric delivery service rates as recommended by Public Counsel effectively forces gas commodity prices above their marginal costs. Additionally, volumetric-based rates tend to swing monthly gas bills up or down without regard to the fixed nature of the costs that are being incurred to provide the energy delivery service. Thus, a volumetric delivery service rate falsely indicates that a customer who reduces gas consumption will somehow reduce the Company's costs of providing delivery services. (Ex. 9, Feingold Sur., p. 16) This is not an efficient pricing signal.

F. Adopting Public Counsel's Rate Design Recommendation will Cause the Company to Discontinue its Energy Efficiency Programs

Reverting to volumetric-based rates as proposed by Public Counsel would cause MGE to be unwilling to continue its administration of the high efficiency gas appliance incentive programs, energy efficiency education and home improvement with energy star program that it has undertaken since 2007. This would be a disappointing consequence and detrimental to the public interest, particularly at a time when customer interest in these programs is really gaining traction. Nevertheless, MGE cannot be expected to assist its customers in reducing natural gas usage when doing so will directly and adversely affect its ability to achieve the Commission-authorized return on capital MGE has devoted to serving the public.

G. Public Counsel has Provided No Compelling Basis for Reverting to the Pre-2007 Rate Design

The Commission should also give due consideration to the value of continuity in ratemaking. Public Counsel has provided no compelling reason for the Commission to revert to a volumetric-based rate design only three years after having adopted a SFV rate design as being just and reasonable. Public Counsel does not present any changed circumstances which have occurred in the last three years which would justify a 180º policy reversal in this case. Absent a

showing of a real problem with SFV rates, the Commission should favor the *status quo*. As noted above, there was no public outcry about the implementation of SFV rates. The number of customers actually complaining about rate design has been so minimal as to be inconsequential. Also, as Commissioner Clayton recognized at the hearing, no rate design will please everyone.

> A: (By Ms. Fred concerning SFV rates) I think once we have communicated to a number of customers, they understand it, we've gotten them to understand it, they're more comfortable with it. But I think overall, emotions being what they are, the economy today being what they are, customers aren't satisfied with this, and I'm not sure they'd be satisfied with any type of rate increase.
>
> Q. Sure. I understand. I mean, no matter how you set things up, you're probably going to have dissatisfaction somewhere.

(Tr. 799-800 (emphasis added)) It is a false hope to think that reverting to a volumetric-based rate design as recommended by Public Counsel will be greeted by uniform enthusiasm by all of MGE's residential customers. To the contrary, the Commission can expect to hear the complaints of MGE's customers when they feel the financial bite of this change during next winter's heating season.

H. The Commission Should Not Consider Nationally Aggregated Income-Consumption Data when such Data is Readily Available Concerning MGE's Customers

Public Counsel's reliance on nationally and regionally aggregated data concerning the impact of SFV rates on low income customers deserves little or no weight. Energy usage patterns in western Missouri (and, in particular, Kansas City) do not mirror the national trends.[20] The Commission has before it a detailed income-consumption study performed by Dr. Philip Thompson examining natural gas usage by customers in MGE's service territory.[21] As such, it

[20] There are ample reasons to disregard the national and regional studies relied on by Ms. Meisenheimer. The DOE Residential Energy Consumption Surveys are compilations of nationwide household usage data. (Meisenheimer, Tr. 471) So, too, is the LIHEAP Home Energy Notebook. (Tr. 472) Even the regionally aggregated data has Missouri lumped together with much more northern states, including North Dakota. (Tr. 473) Given these obvious shortcomings, it is not possible to make reliable parallels to usage characteristics by natural gas customers in western Missouri.

[21] Ex. 36, Thompson Reb., Sch. PBT-2.

need not extrapolate from national or regional studies in order to discern a local implication. The Commission should pay no attention to national studies when the results of an MGE-specific study are readily available.

I. There is No Evidence of a Problem with Customers Disconnecting from the System During Non-Winter Months

Public Counsel witness Barbara Meisenheimer testified at the time of the hearing that she was concerned about the possibility of customers disconnecting from the system on a seasonal basis[22] but there is no data in this record to indicate that seasonal disconnects are a problem. The Company offered no testimony or information indicating that seasonable disconnects have been an issue needing to be addressed since SFV rates were put into effect. Also, there was no testimony offered by Public Counsel that would show that any customers have actually chosen to disconnect from the system during the non-winter months to avoid paying the fixed monthly charge. (Meisenheimer, Tr. 536) Consequently, Ms. Meisenheimer's testimony about customer seasonal disconnects is no more than speculation and conjecture.[23]

J. Concluding Observations

Ultimately, Public Counsel's advocacy of a reversion to volumetric rate design seems to be an article of faith as opposed to a thoughtful, fact-based response to the overriding energy policy considerations that should be guiding the Commission's hand where this topic is concerned. Certainly, Public Counsel has not provided an honest, empirical analysis to show how its volumetric-based rate design proposal is consistent with state and federal energy policy considerations. Nor has Public Counsel ever disputed the existence of the business challenges faced by MGE. A consistent state public policy favoring the principle of energy conservation is

[22] Tr. 482-483.

[23] This is the flip side of the Commission's rejection of MGE's proposed seasonal disconnect tariff in the 2006 rate case because there was no proof of a significant problem that needed to be addressed. Report and Order, pp. 23-24.

a worthy objective for the Commission to pursue. Energy efficiency and conservation is a top priority of Governor Nixon's administration as evidenced by the testimony of MoDNR witness Buchanan. The concept of energy conservation and security should be the policy wallpaper against which the Commission issues its decision in this case. This is a new era and the ratemaking policies adopted by the Commission need to reflect the new energy conservation realities. The Commission should follow the recommendations of its own energy task force reports and hold fast to a SFV, or other revenue decoupling rate design, for MGE's residential class customers and expand its application to a restructured SGS class of customers.

Reverting to a volumetric-based rate design ignores the important regulatory goal of pricing in accordance with cost causation principles to send meaningful signals to customers. Additionally, abandonment of SFV rates will resurrect the problem of seasonal bill volatility and likely will serve just to confuse customers who have become accustomed to the current structure of charges. Not only will a decision of this nature be a step in the wrong direction, but it would do a disservice to the customers of MGE.

III. Energy Efficiency Programs

A. MGE has Implemented a Successful Portfolio of Cost-Effective Energy Efficiency Programs

With the approval of a SFV rate design for its residential class of customers, MGE agreed to administer a number of energy efficiency (EE) programs consistent with the funding level authorized by the Commission in that case. The Commission included $750,000 in MGE's cost of service to fund these programs in MGE's 2006 rate case (Ex. 16, Hendershot Dir., pp. 4-5), which is in addition to the $750,000 for the low income weatherization program established in MGE's 2006 rate case. (Report and Order, pp. 16-17). Those EE programs included (1) $45,000 for communication and education regarding energy efficiency and (2) $705,000 for promotion of

a water heater rebate program designed to encourage the installation of energy efficient appliances and, therefore, improve natural gas conservation efforts.[24] Since its implementation in August of 2007, the EE program has been expanded to include space heating, natural gas boiler systems and combination furnace/water heating systems. (Ex. 16, Hendershot Dir., p. 5) In August of 2009, MGE launched the Home Performance with ENERGY STAR® program jointly with Kansas City Power and Light Company. (Hendershot, Tr. 691, 716; Exh. 102) This is a whole-house approach to energy efficiency that includes improvements to residential building envelopes including windows, doors and wall insulation. (Ex. 87, Buchanan, Dir. p. 14) Already ten (10) of those applications have been approved. (Hendershot, Tr. 692) The development and launch of these programs has been overseen by an energy efficiency collaborative (EEC) comprised of representatives of MGE, Staff, Public Counsel and the Missouri Department of Natural Resources. The EEC was established by agreement in the context of Case No. GT-2008-0005.

The results of the EE programs have been gratifying and demonstrate that MGE is administering an increasingly successful energy conservation initiative. Thousands of energy efficiency kits have been purchased for senior serving organizations; 470 of which have been installed. General information has been made available through print media, bill inserts, radio advertising and on the MGE website. The website traffic to the energy efficiency and water heater pages is in excess of 60,000 visits. (Hendershot, Tr. 692). More than 8000 self-audits available on the MGE website have been completed since January of 2009. (Hendershot, Tr. 692) Nearly 560 high efficiency water heaters have been approved for a total of $84,800. Over 800 furnace and boiler applications and 400 thermostats have been approved for a total of over $300,000 worth of incentives. (Ex.16, Hendershot Dir., pp. 4-5; Ex. 18, Sur., p. 3; Tr. 691)

[24] Report and Order, pp. 17-18.

MGE proposes to expand a number of its EE programs to the new SGS customer class if the Commission adopts a revenue decoupling rate design such as SFV for this class that leaves the Company financially indifferent to the volumes of gas consumed. (Ex. 17, Hendershot Reb., p. 4)

Customer interest and participation in the Company's portfolio of EE programs are on a steep, upward trajectory. The Company has seen "dramatic growth" in the space heater incentive program "in a very short period of time." (Ex. 18, Hendershot Sur. p. 4; Tr. 705) Demand is rapidly catching up with current funding levels. (Tr. 709) The evidence shows that the incentive burn rates are much better now than just a few months ago and MGE has every reason to believe that trend will continue. Customer participation rates speak to the value of continuing these programs to optimize benefits for all customers.

The Company's commitment to its EE programs in the context of a SFV rate design is strong. MGE is optimistic about the prospects for the programs in place and the possibility of continuing to expand them to include other initiatives. (Hendershot, Tr. 696-697)

B. The Company's Proposal to Expand EE Programs to the New SGS Class of Customers

Assuming an effective revenue decoupling rate design (in this case, SFV), MGE enthusiastically supports this initiative and looks forward to increased customer use of the Company's efficiency offerings. Initially, MGE recommended that funding for EE programs be retained at current levels through rates but funded proportionally to customer numbers in the RS (90%) and SGS (10%) classes. (Ex. 17, Hendershot Reb., p. 2) The Company stated its willingness to segregate unexpended funds and to accrue interest on a going-forward basis at the short-term debt rate included in the capital structure as determined by the Commission. (Ex. 32, Noack Reb., p. 29) The EE programs for the new SGS class would include incentives to replace

less efficient equipment with high efficiency ENERGY STAR® equipment. (Ex. 17, Hendershot Reb., p. 4) The Company stated its support for the continuation of the EEC but only in an advisory capacity. (Ex. 17, Hendershot Reb., p. 3)

During the course of the hearing, the Company presented to the Commission a proposal to deal with EE programs that varied somewhat from its case as filed.[25] The alternative proposal maintains some of the basis features of the Company's case as filed but significantly modifies certain elements of that proposal to address issues that have been raised by other parties including the MDNR and Public Counsel.[26] This proposal now features an initial increase in funding from $750,000 to $1 million. The proposal also features an annual review of expenditures that would allow the EEC or its individual members to recommend annual increases or decreases in funding to the Commission.

The Company's alternative proposal includes the following features:

a. The Company will initially fund an annual amount of $1 million per year for its EE programs, beginning when rates go into effect in this case. This annual funding amount would initially not be included in the Company's rates. This amount would be subject to increase if warranted by the program's continued growth and success. This would be a topic to be addressed by the EEC.

b. The Company's annual funding amount will be deferred and treated as a regulatory asset with a 10 (ten) year amortization period. The amortization would begin with the effective date of any rates resulting from the Company's next general rate case. Any amounts would be included in the Company's rate base in its next general rate case.

c. Funds will be divided proportionally between classes (the new SGS class would receive up to 10% of funding, Residential will receive up to 90% of the funding);

d. Company funding and administration of its EE programs is contingent, respectively, on the Commission's authorization (1) to continue SFV rates for the

[25] Tr. 680-681. In response to input at the hearing, the Company has increased its proposal to $1million.

[26] Chief among the changes is MGE's willingness to fund the EE programs up to $1 million as contrasted with its as-filed proposal that the $750,000 of funding for EE programs be include in cost of service for purposes of establishing rates for service.

RS class of customers and (2) to implement a SFV rate design for the newly-identified SGS class of customers.

e. The Company would assign the same short term interest rate determined in this case to any unspent amounts previously collected in rates on a going forward basis;

f. Retain the EEC, but modify its structure to an advisory capacity;

g. The Company will spend currently unspent energy efficiency funds prior to contributing additional amounts to Residential programs.

h. The EE programs would be set forth in a tariff.

i. The SGS Energy Efficient Natural Gas Equipment Incentive Program would be designed to encourage more effective utilization of natural gas by encouraging energy efficiency improvements through the replacement of less efficient natural gas equipment with high efficient Energy Star qualified natural gas equipment and other high efficiency equipment and measures. MGE would solicit input from the EEC on specific programs and incentive levels. Depending on the results of the programs, MGE may in the future request permission from the Commission to expand the program to include other program options after dialogue with the EEC.

   The incentives could include but would not be limited to the following Energy Star qualified appliances:

   1. Natural gas forced air furnaces
   2. Natural gas water heater
   3. Natural gas boiler systems
   4. Natural gas combination systems
   5. Commercial natural gas utilization equipment such as;
   6. Modulating burners
   7. Venturi steam traps
   8. Kitchen exhaust hoods
   9. Waste heat recovery
   10. Heat exchangers

j. The EEC will continue to provide input and suggestions on the Company's EE programs. The Company will continue to provide quarterly reports on its EE programs.

k. On an annual basis, the EEC will review the Company's annual funding amount to and expenditures for its EE programs. The EEC (or the members, if agreement cannot be reached) may submit a recommendation to the Commission to increase or decrease the Company's annual funding amount. The recommended increase

or decrease to the annual amount of funding may be contested by any member of the EEC.

This basic framework presents a comprehensive, balanced and reasonable approach to the ongoing funding of EE programs for the Company's RS and restructured SGS classes of customers. It is also flexible enough to accommodate changes in annual funding depending on circumstances and within the context of EEC oversight and subject to Commission approval.

C. MGE's EE Programs are Directly Linked to an Appropriate Rate Design

As noted in the previous section, MGE is unwilling to administer such programs in the absence of a revenue decoupling rate design like SFV.[27] (Ex. 11, Hack Reb., p. 2). In order for the Company to continue taking affirmative steps to help customers with their energy conservation efforts, it cannot be put in the untenable position of being subject to a rate design that calls for recovery of substantial amounts of fixed, non-gas costs through a volumetric-based rate component. To require the Company to implement a volumetric rate design whereby achieving its Commission-authorized earnings level is predicated on attaining a certain level of volumetric sales and, simultaneously, require it to offer energy efficiency programs designed to reduce the level of volumetric sales would be unreasonable and unfair.

D. Public Counsel's Failed Massachusetts Analogy

Public Counsel points to the fact that MGE's sister company in Massachusetts, New England Gas Company (NEGC), employs a volumetric-based rate design and yet offers demand side management programs. (Ex. 77, Kind Sur., pp. 3-7) This is a superficial and misleading comparison. Public Counsel's witness on this topic, Mr. Kind, exhibited a singular lack of familiarity with natural gas regulation in Massachusetts. He was unaware that, unlike in

[27] The decision to discontinue administration of EE programs would not affect the low income weatherization program to which the Company remains committed until such time as it may be shown that it is no longer cost-justified.

Missouri, such energy efficiency programs are mandated by Massachusetts law, specifically the Green Communities Act. (Tr. 866) Mr. Kind has not read that legislation. *Id.* Mr. Kind pointed favorably to a DSM cost rider in NEGC's tariffs but seemed to be unaware that NEGC's rates are subject to a number of additional revenue tracker and adjustment mechanisms such as for environmental remediation costs, residential assistance costs, pension and OPEB expenses and energy conservation services.[28] (Tr. 861-864) Mr. Kind was not aware that rates established for NEGC are based on a 20 year rolling weather normal instead of the NOAA 30-year normal. (Tr. 869)[29] Mr. Kind had not compared the number of heating degree days in Massachusetts compared to the State of Missouri. (Tr. 870) Surprisingly, he suggested that winters in Massachusetts are not much longer or colder than winters here, a conjecture that would come as a big surprise to many storm-booted New Englanders. *Id.*

Finally, Mr. Kind was not aware that a Massachusetts Department of Public Utilities (MDPU), the Commission's counterpart in that state, has ordered all electric and gas utilities in Massachusetts to implement revenue decoupling mechanisms in their next rate cases. *Id*. In fact, the MDPU on October 30, 2009, authorized Bay State Gas Company to implement a full revenue decoupling mechanism.[30] Given his complete lack of knowledge about NEGC's rate adjustment mechanisms, Massachusetts law and regulation and weather conditions in New England,

[28] Mr. Kind's analogy went only so far as the DSM rider. He seemed unreceptive to a number of other cost recovery riders that allow NEGC to cover its cost of service and earn a reasonable return. (Tr. 862) This *a la carte* approach to regulation does not give this Commission any meaningful context to understand Public Counsel's flawed NEGC analogy.

[29] This difference has significance far beyond the mere ten-year difference in the time span utilized. A rolling average is brought current through the most recent full year of collected weather data whereas the NOAA normal is updated only every decade. That means that the most current weather data covers the years 1971 to 2000; a period that ended nearly ten years ago. This omits crucial data on recent weather trends. Moreover, the updated data covering the period from 1981- 2010 will not be available for several years beyond 2010. The 1971-2000 data, for example, were released in 2003, making it a thirteen year lagging indicator. (Ex. 22, Livezy Dir., pp. 9-10)

[30] *See*, *Petition of Bay State Gas Company, pursuant to G.L. c. 164, § 94 and 220 C.M.R. § 5.00 et seq., for Approval of a General Increase in Gas Distribution Rates Proposed in Tariffs M.D.P.U. Nos. 70 through 105, and for Approval of a Revenue Decoupling Mechanism*. Case No. DPU 09-30.

absolutely no credence should be given to the strained regulatory parallel between MGE and NEGC offered by Mr. Kind.

Recognizing that the continuation of Company-administered EE programs is unsustainable under a volumetric-based rate design, Mr. Kind first proposed in his rebuttal testimony a so-called Lost Margin Revenue Recovery Mechanism (LMRRM) to incent the Company to continue to offer EE programs. (Ex. 76, Kind Reb., pp. 8-9) The fact that the so-called LMRRM was not proposed at the same time that OPC witness Barbara Meisenheimer made her rate design recommendation in direct testimony, makes clear that it cannot be considered an integral part of Public Counsel's rate design recommendation. It is, rather, a hastily offered afterthought.

In any event, the concept only partially addresses the problem of lost margin revenues because it does not address margin losses that occur as a consequence of conservation efforts undertaken by customers independent of Company sponsored EE programs. (Kind, Tr. 860-861) Also, it is not a genuinely viable proposal in that Mr. Kind has provided no detail for the Commission to make an informed decision about how the concept would work, its impact on the Company and its customers and whether it could address the business challenges that gave rise to the Commission's approval of SFV rate design in the first place. It is simply too vague a concept to be seriously considered by the Commission. (Ex. 9, Feingold Sur., pp. 21-22) The public interest is not well served by an *ad hoc* regulatory process that is not fully analyzed or presented in a thoughtful fashion.

E. The EEC should be Continued in an Advisory Role

As noted above, MGE recommends the continuation of the EEC but only in an advisory capacity, rather than in its current "consensus" capacity. Where this topic is concerned, MGE is

supported by both Staff and MDNR. MGE is ultimately responsible for the success or failure for these programs so the advancement of a particular initiative should not necessarily be stalled for lack of unanimity on the part of the EEC membership. (Hendershot, Tr. 710) This is not just an abstract concern. As Mr. Hendershot testified, the only disappointing aspect where the performance of the EE programs is concerned has been of the low level of customer interest in the $40 incentive on a tanked water heater program. (Tr. 703-704) An effort to enhance the customer incentives to use higher efficiency water heaters, even though economically justified, stalled for lack of ability to achieve a consensus. The dissenting member of the EEC on this topic was Mr. Kind, which is ironic given his characterization of MGE's program as one having had only "limited success". (Ross, Tr. 745; Ex. 76, Kind Reb., p. 2)

MGE is not attempting to be heavy-handed or unresponsive to input from others in its administration of these programs. It will continue to work closely with EEC members as it has in the past. Staff witness Ross and MDNR witness Buchanan both testified to the Company's cooperative participation in the EEC. (Ross, Tr. 748; Buchanan, Tr. 758)

F. Concluding Remarks

MGE enthusiastically supports its increasingly popular EE programs assuming adoption of an effective revenue decoupling rate design such as SFV. It is rewarding for the Company to be able to assist its customers with their energy conservation efforts. The success of these programs is a testament to the wisdom of aligning of the economic interests of MGE with those of its customers in advancing energy efficiency throughout MGE's service territory through appropriate rate design decisions. It would be regrettable if these well-received and beneficial programs were to come to an end as a consequence of reverting to the antiquated pre-2007 volumetric-based rate design proposed by Public Counsel. In this regard, the Commission

should keep in mind that, according to MDNR, Missouri ranks 41st in the nation in energy efficiency funding for gas and electric utilities. (Tr. 684) If Public Counsel's volumetric-based rate design is adopted, Missouri's ranking in terms of energy efficiency funding will only get worse. MGE encourages the Commission to take a principled stand where revenue decoupling rate design is concerned. Energy conservation should be the guiding light where rate design is concerned.

IV. Cost of Capital

The cost of capital issues in this case concern the appropriate capital structure to be utilized by the Commission in setting rates for MGE as well as the cost of the various components of that capital structure. The positions of the parties on the cost of capital issues are illustrated by the following tables:

MGE's Recommended Capital Structure and Cost Rates[31]

	Ratio	Cost	Weighted Cost
Long-Term Debt	41.06%	6.080%	2.496%
Short-Term Debt	10.94%	5.492%	0.601%
Common Equity	48.00%	10.50% (ROE)	5.040%
		Rate of Return =	**8.137%**

Public Counsel's Recommended Capital Structure and Cost Rates

	Ratio	Cost	Weighted Cost
Long-Term Debt	56.16%	6.258%	3.514%
Short-Term Debt	3.26%	5.920%	0.193%
Preferred Equity	1.92%	7.758%	0.149%
Common Equity	38.66%	10.0% (ROE)[32]	3.866%
		Rate of Return =	**7.722%**

[31] *See* Ex. 98 (chart of parties' positions) and Ex. 15, Hanley Surreb., Sch. FJH-32. MGE witness Hanley updated his recommendations utilizing data through September of 2009.

[32] Using the mid-point of Public Counsel's ROE range of 9.5 to 10.5 percent.

Staff's Recommended Capital Structure and Cost Rates[33]

	Ratio	Cost	Weighted Cost
Long-Term Debt	42.07%	5.89%	2.48%
Short-Term Debt	7.44%	0.94%	0.07%
Common Equity	50.49%	9.50% (ROE)[34]	4.80%
		Rate of Return =	**7.34%**

A. Capital Structure: What capital structure should be used for determining MGE's rate of return?

Generally speaking, the capital structure issue requires a determination as to how a particular utility is capitalized. By this it is meant that the Commission must decide how much and what levels of debt and equity a company has on its books at a point in time. Normally, that is not a difficult question to answer. The circumstances involving MGE, however, make this task more challenging. This is because MGE is not a standalone utility. Instead, MGE is an operating division of Southern Union Company. Consequently, MGE does not issue its own debt or equity and therefore has no independent capital structure.

If one reviews past cases involving MGE where this question has been litigated, one will find that the Commission has used the actual capital structure of Southern Union Company for ratemaking purposes based on the circumstances that existed at the time of those decisions. Whatever those past circumstances, it is now readily apparent that Southern Union is in no way representative of a local gas distribution company such as MGE. Stated another way, Southern Union's capital structure and related cost components are wholly unlike a typical LDC. The application of sound economic theory to these facts leads to the conclusion that Southern

[33] This table represents Staff's true-up capital structure and cost rates. Ex. 111, Murray True-up Dir., p. 3.
[34] Using the mid-point of Staff's ROE range of 9.25 to 9.75 percent.

Union's capital should not be used for ratemaking purposes for MGE in this case. The Staff concurs with the Company on this point.

Both the Staff and MGE based their proposed capital structures in this case on a study of a proxy group of companies similar to MGE. While the Company and Staff differ somewhat as to the particular ratios of the various components of the hypothetical capital structure, as well as their costs, both parties recognize that MGE is an operating division of Southern Union Company and for ratemaking purposes should have a capital structure based on the capital structures of LDCs comparable to MGE and not based on Southern Union's capital structure.

MGE witness Frank Hanley and Staff witness David Murray both testified as to why the use of Southern Union Company's corporate capital structure is inappropriate for determining MGE's rate of return and why a hypothetical capital structure should be used instead. Their positions on capital structure are conceptually the same and represent sound economic theory. MGE urges a hypothetical capital structure consisting of 52 percent total debt and 48 percent common equity. The Staff's true-up testimony supports a hypothetical capital structure consisting of 42.07 percent long term debt, 7.44 percent short term debt, and 50.49 percent common equity. The Public Counsel is the outlier on this issue and recommends that the Commission utilize Southern Union Company's corporate capital structure for purposes of setting MGE's rates.

It is hornbook law that in setting rates for a public utility such as MGE, the Commission must balance the interests of the utility's owners (i.e., stockholders) and those of its customers. The Commission need look no further than the Public Service Commission Act itself for the principle that this balancing must be the Commission's primary objective.

> The provisions of this chapter shall be liberally construed with a view to the public welfare, efficient facilities and substantial justice between patrons and public utilities.

RSMo. §386.610 (emphasis added). The Commission must provide a utility a reasonable opportunity to earn a fair return on the assets it has devoted to the public service. *Utility Consumer's Council of Missouri v. Public Service Commission*, 585 S.W.2d 41, 49 (Mo. banc 1979). This is a constitutional right of the stockholders of the utility. *State ex rel. Missouri Public Service Company v. Fraas,* 627 S.W.2d 882, (Mo.App. 1981). In this regard, the Missouri Supreme Court explained the purpose of the Public Service Act:

> The enactment of the Public Service Act marks a new era in the history of public utilities. Its purpose is to require the general public not only to pay rates which will keep public utility plants in proper repair for effective public service, but to further insure to the investors a reasonable return upon funds invested. The police power of the state demands as much. We can never have efficient service, unless there is a reasonable guarantee of fair returns for capital invested. . . . These instrumentalities are a part of the very life blood of the state, and of its people, and a fair administration of the act is mandatory. When we say 'fair', we mean fair to the public, and fair to the investors.

State ex rel. Washington University v. Public Service Commission, 272 S.W. 971, 973 (Mo. banc 1925) (emphasis added).

These principles -- the balancing of interests and affording the utility a reasonable opportunity to earn a fair return -- are fundamental to determining the capital structure issue in this case and the related capital structure cost components. Underlying all of this is what can be characterized as the "risk" issue.

It is well understood that the greater the amount of debt in a capital structure the greater the financial risk. Stated another way, the lower the ratio of equity to debt, the greater the financial risk. Southern Union Company, with a 38.66 percent common equity ratio, has a capital structure with greater financial risk which is not representative of the risk reflected in a

capital structure of a typical local gas distribution company such as MGE. (Ex. 13, Hanley Direct, Sch. FJH-4, p. 1) To satisfy the constitutional mandates of an opportunity to earn a fair return, therefore, the Commission must address and deal with this imbalance. In setting MGE's rates in this proceeding and satisfying the legal requirements, the greater risk associated with Southern Union's capital structure may be addressed in essentially one of two ways – (1) a risk premium may be added to the recommended return on common equity ("ROE"), or (2) a more balanced, more representative, more conservative hypothetical capital structure may be used instead of Southern Union's actual corporate capital structure. MGE submits that the use of a hypothetical capital structure is the approach the Commission should take in this case. In this regard, the Commission should view MGE as a stand-alone entity, separate from its relationship to Southern Union Company, and impute a capital structure that is "more normal" for a local gas distribution company, one that consists of an LDC industry average amount of equity and debt.

Whatever the facts may have been in the past, it is clear that at the present time Southern Union is considered primarily a "natural gas transmission company." MGE, as well as the appropriate proxy companies, on the other hand, are considered gas distribution companies. (Ex. 13, Hanley Dir., p. 16) The Staff also recognizes these striking changes in the character of Southern Union Company. Southern Union uses a liberal amount of debt, and its business risk has increased due to its movement away from being predominately a natural gas distribution company to predominately being a midstream gas company. Southern Union's corporate credit rating is only one step above junk status. (Ex. 40, Staff Report – Cost of Service, p. 22) Southern Union's corporate credit rating was downgraded on November 20, 2006, due primarily to Southern Union's higher business risk profile associated with its natural gas gathering and processing operations. (Ex. 40, Staff Report – Cost of Service, p. 27) The Staff goes so far to

say that continued use of the approach utilized in MGE's last two rate cases (use of Southern Union's consolidate capital structure with a cost of long-term debt that excluded debt issued by Panhandle Eastern) would unfairly require MGE's ratepayers to pay a higher embedded cost of debt in this case. (Ex. 40, Staff Report – Cost of Service, pp. 26-27)

While both the Staff and MGE recognize that it would be inappropriate to use Southern Union's capital structure, with its 38.66 percent common equity ratio, for purposes of setting MGE's rates, the Public Counsel takes the opposite view and recommends that Southern Union's more risky capital structure should be used in setting the Company's rates in this case. Public Counsel's position on this issue is based largely on the fact that this is what the Commission has ordered in the past.[35] However, it is clear that whatever the circumstances may have been in those prior cases, the facts in the current case demonstrate that Southern Union Company has changed dramatically and its existing diversified businesses preclude the treatment of its capital structure as an appropriate proxy for MGE.

Again, the true character of Southern Union Company's operations should be closely examined. The facts are that Southern Union's capital structure represents its collective operations and has what Standard & Poor's considers an "aggressive" level of financial risk. (Ex. 13, Hanley Dir., p. 6) On the other side of the ledger, MGE, the entity that this Commission regulates, is somewhat more risky than the average local gas distribution company due to its smaller size. (Ex. 13, Hanley Dir., p. 4) In addition, for the numerous reasons outlined in Mr. Hanley's testimony, and as illustrated in Schedule FJH-4, Southern Union Company is in no way representative of a local gas distribution company and thus, its capital structure and related capital cost components are unrelated to and not representative of MGE. Significantly, the

[35] Public Counsel witness Lawton also argues that employing a hypothetical capital structure would allow Southern Union to recover 4.8 million in "phantom equity" return. (Tr. 302; Ex. 69, Lawton Dir., pp. 50-51)

Public Counsel witness acknowledges this. Contrary to his own recommendation to use Southern Union's capital structure, the Public Counsel cost of capital witness confirms that MGE's proposed capital structure with 48 percent common equity compares "quite favorably" to the equity ratios in the natural gas utility industry. (Ex. 69, Lawton Dir., p. 49)

An additional conceptual error exacerbates the Public Counsel's erroneous use of Southern Union's capital structure. While Mr. Lawton, the Public Counsel witness relied upon his proxy group of gas distribution companies in formulating a recommended ROE for MGE, he refused to rely on this same proxy group when it comes to the capital structure issue. Instead, he incorrectly applies his common equity cost rate derived from a group of proxy companies to the amount of equity in Southern Union's capital structure. Because Southern Union's capital structure has a relatively low common equity ratio (38.66 percent), Mr. Lawton was required by sound economic practice to take the next step and make a financial risk adjustment to his ROE recommendation. He failed to do so, however, in spite of his admissions that an "equity ratio of about 39% is below the gas industry average" and "reflects higher financial risks" for MGE. (Ex. 69, Lawton Dir., p. 49) The financial risk adjustment which Mr. Lawton should have made would have substantially increased the required ROE due to Southern Union's much lower common equity ratio. (Ex. 14, Hanley Reb., p. 35)

In reaching its decision on this issue, the Commission should focus on the approach taken by MGE witness Hanley. In formulating his recommendations in this case, and consistent with sound economic theory and the legal principles outlined above, MGE witness Hanley analyzed market evidence of common equity cost rates of a proxy group of nine LDCs of similar risk for insight into a capital structure and related ratios. He also considered the component costs of debt and common equity capital for this proxy group as appropriate for use in establishing a fair rate

of return for MGE. Mr. Hanley's approach, the use of comparable risk proxies, adds reliability to the exercise of informed expert judgment and is consistent with the principles of fair rate of return established in United States Supreme Court in *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944), and *Bluefield Water Works v. Public Service Commission*, 262 U.S. 679 (1922). (Ex. 13, Hanley Dir., p. 4)

There is other support for the MGE position. For example, the financial literature demonstrates that risk relates to where capital is invested – i.e., the purpose to which the capital has been devoted. Since MGE has no traded stock, investors must look to similar risk enterprises to see how MGE should be financed, as well as for an indication of MGE's cost of capital. (Ex. 13, Hanley Dir., p. 19; Sch. FJH-7) MGE is an operating division of Southern Union Company. When dealing with divisional cost of capital and divisions with differing risks, different rates of return which are commensurate with individual risks, are required. (Ex. 13, Hanley Dir., pp. 20-21; Sch. FJH-8) MGE's debt cost and equity cost rates must relate to MGE's risk, and that level of risk is best estimated by observing a group of similar risk enterprises. (Ex. 13, Hanley Dir., p. 21) This is exactly what has been done through Mr. Hanley's selection of an appropriate proxy group and the formulation of a hypothetical capital structure. For the purposes of setting rates in this proceeding for MGE, the Commission should utilize a hypothetical capital structure consisting of 52 percent total debt and 48 percent common equity.

B. Return on Common Equity: What return on common equity (ROE) should be used for determining MGE's rate of return (ROR)?

Based on MGE's recommended ROE and the midpoints of the ROE ranges of Staff and Public Counsel, the Commission is presented with a relatively narrow ROE range in this case of 9.5 to 10.5 percent. In fact, this range gets even narrower when one looks to the actual range

derived by Staff when based on its proxy companies[36] and also takes into consideration the fact that the Public Counsel witness conceded that an ROE of 10.5 percent would be appropriate for MGE in this case.[37]

MGE submits that based on the testimony of its witness Hanley and sound economic theory and legal principles, a proper common equity cost rate for MGE in this case is 10.5 percent. This 10.5 percent ROE is necessary in order for the Company to continue to provide safe and adequate service to its customers while also having the opportunity to earn a fair and reasonable return on the capital MGE has devoted to public service.

The common equity cost rate authorized by the Commission in this case should be adequate to fulfill investors' requirements and assure that the utility will be able to fulfill its obligations to its customers. (Ex. 13, Hanley Dir., p. 8) As noted above, it is a constitutional right of the stockholders of a utility that the utility be afforded a reasonable opportunity to earn a fair return on the assets it has devoted to the public service. *Utility Consumer's Council of Missouri v. Public Service Commission*, 585 S.W.2d 41, 49 (Mo. banc 1979); *State ex rel. Missouri Public Service Company v. Fraas,* 627 S.W.2d 882, (Mo.App. 1981). The standards for a fair rate of return have also been established by the United States Supreme Court in *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944), and *Bluefield Water Works v. Public Service Commission*, 262 U.S. 679 (1922) ("rates which are not sufficient to yield a reasonable return on the value of the property used at the time it is being used to render the

[36] The Staff's study, based on a 9 company proxy group, supports a common equity range of 9.25 to 10.25, with a true mid-point of 9.75 percent, but the Staff witness elected to ignore this and elected to use a range of only 9.25 to 9.75. "Staff's estimate of the proxy group's cost of common equity . . . is 9.25 percent to 10.25 percent." (Ex. 40, Staff Report – Cost of Service, p. 36)

[37] "Every number from the bottom to the top is a reasonable estimate . . . [10.5 percent] is within the reasonable results of the study . . ." Mr. Lawton went on to explain that he found no reason to select any particular point within his range. (Tr. 320-321)

service are unjust, unreasonable and confiscatory, and their enforcement deprives the public utility company of its property in violation of the Fourteenth Amendment").

With public utilities, regulation traditionally acts as a substitute for marketplace competition, and, therefore, analyses based on companies whose securities are actively traded in the marketplace are imperative in estimating a proper common equity cost rate. In this regard, to arrive at his recommended ROE of 10.5 percent, Mr. Hanley utilized four well-tested market-based cost of common equity models, as applied to a proxy group.[38] All four of the models utilized are market-based, as they are predicated upon the Efficient Market Hypothesis – the cornerstone of modern investment theory. (Ex. 13, Hanley Dir., pp. 5-6, 26) Mr. Hanley applied his common equity models to a proxy group of nine LDCs (local distribution companies).[39]

Because Mr. Hanley found it would be appropriate to provide the Commission with an updated study which is more reflective of current and prospective capital market conditions, with his rebuttal testimony, Mr. Hanley adjusted for significant changes in the capital markets over the approximately seven months since he originally formulated his ROE recommendation. (Ex. 14, Hanley Reb., p. 2) Mr. Hanley's updated study utilizes the same methods as were used by him in his original study, with two exceptions – both of which were explained in MGE's pre-hearing brief.[40]

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[38] The Discounted Cash Flow Model (DCF), the Risk Premium Model, the Capital Asset Pricing Model (CAPM), and the Comparable Earnings Model (CEM). Mr. Hanley placed no reliance on the results of his CEM analysis, because it is an extreme high-side outlier when compared to the results derived from the application of the DCF, risk premium, and CAPM models. (Ex. 13, Hanley Direct, p. 6)

[39] Mr. Hanley selected the comparable companies using the following criteria: (1) included in the Value Line Natural Gas Utility Group; (2) having a Value Line five-year projections of growth rate in EPS; (3) having a Value Line beta; (4) having not cut or omitted their cash common stock dividends during the five previous years; (5) deriving 60% or greater of both net operating income and assets from regulated gas operations; and (6) having not publicly announced involvement in any merger or acquisition activity at the time of the study. (Ex. 13, Hanley Dir., p. 17) Nine companies met all of the criteria. Their financial profile is summarized in Schedule FJH-5.

[40] When Mr. Hanley prepared his direct testimony, the stock market was near the 2008-2009 low, yielding considerable potential for capital appreciation. This resulted in Mr. Hanley applying the risk premium and CAPM/ECAPM models in a way which only gave 20 percent weight to the market appreciation potential in order to estimate a norm. The potential for capital market appreciation has declined dramatically since March of 2009. It is

Mr. Hanley utilized nine companies in his proxy group. Public Counsel witness Lawton, on the other hand, utilized the same nine plus three additional companies. Mr. Lawton's inclusion of three additional companies, however, is misplaced. One of these companies, Nicor, Inc., was involved in a pending merger-acquisition, placing undue pressure on market prices. The other two companies, Nisource, Inc. and UGI Corporation, are not considered to be primarily gas distribution companies. In 2008, Nisource and UGI derived only 36.49% and 23.51% of operating income from gas distribution operations, respectively. With these three, non-representative companies eliminated from Mr. Lawton's proxy group, Mr. Lawton and Mr. Hanley would have the same nine companies in their proxy groups. (Ex. 14, Hanley Reb., p.9) Another problem with the analysis of the Public Counsel witness is that his recommended ROE is based solely upon the application of the DCF method.

Although Mr. Lawton testified that the CAPM and risk premium models are often used to check the reasonableness of DCF results, he employed only the DCF method to estimate a cost of equity for MGE. (Ex. 14, Hanley Reb., pp. 16-17; Lawton Dir., pp. 5-7, 18-19) The Efficient Market Hypothesis, however, requires the assumption that investors rely upon multiple cost of common equity models. (Ex. 13, Hanley Dir., pp. 26-32) As such, rate of return analysts should use multiple cost of common equity models as primary methods in arriving at a proper recommended cost of common equity capital. (Ex. 14, Hanley Reb., p. 17)

Mr. Hanley's opinion that under more normal conditions, investors give equal weight to long-term historical market risk premia and expected market risk premia. As such, with his updated study performed under current conditions, Mr. Hanley gives 60% weight to historical appreciation and 40% weight (up from 20%) to the Value Line forecasted appreciation potential. (Ex. 14, Hanley Reb., pp. 6-7) Contrary to the assertions of Public Counsel witness Lawton, this decline in the potential for capital market appreciation is not to say that capital costs are back to pre-financial crisis levels and that there is little expectation of capital appreciation on the part of investors. The bottom of investment grade long-term debt of utilities (Baa) is still more costly than prior to the financial crises. The rate of increase in capital appreciation expectations will continue to decline, but will remain significant. Greater risk equals investors' greater expected return for the commitment of capital. (Ex. 14, Hanley Reb., p. 18) A second variance from Mr. Hanley's original study to his updated study is that at the time of Mr. Hanley's original study, 2008 actual results were not yet available. These numbers, including those from the Morningstar 2009 Valuation Yearbook, are now available and have been incorporated into Mr. Hanley's updated study and recommendation. (Ex. 14, Hanley Reb., p. 8)

The financial literature encourages reliance upon multiple models, as no single cost of common equity estimation model is so theoretically superior or precise that it should be used to the exclusion of all other models. (Ex.13, Hanley Dir., p. 6) The Commission has also acknowledged the superiority of using multiple cost of equity models. *In the Matter of Union Electric Company*, Case No. ER-2008-0318, Report and Order dated January 27, 2009 (". . . the problems with those models illustrate the desirability of considering his model that produces a relatively high return on equity as a balance to his DCF models that show a relatively low return on equity. In that way, the possibly unreasonable impact of one model is counterbalanced by other models.").

Staff witness Murray also made a mistake with regard to the application of the DCF model. Mr. Murray indicates at page six of the Staff Report that his recommended ROE range was derived by applying a single-stage, constant-growth DCF model to a group of comparable companies. As noted with regard to the errors of Public Counsel witness Lawton, exclusive reliance on any single method, including the DCF, as the primary tool in arriving at a recommended ROE is inconsistent with the Efficient Market Hypothesis (EMH). Multiple models should be utilized to be consistent with the EMH. (Ex.14, Hanley Reb., p. 39)

Mr. Murray's reliance on the lower half of his cost of equity range is also incorrect. While admitting that his comparable companies have decoupled rate designs, Mr. Murray nonetheless adopts the lower half of his ROE range for the stated reason that his proxy companies "all have at least some degree of non-regulated operations." (Ex. 14, Hanley Reb., p. 39; Ex. 40, Staff Report, p. 36) The following of this approach is illustrated by Mr. Hanley in his Schedule FJH-28, where it is shown that all seven of Mr. Murray's proxy companies are included in the Edward Jones gas distribution companies group and all are included in the Value

Line natural gas utility group. Further, MGE also engages in unrelated operations, with significant earnings in 2007 and 2008 coming from capacity release and off-system sales transactions. In any event, the average of Staff's seven proxy companies had 73.45% of net operating income in 2008 derived from gas distribution operations, with an average of 82.87% of total assets being devoted to gas distribution operations. It is clear that investors consider these companies to be gas distribution utilities and that the use of the lower half of Mr. Murray's recommended ROE range is without justification. (Ex. 14, Hanley Reb., pp. 39-40) Staff's estimate of its proxy group's cost of common equity is 9.25 to 10.25 percent. (Ex.40, Staff Report – Cost of Service, p. 36) Accordingly, without Staff's unwarranted downward adjustment, the midpoint of Staff's ROE range would be 9.75 percent.

Although MGE is recommending an ROE of 10.5 percent, absent MGE's existing SFV rate design, the common equity cost rate should be no less than 10.75 percent. As will be discussed below in the section on risk, this is because the proxy gas distribution companies overwhelmingly have protection from the unpredictability of weather and declining usage per customer, and an ROE derived from market data of these proxy gas distribution companies reflects any risk-reducing benefits derived from a SFV-type rate mechanism. (Ex. 14, Hanley Reb., pp. 7-8) Under the Efficient Market Hypothesis, the benefits of these mechanisms are reflected by investors in the market prices they pay for securities, and, accordingly, common equity costs rates derived from this market data already reflect the mechanisms' risk-reducing benefits. (Ex. 14, Hanley Reb., pp. 11-12) If MGE does not have its SFV rate design, its risk will be greater than the proxy companies, and an upward adjustment of 25 basis points from MGE's ROE recommendation of 10.5 percent will be necessary. (Ex. 14, Hanley Reb., pp. 12, 36)

C. Cost of Debt: What cost of short term debt should be used for determining MGE's rate of return?

A 5.492 percent prospective short-term cost rate should be used for purposes of setting MGE's rates in this case.[41] Staff, however, recommends only a 0.94 percent cost of short-term debt, while Public Counsel, based on Southern Union's consolidated capital structure, recommends a 5.920 percent short-term debt cost.

As is noted by both MGE and the Staff, the precise basis of the cost of short-term debt for each of the proxy companies is not available. However, as explained by MGE witness Hanley, a short-term debt cost rate based upon a utility with a similar credit rating to the proxy group would consist of three-month LIBOR rate plus 262.5 basis points plus an upfront fee of 200 basis points.

Short-term debt cost rates fluctuate, and, as is frequently noted by this Commission and the courts, ratemaking is to be prospective in nature. As such, the use of a three-month prospective average LIBOR rate is appropriate. As of September 1, 2009, the six quarter average forecast three-month LIBOR rate is 0.8667 percent. (Ex. 14, Hanley Reb., p. 38; Sch. FJH-21) When added to the market-required margin of 262.5 basis points over the LIBOR rate plus a 200 basis point upfront fee, a 5.492 percent prospective short-term debt cost rate is indicated for a gas distribution company with a credit rating of Moody's A3 and an S&P rating of A. (Hanley Sch. FJH-32, Note 3)

[41] The basis of Mr. Hanley's long-term debt cost rate of 6.08 percent is explained in his direct testimony beginning at page 23 and is grounded in the long-term debt interest cost rate for each company in his proxy group of nine LDCs. The average inherent cost for the group is 5.93 percent, to which is added an allowance of 0.15 percent for issuance costs resulting in a cost rate of 6.08 percent. Staff is recommending a long-term debt cost of 5.89 percent. Public Counsel is recommending a long-term debt cost of 6.258 percent and a preferred equity cost rate of 7.758 percent.

Staff witness Murray in his true-up testimony suggests that a short-term debt cost rate of only 0.94 percent should be used for determining MGE's rate of return. This recommendation, however, is based upon a remarkably flawed analysis. Yields on government securities, including U.S. Treasuries, have increased considerably as of late, and the spot cost rate utilized by Mr. Murray is understated. Further, as explained by Mr. Hanley, it is inappropriate for Mr. Murray to utilize and rely on a spot short-term cost rate based upon only two of his seven proxy companies. (Ex. 14, Hanley Reb., p. 37) In fact, making matters worse, Mr. Murray looked to the short-term cost of debt for only one company when he prepared his true-up testimony, lowering his recommended cost of short-term debt from 1.0 percent to 0.94 percent. (Ex. 111, Murray True-up Dir., p. 4) As noted, a proper short-term cost rate is 5.920 percent.

D. Risk: Would the Commission's adoption of MGE's proposed rate design that recovers all non-gas costs in a fixed customer charge for Residential and SGS customers reduce MGE's business risks? If the answer is "yes," should that reduced risk be recognized in the determination of either cost of capital or the revenue requirement?

To the extent the Straight Fixed-Variable (SFV) rate design reduces MGE's business risks, this risk reduction is already reflected in MGE's proposed return on equity (ROE) in this proceeding. This is because MGE witness Hanley arrived at his ROE recommendation by utilizing four well-tested market-based cost of common equity models, as applied to a proxy group. As explained in MGE's pre-hearing brief and in the prefiled testimony of Mr. Hanley:

> . . . a common equity cost rate derived from my proxy group of nine LDCs . . . is reflective of a similar level of risk reduction for MGE as a result of its SFV rate design. Thus there is a quid pro quo vis-à-vis the proxy group of nine LDCs and no adjustment to common equity cost rate derived from the proxy group is needed as a result of MGE's SFV rate design.

(Ex. 13, Hanley Dir., p. 7)

It is the Company's position that a proper common equity cost rate for MGE in this case is 10.5 percent, but absent MGE's existing SFV rate design, the common equity cost rate should be no less than 10.75 percent. As noted above, the proxy gas distribution companies overwhelmingly have protection from the unpredictability of weather and declining usage per customer, and an ROE derived from market data of these proxy gas distribution companies already reflects any risk-reducing benefits derived from a SFV-type rate mechanism. (Hanley Reb., pp. 7-8)

Public Counsel witness Lawton argues that a 50 basis point reduction in ROE is appropriate due to the SFV rate design.[42] His position is based in large part on a 2000 Maryland Public Service Commission case. In that proceeding, a 50 basis point reduction in ROE was imposed as a result of the implementation of "Rider 8" – a decoupling mechanism accounting for changes in weather and other factors affecting gas usage. Of significance, however, is the fact that in 1999 and 2000, the proxy gas distribution companies that were under consideration did not have decoupling mechanisms in place. When this issue came before the Maryland Commission in 2005, however, the Commission reversed course and eliminated the 50 basis point reduction because the impact of decoupling was then reflected in the data of the proxy companies. (Ex. 70, Lawton Reb., pp. 12-13)

The circumstances are much the same in this case. As explained by Mr. Hanley, the facts are that the nine appropriate proxy gas companies currently have nearly 85% of their revenues either wholly or partially decoupled. (Ex. 14, Hanley Reb., p. 10; Sch. FJH-3, p. 2) Eight of the proxy companies have decoupling mechanisms in place to varying degrees, and all nine companies have protection from the vagaries of weather – the largest single variant of sales and

[42] Public Counsel witness Lawton proposes either a revenue requirement or cost of service reduction in the amount of $1,842,034 or a 50 basis point reduction to ROE. (Tr. 307-308) From page 49 of his Direct Testimony, at lines 17-20, it appears that Mr. Lawton has included both in his recommendation.

revenues. For proxy company AGL Resources, its largest jurisdiction is Georgia, which employs the SFV rate design. For proxy companies New Jersey Resources and South Jersey Industries, the Consumer Incentive Program decoupling mechanism is in place. This CIP protects the companies against the weather variances and eliminates the disincentive to promote conservation. (Ex. 14, Hanley Reb., pp. 10-11) The various other decoupling mechanisms and similar protections for the proxy companies are set forth on page eleven of Mr. Hanley's rebuttal testimony.

In making his "risk" adjustment, Public Counsel witness Lawton completely ignores these mechanisms and other protections afforded to the proxy companies. However, under the Efficient Market Hypothesis, the benefits of these mechanisms are reflected by investors in the market prices they pay for securities, and, accordingly, common equity costs rates derived from this market data already reflect the mechanisms' risk-reducing benefits. (Ex. 14, Hanley Reb., pp. 11-12) Public Counsel's witness offered no rebuttal to these arguments in his pre-filed testimony or on the stand before the Commission. In fact, as noted above, Mr. Lawton acknowledged that the straight fixed variable rate design is "starting to sweep the country." (Tr. 358) Mr. Lawton stated, "I'm seeing it all over the country, called different things." (Tr. 358) Mr. Lawton went on to explain that this rate design "is happening all over the country. It's been around for a while, but it's really picking up – picking up steam in – among regulatory authorities around the country." (Tr. 358) Although it is difficult to classify and quantify the various mechanisms by degree and effectiveness with regard to the reduction in equity risk, and although they might not all go by the same name, they cannot be ignored while still arriving at an appropriate ROE recommendation.

The Massachusetts Department of Utilities recently faced a similar situation in a rate case filed by the Bay State Gas Company, D.P.U. Case No. 09-30. In that case, the utility proposed a "full revenue decoupling mechanism." The Attorney General for the state argued for a 50 basis point reduction to ROE to account for a decrease in risk associated with the decoupling mechanism, but the utility, like MGE in the instant case, argued that the relevant analysis in determining whether the implementation of revenue decoupling should have an impact on a company's authorized ROE is not properly derived by looking at the company's risk with and without the mechanism, but rather by comparing the company's risk profile with the mechanism in place relative to the proxy group. With its 429 page order dated October 30, 2009, the Massachusetts Department of Utilities specifically rejected the 50 basis point reduction suggested by the Attorney General. After making a non-quantified downward ROE adjustment due to the fact that the decoupling mechanism approved in the case for the Bay State Gas Company is more comprehensive than those of the proxy companies, the Massachusetts Department of Utilities awarded a final ROE of 9.95 percent.

The situation with gas distribution companies and decoupling mechanisms is also analogous to the situation presented to this Commission in Case No. ER-2008-0318 involving AmerenUE. With regard to fuel adjustment clauses (FAC), this Commission correctly recognized that, when looking at an ROE derived from cost estimates as applied to a group of proxy companies, an upward adjustment may be appropriate in the absence of a FAC, but that a downward adjustment to ROE is not warranted when the proxy companies have similar mechanisms in place. *See In re Union Electric Company*, Report and Order dated January 27, 2009, Case No. ER-2008-0318. Similarly, in this case involving MGE, a downward adjustment to ROE would be inappropriate with the continuation of the SVF rate design for the Company.

On the other hand, if MGE is not allowed to continue to operate under its SFV rate design, the Company's risk will be greater than the proxy companies, and a minimum upward adjustment of 25 basis points to its authorized ROE will be necessary and appropriate. (Ex. 14, Hanley Reb., pp. 12, 36)

Finally on the question of risk, Public Counsel witness Lawton conveniently ignores the fact that the SFV rate design eliminates the potential that the Company might have for increased recovery during colder-than-normal weather. With the SFV rate structure, when it is warmer than normal, customers do not underpay for the Company's fixed costs, and the Company does not under-recover margin. Conversely, when it is colder than normal, customers do not overpay for the Company's fixed costs, and the Company does not over-recover margin. (Feingold Dir., p. 18)

V. Conclusion

As noted, MGE's focus is to be a low-cost local distributor of natural gas with quality customer service, and MGE's objective is to do this while appropriately balancing the interests of its customers, employees, and shareholders. The record in this case demonstrates that while MGE provides the most cost effective service of any Missouri LDC, it has not been able to achieve its Commission-authorized rate of return. It is a constitutional right of the stockholders of a utility that the utility be afforded a reasonable opportunity to earn a fair return on the assets it has devoted to the public service, and the rates in this case must be set so as to provide MGE with a reasonable opportunity to recover its operational costs and to achieve a reasonable, authorized return on its plant investment. To accomplish this, the Commission should use a hypothetical capital structure in determining MGE's authorized rate of return, authorize an ROE of 10.5 percent, and authorize the continuation of the SFV rate design for MGE's residential

class of customers and the expansion of this fair and reasonable rate design to a restructured small general service class.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the above and foregoing document was delivered by first class mail, electronic mail or hand delivery on the 18th day of December, 2009, to the following:

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