



Control Number: 38339



Item Number: 667

Addendum StartPage: 0

**P.U.C. DOCKET NO. 38339
SOAH DOCKET NO. 473-10-5001**

**APPLICATION OF CENTERPOINT § BEFORE THE
ENERGY HOUSTON ELECTRIC, LLC § PUBLIC UTILITY COMMISSION
FOR AUTHORITY TO CHANGE RATES § OF TEXAS**

**CITY OF HOUSTON AND HOUSTON COALITION OF CITIES' MOTION TO
STRIKE PORTIONS OF THE DIRECT AND REBUTTAL TESTIMONY OF JOHN
J. REED AND ALAN D. FELSENTHAL**

The City of Houston and Houston Coalition of Cities ("COH/HCOC") file this motion to strike portions of the direct rebuttal testimony of John J. Reed and Alan D. Felsenthal and, in support thereof, respectfully show as follows:

Summary of Argument

The ALJ should strike portions of the direct and rebuttal testimony of John J. Reed for a number of reasons. First, the majority of Reed's testimony is nothing more than an attack on PURA § 36.060, which requires the Commission to calculate CEHE's income taxes as though a consolidated return had been filed and the utility had realized its fair share of the savings resulting from that return. The Commission is bound to follow PURA § 36.060; therefore, Mr. Reed's criticism of this provision is irrelevant.

Second, Reed improperly attempts to introduce inadmissible hearsay through his rebuttal testimony. Specifically, Reed attaches the testimony of another witness, in an entirely separate proceeding, and relies upon and quotes extensively from that testimony. Clearly, Reed is relying on this testimony for the truth of the matter asserted, and not simply as a basis for his opinions. Further, Gee is not a witness in this case and not subject to cross examination. Therefore, this testimony should be stricken.

Likewise, the Company is barred under hearsay rules from introducing into evidence its own discovery responses through an expert. Therefore, this testimony should be stricken.

Finally, the testimony of Reed should be stricken because it is duplicative of CEHE witness Felsenthal. Reed charges at a rate of \$595/hour for his services in this proceeding. Felsenthal charges \$490/hour in this proceeding. This duplicative testimony needlessly burdens the record in this proceeding and increases rate case expenses to be borne by ratepayers..

The Commission should also strike portions of the Rebuttal Testimony of Felsenthal due to discovery abuse. Felsenthal, in rebuttal, offers for the first time in this proceeding an alternative consolidated tax savings adjustment. However, the COH/HCOC specifically asked the Company calculate a consolidated tax savings adjustment in discovery. The Company refused to provide this information. Therefore, this testimony should be stricken.

Argument & Authorities

A. Legal Standard for Admissibility of Expert Testimony

The decision whether to admit evidence rests within the discretion of the trial court, or in this case, the tribunal. *E.I. du Pont de Nemours and Co., Inc. v. Robinson*, 923 S.W.2d 549, 558 (Tex. 1995). To be admissible, the expert must be qualified to give an expert opinion “by knowledge, skill, experience, training, or education.” TEX. R. CIV. EVID. 702. The expert must have a higher degree of knowledge, skill, experience, training, or education about the subject of the testimony than an ordinary person. *Id.*; *Roberts v. Williamson*, 111 S.W.3d 113, 121 (Tex. 2003). Non-scientific testimony is

admissible if it is offered by a qualified expert and the testimony is relevant and based on a reliable foundation. See *Gammill v. Jack Williams Chevrolet, Inc.*, 972 S.W.2d 713, 723 (Tex. 1998). The offering party must establish that the expert has knowledge, skill, experience, or education regarding the specific issue before the court which would qualify the expert to give an opinion on that particular subject. *Brooders v. Heise*, 924 S.W.2d 148, 153 (Tex. 1996).

B. Reed's Testimony is Contrary to PURA § 36.060 and, Therefore, Irrelevant

The Commission should strike portions of the direct and rebuttal testimony of John J. Reed because the testimony is contrary to PURA § 36.060, which states as follows:

(a) Unless it is shown to the satisfaction of the regulatory authority that it was reasonable to choose not to consolidate returns, an electric utility's income taxes shall be computed as though a consolidated return had been filed and the utility had realized its fair share of the savings resulting from that return if:

- (1) the utility is a member of an affiliated group eligible to file a consolidated income tax return; and
- (2) it is advantageous to the utility to do so.

While Reed attempts to "artfully word" his testimony to appear as though he is not attacking PURA § 36.060, a close examination of his testimony and the authorities relied upon by Mr. Reed make clear that the substance of his consolidated tax savings testimony is nothing more than a criticism of PURA § 36.060. Clearly, this type of testimony is inappropriate in this proceeding, as the Commission is bound to follow the statute.

For example, starting on Page 25 of his Direct Testimony, Reed criticizes the CTSA and discusses how other jurisdictions have rejected CTSA's. This is absolutely irrelevant to this proceeding because the Texas legislature has already determined that the Commission must determine the utility's fair share of tax savings as though it filed a consolidated tax return. With limited time for hearing in this matter, the parties simply do not have the time or resources to conduct a "side show" trial as to whether a consolidated tax savings adjustment should have been adopted in Texas. The legislature has already made that determination and the parties are bound to follow the statute.

Further, starting on page 5 of his rebuttal testimony, Reed discusses how other jurisdictions have determined that the utilities "fair share" of savings is zero. However, a simple reading of the text quoted in Reed's testimony makes clear that these are jurisdictions that have rejected a consolidated tax savings adjustments outright—not those that have calculated a particular utilities fair share savings as zero. In fact, the sentence immediately before the quoted text reads as follows:

"We, however, decline to require a consolidated income tax return of SoureGas' parent companies be filed in any future rate proceeding."¹

Similarly, Reed implies that the Iowa Public Service Corporation calculated a consolidated tax savings adjustment, but found the utility's fair share to be zero. Again, reviewing the text makes clear that the Iowa Public Service Corporation rejected this type of adjustment outright—it did not simply perform a calculation which netted a zero savings: As noted in Reed's testimony, the Iowa Public Service Corporation states as follows:

¹ SourceGas Distribution LLC, Application No. NG-0060, Nebraska Public Service Corporation, Order Granting Application in Part, at p. 15 (March 9, 2010) attached hereto as Ex. A.

"Based on consideration of all the arguments and of the strongly competing principles, the Board has decided that it will not deviate from its precedent and will maintain its stand along policy."²

Clearly, Reed's testimony on this issue amounts to nothing more than an attack on PURA § 36.060. The Commission, however, is bound to adhere to the statute and has no discretion to reject Section 36.060. For these reasons, Reed's testimony is irrelevant and should be stricken as follows:

Page 5, line 6 to Page 6, line 27.

Page 12, line 1 – Page 13, line 33

For the same reasons, the following Direct Testimony of Mr. Reed should be stricken:

Page 25, line 8 to Page 26, line 23

Page 27, line 12 to Page 28, line 2

Page 36, line 18 to Page 47, line 5

Page 47, line 14 to Page 48, line 7

B. The ALJs Should Strike the Inadmissible Hearsay Exhibit of Robert W. Gee and Reed's Testimony Pertaining Thereto

Further, the ALJs should strike Exhibit JJR07 which is the Direct Testimony of Robert W. Gee in a Texas New Mexico Power rate case. The ALJs should also strike any reference to this testimony. Clearly, Mr. Gee is not a witness in this case, and is not subject to cross examination by the parties. It is highly inappropriate to admit the testimony of this witness into the record through a entirely separate testifying expert.

This testimony is clearly hearsay that Reed is offering for the truth of the matter asserted. While an expert may rely upon hearsay to form his opinions, a party cannot rely

² Midwest Gas, a Division of Iowa Public Service Company, Docket No. RPU-91-5, Iowa Utilities Board, May 15, 1992 attached hereto as Ex. B.

upon that expert to introduce inadmissible hearsay to prove the truth of the matter asserted. Rather, the testimony is admissible merely to show the facts upon which the expert relied. Reed goes beyond simply using Gee's testimony to show the facts on which he relied. He quotes extensively from this testimony and attempts to establish the truth of the testimony. Clearly, CEHE is attempting to offer Mr. Gee's testimony for the truth of the matter asserted. It is, therefore, inadmissible hearsay. *See* Tex. R. Evid. 801, 802; *Texas Power & Light Co. v. Adams*, 404 S.W.2d 930 (Tex. Civ. App. Tyler 1966); *Scott v. State*, 155 S.W.3d 312 (Tex. App. El Paso 2004).

Further, the testimony of Gee is not the type of testimony that is reasonable relied upon by economists; therefore, the ALJ should reject the evidence. Tex. R. Evid. 703. Reed is an economist that purports to testify as to what CEHE's fair share of tax savings is through the filing of a consolidated tax return. Experts in this field do not routinely rely upon other witnesses that have filed testimony to calculate the fair share of tax savings. CEHE has no evidence that experts routinely rely upon this type of evidence. *Scott v. State*, 155 S.W.3d 312 (Tex. App. El Paso 2004).

For these reasons, the following testimony should be stricken:

Page 18, line 17 (starting with "My") to Page 19, line 4.

Page 22, line 18 (starting with "Mr. Gee") to Page 23, line 13.

C. The ALJs Should Strike the Company's Discovery Responses

The Company inappropriately attempts to introduce its own discovery responses into evidence in this case through the rebuttal testimony of Reed. Specifically, Rebuttal Ex. JR06 is CEHE's response to GCCC 01-7. For the reasons discussed above, this testimony should be excluded as inadmissible hearsay. Tex. R. Evid. 801, 802.

D. Reed's Testimony is Cumulative

There is a final reason why the ALJs should strike the testimony of Reed—the testimony is cumulative of CEHE witness Felsenthal. Both witnesses testify on the consolidated tax savings adjustment and opine that CEHE's fair share of consolidated tax savings is zero. Mr. Reed charges *\$575/hour* in this proceeding.³ Mr. Felsenthal charges *\$490/ hour*.⁴ There is simply no reason for ratepayers to incur such an expense for one party to introduce testimony of two witnesses that make the same recommendation. This is especially true given that Reed's testimony amounts to no more than a criticism of the Texas legislature's enactment of PURA § 36.060. Further, there is no reason why intervenors, and the ALJs, should have to burden themselves with review and cross examination of two witnesses from CEHE on this issue. For this additional reason, the ALJs should strike this testimony. Tex. R. Evid. 403.

E. Commission Should Strike Felsenthal Rebuttal

Further, the ALJs should strike portions of the rebuttal testimony of Alan D. Felsenthal because the Company, through discovery, refused to provide a consolidated tax savings calculation. Yet, in his rebuttal testimony, Felsenthal provides just such a calculation. The COH/HCOC asked the Company the following:

Please provide a consolidated tax savings adjustment that includes the years 1994-2009 using the Commission's methodology adopted in Dockets 14965, 28840, and 33309. Provide all calculations in electronic format. Provide all underlying documents relied upon for the amounts included in the calculations.⁵

The Company responded by claiming that the fair share of the tax savings was "zero" and referring the COH/HCOC to a response to another party's data request , which

³ Docket Entry No. 505 at pp. 42-43 (September 22, 2010) attached hereto as Ex. C.

⁴ Workpapers of Jeffrey Andrien at p. 237 attached hereto as Ex. D.

⁵ Docket Entry No. 224 (August 19, 2010) attached hereto as Ex. E.

purportedly could be used to make such a calculation. However, importantly, the Company never performed the calculation. Further, the information provided did not provide all information that was necessary in a user friendly format. Specifically, for some of the years, the Company provided summary information rather than the actual information that was included in the filed tax returns. This summary information does not include employer identification numbers. Over the fifteen years included in the consolidated tax savings adjustment, company names changed several times. Without employer identification numbers, it is impossible to correctly match a company's reported taxable income or loss as company names change. The information provided required interpretation by the reader, which Felsenthal now complains about. This discovery response failed to provide the Commission with a clear and concise presentation of the issues.

It is highly inappropriate for the Company to refuse to provide the calculation in discovery (or in the rate filing package), and then turn around and provide the actual calculation for the first time in rebuttal, only one week before the hearing on the merits begins.⁶ The Company was well aware of the limitations facing Intervenor with only a week to review 21 pieces of rebuttal testimony, all while preparing for the hearing on the merits. It appears that this was a deliberate attempt on the part of the Company to disadvantage the Intervenor. This clearly amounts to discovery abuse. Tex. R. Civ. Proc. 215.2(b); Tex. R. Civ. Proc. 194.2(f). Therefore, the following testimony should be stricken:

Page 12, line 11 to Page 16, line 21

⁶ Schedule II E 3.4 and II E 3.5 of the Commission's Rate Filing Package also require this information. A copy of these schedules are attached hereto as Ex. F.

Exhibit ADF-4

FOR THESE REASONS, the City of Houston and Houston Coalition of Cities respectfully request that the Commission grant this motion to strike and grant all other relief to which they are justly entitled.

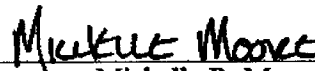
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CERTIFICATE OF SERVICE

On this the 5th day of October, 2010, a true and correct copy of the foregoing document was served upon all parties of record by facsimile, email and/or U.S. mail, postage paid.

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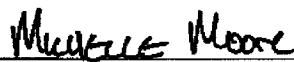
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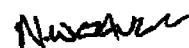
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EXHIBIT “A”

SECRETARY'S RECORD, NEBRASKA PUBLIC SERVICE COMMISSION

Application No. NG-0060

Page 15

Advocate raises two issues regarding SourceGas' calculation of income tax. First, SourceGas Distribution as a wholly-owned subsidiary does not pay federal income taxes. Second, the owners of SourceGas Distribution, Alinda and Aircraft Services Corporation, file a consolidated federal income tax return which includes SourceGas Distribution among other subsidiaries. The Public Advocate raises the possibility that there may have been some consolidated tax savings to the Company as whole, a portion of which should have been assigned to SourceGas Distribution. The Company did not file the consolidated tax return schedules in this case. The Public Advocate recommends that SourceGas Holdings, LLC, the direct parent of SourceGas Distribution, be required to file the consolidated schedule of its parent companies in its next rate case.³⁸

Income taxes paid by a utility are a necessary and reasonable cost and should be included in SourceGas' rates. In the current proceeding, the Company submitted a 35% federal income tax based on its estimated income if granted the rate of return proposed by the Company in this case. However, as discussed by the Commission below, the federal income tax owed on SourceGas' taxable income should be adjusted to reflect the rate of return finally determined in this proceeding. Therefore, based on the final results as outlined in this order, the applicable federal income tax rate should be 34 percent.³⁹ The adjustment to the revenue requirement shall be made pursuant to the applicable federal rate.

It is speculation as to whether consolidated tax savings were realized by SourceGas' parent due in any part to the operations of SourceGas Distribution. The Public Advocate recommended the Commission order SourceGas in its next general rate case filing to file a consolidated income tax return to evaluate any consolidated tax savings that may have been realized by the entire family of companies. We, however, decline to require a consolidated income tax return of SourceGas' parent companies be filed in any future rate case proceeding. The Commission will instead estimate the taxable income the Company would report if it filed federal income taxes on its own and apply the appropriate federal tax levy to that amount to determine the fair and reasonable amount of federal taxes to be included in the revenue requirement by SourceGas Distribution. In the absence of a federal income tax return filed by SourceGas Distribution, we find this is the most reasonable way of determining the appropriate federal tax expense.

³⁸ See Post-Hearing Brief of the Public Advocate at pg. 51.

³⁹ 26 U.S.C. § 11 (West 2010).

EXHIBIT “B”

Westlaw

133 P.U.R.4th 380, 1992 WL 207197 (Iowa U.B.)

Page 1

H

Re Midwest Gas, a Division of Iowa Public Service
Company
Docket No. RPU-91-5

Iowa Utilities Board
May 15, 1992

ORDER authorizing a natural gas local distribution company (LDC) to increase its retail rates by some \$6.1 million, reflecting a 12.25% equity cost rate.

The LDC, Midwest Gas, is allowed to recover a representative level of coal tar clean-up costs, but it must share with ratepayers any clean-up costs recovered from its insurers or other third-parties. Board rejects suggested disallowance of clean-up costs incurred at those manufactured gas plant sites obtained by Midwest as part of its mid-1980s acquisition of Iowa Gas and North Central Public Service Co., even though it agreed that Midwest had negligently failed to evaluate its potential exposure at the time of the acquisitions. Instead, the board chooses to subtract clean-up costs from the unamortized balance of a rate base acquisition adjustment.

Federal income tax liability is calculated on a "stand-alone" basis, despite the withdrawal by the Internal Revenue Service of its prior determinations that the calculation of tax liability for rate-making purposes on a consolidated basis would violate normalization principles. The board finds that state legislation that mandates that utility and affiliate operations remain financially separate supports the continuation of its stand-alone policy.

Expenditures relating to energy efficiency projects are excluded from general rates based on a finding that such costs should be considered in a separate energy-efficiency proceeding in the context of the LDC's total energy-efficiency plan.

The LDC is authorized to recover, over a four-year amortization period, nonrecurring costs associated with its merger into a holding company. However, the overall expense allowance was adjusted to reflect merger-re-

lated savings identified by the LDC.

Board adjusts the cost of common equity upward by 50 basis points, finding that consistently superior service, beneficial corporate restructuring, and investment in a pipeline interconnection stemmed from extraordinary management efficiency and resulted in tangible financial benefit to ratepayers. Nevertheless, the board rejects a proposed adjustment to revenue requirement to reflect a sharing of the savings resulting from the pipeline interconnection.

Negotiated pricing of transportation and electric generation service is approved, subject to reporting requirements and other conditions designed to ensure against unfair subsidization, discrimination, and/or self-dealing.

Board approves tariffs for "new uses" of gas, including gas heat pump/air conditioning and compressed natural gas.

P.U.R. Headnote and Classification

1. EXPENSES

s19
Iowa U.B. 1992
Energy-efficiency projects - Method of recovery - Natural gas local distribution company.

Re Midwest Gas, a Division of Iowa Public Service Company

P.U.R. Headnote and Classification

2. CONSERVATION

s1
Iowa U.B. 1992
Natural gas - Energy-efficiency projects - Cost recovery - Local distribution company.

Re Midwest Gas, a Division of Iowa Public Service Company

133 P.U.R.4th 380, 1992 WL 207197 (Iowa U.B.)

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P.U.R. Headnote and Classification

3.
RATES

s380

Iowa U.B. 1992

Natural gas - Special factors - Energy-efficiency expenditures - Local distribution company.

Re Midwest Gas, a Division of Iowa Public Service Company

P.U.R. Headnote and Classification

4.
VALUATION

s67

Iowa U.B. 1992

Acquisition adjustment - Standard for inclusion - Benefit to ratepayers - Cost savings - Natural gas local distribution company.

Re Midwest Gas, a Division of Iowa Public Service Company

P.U.R. Headnote and Classification

5.
CONSOLIDATION, MERGER, AND SALE

s54

Iowa U.B. 1992

Purchase price - Acquisition adjustment - Use in future proceedings - Natural gas local distribution company.

Re Midwest Gas, a Division of Iowa Public Service Company

P.U.R. Headnote and Classification

6.
VALUATION

s67

Iowa U.B. 1992

Acquisition adjustment - Unamortized premium balance

- Removal of expensed amounts - Cost savings - Natural gas local distribution company.

Re Midwest Gas, a Division of Iowa Public Service Company

P.U.R. Headnote and Classification

7.
EXPENSES

s37

Iowa U.B. 1992

Acquisition adjustment - Amortization - Natural gas local distribution company.

Re Midwest Gas, a Division of Iowa Public Service Company

P.U.R. Headnote and Classification

8.
VALUATION

s67

Iowa U.B. 1992

Acquisition adjustment - Unamortized balance - Reduction for remediation of former manufactured gas plant sites - Coal tar clean-up - Natural gas local distribution company.

Re Midwest Gas, a Division of Iowa Public Service Company

P.U.R. Headnote and Classification

9.
EXPENSES

s20

Iowa U.B. 1992

Environmental remediation - Gas manufacturing sites - Coal tar clean-up - Third-party recoveries - Natural gas local distribution company.

Re Midwest Gas, a Division of Iowa Public Service Company

133 P.U.R.4th 380, 1992 WL 207197 (Iowa U.B.)

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P.U.R. Headnote and Classification

10.
EXPENSES

s125
Iowa U.B. 1992
Natural gas local distribution company - Environmental remediation - Gas manufacturing sites - Coal tar clean-up - Third-party recoveries.

Re Midwest Gas, a Division of Iowa Public Service Company

P.U.R. Headnote and Classification

11.
GAS

s4
Iowa U.B. 1992
Liability for damage - Gas manufacturing sites - Environmental remediation - Coal tar residues - Third-party recoveries - Local distribution company.

Re Midwest Gas, a Division of Iowa Public Service Company

P.U.R. Headnote and Classification

12.
EXPENSES

s12
Iowa U.B. 1992
Nonrecurring costs - Holding company formation - Utility mergers - Amortization period - Natural gas local distribution company.

Re Midwest Gas, a Division of Iowa Public Service Company

P.U.R. Headnote and Classification

*382 13.
EXPENSES

s40

Iowa U.B. 1992
Utility mergers - Incomplete transactions - Costs disallowed.

Re Midwest Gas, a Division of Iowa Public Service Company

P.U.R. Headnote and Classification

14.
EXPENSES

s40
Iowa U.B. 1992
Holding company formation - Utility mergers - Offset to expenses for merger-related savings - No other sharing of savings with ratepayers - Natural gas local distribution company.

Re Midwest Gas, a Division of Iowa Public Service Company

P.U.R. Headnote and Classification

15.
RETURN

s36
Iowa U.B. 1992
Management efficiency reward - Beneficial restructuring - Service quality - Pipeline interconnection - Adjustment to cost of equity - Natural gas local distribution company.

Re Midwest Gas, a Division of Iowa Public Service Company

P.U.R. Headnote and Classification

16.
EXPENSES

s95
Iowa U.B. 1992
Salaries and wages - Adjustment to test period - Early retirements - Salary increases.

Re Midwest Gas, a Division of Iowa Public Service

Company

P.U.R. Headnote and Classification

17.
REVENUES

s5

Iowa U.B. 1992

Natural gas - Shared savings adjustment - Pipeline interconnection - Market-based performance adjustment - Rejection - Local distribution company.

Re Midwest Gas, a Division of Iowa Public Service Company

P.U.R. Headnote and Classification

18.
RETURN

s36

Iowa U.B. 1992

Management efficiency - Shared savings proposal - Market-based performance adjustment - Beneficial pipeline interconnection - Natural gas local distribution company.

Re Midwest Gas, a Division of Iowa Public Service Company

P.U.R. Headnote and Classification

19.
EXPENSES

s114

Iowa U.B. 1992

Federal income taxes - Method of calculation - Stand-alone method - Natural gas local distribution company.

Re Midwest Gas, a Division of Iowa Public Service Company

P.U.R. Headnote and Classification

20.
EXPENSES

s117

Iowa U.B. 1992

Federal income taxes - Consolidated tax savings adjustment - Rejection - Natural gas local distribution company.

Re Midwest Gas, a Division of Iowa Public Service Company

P.U.R. Headnote and Classification

21.
RETURN

s15

Iowa U.B. 1992

Reasonableness - Legal standard - Hope - Duquesne Light.

Re Midwest Gas, a Division of Iowa Public Service Company

P.U.R. Headnote and Classification

22.
RETURN

s26.4

Iowa U.B. 1992

Reasonableness - Cost of equity - Discounted cash flow model - Risk premium model - Natural gas local distribution company.

Re Midwest Gas, a Division of Iowa Public Service Company

P.U.R. Headnote and Classification

23.
RETURN

s26.4

Iowa U.B. 1992

Reasonableness - Cost of equity - Discounted cash flow model - FERC Model - Annually discrete models.

Re Midwest Gas, a Division of Iowa Public Service Company

P.U.R. Headnote and Classification

24.
RETURN

s26.4
Iowa U.B. 1992
Reasonableness - Cost of equity - Flotation adjustment -
Natural gas local distribution company.

Re Midwest Gas, a Division of Iowa Public Service
Company

P.U.R. Headnote and Classification

25.
RETURN

s26.4
Iowa U.B. 1992
Reasonableness - Cost of equity - Risk premium model
- Capital asset pricing model - Natural gas local distri-
bution company.

Re Midwest Gas, a Division of Iowa Public Service
Company

P.U.R. Headnote and Classification

26.
RETURN

s25
Iowa U.B. 1992
Reasonableness - Returns of other enterprises - Natural
gas local distribution company.

Re Midwest Gas, a Division of Iowa Public Service
Company

P.U.R. Headnote and Classification

27.
APPORTIONMENT

s30
Iowa U.B. 1992
Expenses and costs - Natural gas - Supply allowance

expense - Throughput allocator - Local distribution
company.

Re Midwest Gas, a Division of Iowa Public Service
Company

P.U.R. Headnote and Classification

28.
AUTOMATIC ADJUSTMENT CLAUSES

s7
Iowa U.B. 1992
Energy cost clauses - Utility mergers - Continuation of
separate purchased gas adjustments - Natural gas local
distribution company.

Re Midwest Gas, a Division of Iowa Public Service
Company

P.U.R. Headnote and Classification

29.
RATES

s141
Iowa U.B. 1992
Reasonableness - Effect of consolidation*383 - Con-
tinuation of separate purchased gas adjustments - Natur-
al gas local distribution company.

Re Midwest Gas, a Division of Iowa Public Service
Company

P.U.R. Headnote and Classification

30.
SERVICE

s332
Iowa U.B. 1992
Gas lighting - Unmetered service - Local distribution
company.

Re Midwest Gas, a Division of Iowa Public Service
Company

P.U.R. Headnote and Classification

31.
RATES

s384
Iowa U.B. 1992
Natural gas rate design - Kinds of service - Unmetered lighting - Local distribution company.

Re Midwest Gas, a Division of Iowa Public Service Company

P.U.R. Headnote and Classification

32.
RATES

s384
Iowa U.B. 1992
Natural gas rate design - Kinds of service - Interruptible service - Transportation service - Nongas costs - Customer classes - Customer charges - Local distribution company.

Re Midwest Gas, a Division of Iowa Public Service Company

P.U.R. Headnote and Classification

33.
RATES

s380
Iowa U.B. 1992
Natural gas rate design - Special factors - Competition - Negotiated transportation pricing - Local distribution company.

Re Midwest Gas, a Division of Iowa Public Service Company

P.U.R. Headnote and Classification

34.
RATES

s384
Iowa U.B. 1992
Natural gas rate design - Transportation service - Nego-

tiated pricing - Local distribution company.

Re Midwest Gas, a Division of Iowa Public Service Company

P.U.R. Headnote and Classification

35.
RATES

s380
Iowa U.B. 1992
Natural gas rate design - Special factors - Electric generation service - Negotiated pricing - Transactions with affiliates - Local distribution company.

Re Midwest Gas, a Division of Iowa Public Service Company

P.U.R. Headnote and Classification

36.
RATES

s384
Iowa U.B. 1992
Natural gas rate design - Kinds of service - Electric generation service - Negotiated pricing - Local distribution company.

Re Midwest Gas, a Division of Iowa Public Service Company

P.U.R. Headnote and Classification

37.
SERVICE

s332
Iowa U.B. 1992
Natural gas - New uses - Heat pump and air conditioning - Compressed natural gas - Local distribution company.

Re Midwest Gas, a Division of Iowa Public Service Company

P.U.R. Headnote and Classification

38.
RATES

s384

Iowa U.B. 1992

Natural gas rate design - Kinds of service - New uses -
Compressed natural gas - Heat pump and air conditioning - Local distribution company.

Re Midwest Gas, a Division of Iowa Public Service Company

P.U.R. Headnote and Classification

39.
EXPENSES

s114

Iowa U.B. 1992

Federal income taxes - Method of calculation - Stand-alone method - Natural gas local distribution company - Dissent.

Re Midwest Gas, a Division of Iowa Public Service Company

P.U.R. Headnote and Classification

40.
EXPENSES

s117

Iowa U.B. 1992

Federal income taxes - Consolidated tax savings adjustment - Rejection - Natural gas local distribution company - Dissent.

Re Midwest Gas, a Division of Iowa Public Service Company

APPEARANCES: J. GREGORY PORTER and J. CHRISTOPHER COOK, Attorneys, Midwest Gas, a Division of Iowa Public Service Company, 401 Douglas Street, Sioux City, IA 51104, representing Midwest Gas. MICHAEL R. MAY, Attorney, Suite 935, Two Ruan Center, 601 Locust Street, Des Moines, IA 50309, representing Intervenor Mid-Size Energy Group, Inc. JAMES R. MARET, RONALD C. POLLE, WILLIAM

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Before Nagel, Boyd, and George (dissenting), commissioners.

*384 By the BOARD:

FINAL DECISION AND ORDER

SYNOPSIS ^{FN1}

On July 15, 1991, Midwest Gas, a division of Iowa Public Service Company, filed a request to increase its gas rates. The Utilities Board (Board) authorized an increase of approximately \$6.1 million. The Board allowed a rate of return on common equity of 12.25 percent. The rate base allowed was \$207.2 million and the revenue requirement allowed was \$281.7 million.

The above amounts are calculated on a total Midwest Gas division basis and will be allocated to the various state jurisdictions, resulting in a lesser amount for the Iowa jurisdiction.

Several adjustments to the test year were part of a settlement agreement approved by the Board on February 27, 1992.

Adjustments to 1990 test year revenues and expenses over and above the adjustments approved in the settlement included, but were not limited to, costs associated with former manufactured gas clean-up, 1992 salary increase, an adjusted acquisition adjustment, holding

company merger costs and related of merger savings, and a management efficiency reward.

I. PROCEDURAL HISTORY

On July 15, 1991, Midwest Gas, a division of Iowa Public Service Company, filed revised rate schedules to produce additional revenues of \$14.5 million based on a 1990 test year. On October 11, 1991, a temporary increase was approved to produce an increase of approximately \$4.2 million. On October 14, 1991, the Utilities Board (Board) issued an order consolidating Docket Nos. TF-91-143 and TF-91-170 with this docket.

An appearance was filed by the Consumer Advocate Division of the Department of Justice (Consumer Advocate). Intervention was granted to Mid-Size Energy Group, Inc. (Mid-Size), and Deere & Company on August 14, 1991, and to Northern Natural Gas Company on October 4, 1991. Hearings were held on February 17, 18, 21, and 24, 1992. On February 27, 1992, the Board granted the parties' joint motion to approve a partial settlement agreement which resolved several of the issues in the case. Initial briefs were filed on March 10, 1992, and reply briefs were filed on March 20, 1992.

II. TEST YEAR

The test year for the proceeding is calendar year 1990.

III. RATE BASE

A. ROCK VALLEY ENERGY EFFICIENCY PROJECT

[1][2][3] Midwest Gas began developing the Rock Valley Energy Efficiency Project in 1989 in the community of Rock Valley, Iowa, a northwest Iowa community with a population of about 3,000. (Tr. 761, Ex. 106). According to Midwest Gas, the purpose of the project was to determine the impact of a coordinated offering of energy efficiency programs on a single community for use in developing its future energy efficiency programs systemwide. Midwest Gas installed in Rock Valley the Metricom metering system, an advanced metering and

two-way radio communications system, and in a local building established the Energy Center, a technology demonstration and education facility. (Tr. 631-32, Ex. 10, 62, 143).

Midwest Gas proposed recovery of the expense and capital items related to the project. (Tr. 571-73, Ex. 128). Midwest Gas argued the costs of the Energy Center and the Metricom metering system are associated with providing utility service and should be collected through general rates, rather than as energy efficiency expenditures. (Tr. 574-75). According to Midwest Gas, the Energy Center, which now contains displays of energy efficiency equipment as well as office space for project and Metricom employees, could eventually be converted to a utility service center and, therefore, its long-term usefulness is as a utility property. In addition, Midwest Gas contended the costs of the Metricom meters and the replacement gas meters compatible with the Metricom meters should be recovered as costs associated with the provision of utility service. (Tr. 575, Ex. 128).

Consumer Advocate stated the energy efficiency project is of no value to customers, and customers should not be required to pay for it. (Tr. 726, 730-31). According to Consumer *385 Advocate, Rock Valley is not an appropriate test site for an energy efficiency pilot project because the population of Rock Valley is small, Rock Valley customers use less gas on a per customer basis than average Midwest Gas customers, and Rock Valley customers' income is only 70 percent of average Midwest Gas customers' income. (Tr. 721-23). For these reasons, Consumer Advocate contended the potential success of any systemwide energy efficiency program cannot be predicted based on the results of the Rock Valley programs. (Tr. 725-26). In addition, Consumer Advocate argued the cost of the Metricom metering system was excessive and Midwest Gas's characterization of the Energy Center as useful for utility service is unjustified. (Tr. 628-29, Ex. 143, 146).

The Board finds that the costs of the Energy Center and the Metricom metering system are energy efficiency expenditures, rather than ordinary costs for the provision of utility service. Midwest Gas has consistently presen-

ted the project to the Board as an energy efficiency project. See, "Order Docketing Pilot Project," Docket No. PRP-90-3 (November 9, 1990). The title of the project is the "Rock Valley Energy Efficiency Research Project." (Ex. 106). The record shows that the Energy Center is used to display energy efficiency equipment and as office space for the project's employees. (Tr. 631-32). While it is true that the center may also be used as a customer service center in the future, that is as yet only a proposal. It is being used exclusively for the energy efficiency project at this time and will continue to be so used in the foreseeable future. (Tr. 737). Second, the Metricom metering system was installed on an experimental basis, and there is nothing in the record which suggests the metering system will be necessarily used elsewhere in Midwest Gas's service territory. At this time, the meters and the Energy Center are part of an energy efficiency pilot project and the costs of those meters should be considered as energy efficiency expenditures, pursuant to IOWA CODE § 476.6(19) (1991).

Since the expenditures related to Rock Valley are energy efficiency expenditures, the costs incurred after July 1, 1990, may be considered for approval by the Board in an IOWA CODE § 476.6(19) energy efficiency proceeding. IOWA CODE § 476.6(19) "b"(2) (1991) states, in part:

Energy efficiency expenditures incurred on or after July 1, 1990, may be included in a utility's initial energy efficiency plan and budget submitted pursuant to paragraph "a."

In rules adopted pursuant to that Code section, the Board specified that proposed rates which contain expenditures incurred after July 1, 1990, for demand side energy efficiency programs shall not be included in a proposed tariff relating to a general increase in revenue. IOWA ADMIN. CODE 199-7.4(4) (1992). An individual energy efficiency program should not be considered in isolation, but instead should be considered in the context of the utility's total energy efficiency plan.

The post-July 1, 1990, expenditures related to the Rock Valley pilot project may, therefore, be considered by

the Board in the energy efficiency proceeding currently pending before the Board, and the Board will not reach a determination of the prudence of the project in this proceeding. Although the record is not clear as to which proposed expenditures were incurred prior to July 1, 1990, and which were incurred after July 1, 1990, Exhibit 128 shows that Midwest Gas has designated some expenses as "charged" and others as "deferred." It is reasonable to assume the "charged" expenses of \$137,804 were incurred prior to July 1, 1990, and all "deferred" expenses were incurred after July 1, 1990, and are being deferred according to IOWA ADMIN. CODE 199-35.12 (1992). Therefore, the expenses designated as "deferred" will not be considered in this proceeding and instead be deferred until consideration of cost recovery in Midwest Gas's energy efficiency plan.

Exhibit 128 does not clearly distinguish between pre- and post-July 1, 1990, rate base expenditures. However, because the amount identified as "One Month of 1990 Cost Included in Rate Base" in Exhibit 128 is only \$2,965, the Board believes most of the 1990 rate base expenditures occurred after July 1, 1990. Therefore, although it is not completely clear under this record, it appears as if there were approximately \$137,804 in expenses and approximately \$2,965 in rate base amounts incurred prior to July 1, 1990 which were reflected in test year amounts. However, because the amounts Midwest Gas will spend on energy efficiency will become eligible for recovery through the IOWA ADMIN. CODE 199-Chapter 35 energy efficiency proceedings in the future, it is not necessary to reflect a representative amount in base rates. In effect, the pre-July 1, 1990, energy efficiency expenditures are non-recurring. Because energy efficiency expenditures will no longer be reflected in base rates and will be recovered through the energy efficiency proceedings, they will not recur for regulatory purposes and should not be reflected in representative rates.

Rates are based on a representative test year and are to be implemented prospectively. IOWA CODE § 476.33(4) (1991). In contrast, recovery of energy efficiency expenditures will be accomplished directly. IOWA CODE § 476.6(19) (1991). If the Board were to

allow a representative amount in base rates for energy efficiency for prospective recovery, it would be ignoring the fact that energy efficiency costs will be recovered through IOWA CODE § 476.6(19) (1992) in the future. The pre-July 1, 1990, costs will be disallowed.

B. ACQUISITION ADJUSTMENT

[4][5][6][7] In December 1985 Midwest Energy, the holding company (at that time) of Iowa Public Service Company (IPS), acquired Iowa Gas from Iowa Resources. In 1986 IPS acquired the Donovan Companies, which included North Central Public Service Company (North Central) as a subsidiary. Iowa Gas and North Central were made operating divisions of IPS. In 1990 Midwest Energy and Iowa Resources merged to form Midwest Resources. See, *Iowa Resources Incorporated and Midwest Energy Company*, "Order Terminating Docket," Docket No. SPU-90-5 (July 2, 1990). In *Midwest Gas*, Docket No. RPU-87-3, the Board found IPS's acquisition of Iowa Gas and North Central resulted in actual net benefit to ratepayers and allowed an acquisition adjustment of \$12,442,193 in rate base with recovery of the unamortized balance over 30 years.

1. General

Consumer Advocate proposed removal of the acquisition adjustment, stating proper application of the cost benefit analysis requires a finding that the acquisition is no longer warranted. According to Consumer Advocate, shareholders have already been reimbursed a portion of the original acquisition adjustment and the merger of Midwest Energy with Iowa Resources means Iowa Resources stockholders were compensated twice for the sale of Iowa Gas. (Tr. 1331).

Consumer Advocate reviewed gas cost savings, non-gas cost savings, former manufactured gas plant clean-up savings, and other intangible savings and concluded that the net savings are less by a significant margin than the cost of the acquisition adjustment. (Tr. 1328-46). Consumer Advocate claimed savings which had been attributed to a shift of contract demand from Terra Chemical

benefitted Minnesota customers rather than Iowa customers and asserted that changes in the gas industry have resulted in lower gas costs for all utilities. (Tr. 948). Finally, Consumer Advocate argued that if the Board maintains the acquisition adjustment in rate base, the unamortized portion must be reduced to reflect the known and measurable reduction in the unamortized balance. (Tr. 1347).

Midwest Gas stated the record shows that customers continue to benefit from the acquisitions and consolidations. Midwest Gas claimed savings previously identified in Docket No. RPU-87-3, which it maintains still exist, and produced evidence showing new savings in the areas of consolidated gas supply departments; consolidated operations; administrative savings; consolidated manufactured gas cleanup costs; consolidated drug testing programs; administrative gas supply savings; training; consolidated peak shaving plant management and operation; joint standards committee; computer system costs; consolidated safety program; and consolidated state and federal regulatory activity. (Tr. 1522-29, 508-10). In total, Midwest Gas claimed current quantifiable annual savings in excess of \$3.5 million and nonrecurring savings of \$1.6 million. (Tr. 506-10, 1521-29, Ex. 5).

The Board has identified the standard for inclusion of an acquisition adjustment in rate base as whether the acquisition resulted in "actual benefit" to customers. In Docket No. *387 RPU-87-3, the Board stated:

[T]he nature of the savings offered by IPS or by any other applicant will vary. Some will be one-time savings; others will be recurring but for an indefinite period; others will be intangible and thus not quantifiable. The Board believes the proper test as to the amount of required savings is that they must be in relative proportion to the size of the acquisition adjustment sought.

A review of the savings outlined by the Board in Docket No. RPU-87-3 and the new cost savings claimed by Midwest Gas in this case illustrates the fact that the utility is functioning in a dynamic environment. As time passes, it becomes increasingly difficult to make a valid comparison to the elements the Board considered at the

time of the prior decision. As circumstances continue to change, the asserted savings or lack thereof will become increasingly hypothetical. It will become more and more difficult to ascertain whether a particular cost savings is directly attributable to a specific event. For example, it will become increasingly difficult to hypothesize what expenses and what savings Iowa Gas and North Central would have experienced had they remained separate utilities.

Nevertheless, it is apparent from the record in this proceeding that the four areas of identified savings continue to provide actual benefit to the customers of Midwest Gas. The largest cost savings element identified by the Board in Docket No. RPU-87-3 was the gas cost savings. The amount identified in Docket No. RPU-87-3 was approximately \$2.7 million. Since the earlier case, contracts have changed as well as some fundamental premises and arrangements within the gas industry itself. (Tr. 1089-91). It appears as if Iowa Gas and North Central could have taken advantage of many of the new contract offerings on their own within those changed circumstances. Some of the gas cost savings which are identified in the earlier case as directly attributable to the acquisition have probably diminished. On the other hand, Midwest Gas demonstrated that \$715,000 of new savings took place in 1991. (Tr. 933). Midwest Gas continues to enjoy the advantage of increased leverage and flexibility because of its larger size. Significant cost savings continue to be realized by ratepayers. While it is unclear the precise amount of the remaining savings, it is clear from this record that the total remains significant.

Second, Midwest Gas has identified \$391,771 in non-gas cost savings attributable to the acquisition of North Central. (Tr. 527). The fact that Midwest Gas witness Wharton could not identify whether the reductions were due solely to employees covered by early retirement programs does not mean that the cost savings do not exist. Third, Midwest Gas should be commended for its actions taken to reduce the costs of remediation of former manufactured gas plant sites. Midwest Gas has estimated a one-time savings of \$1,637,517 in the costs of remediation of former manufactured gas plant sites

attributable to the acquisition as well as recurring savings of \$383,229.

Finally, the Board does not discount the nonquantifiable savings identified by Midwest Gas. The Board recognizes that identifying nonquantifiable savings is problematic, but the savings are real whether or not a specific number can be assigned to the benefit. One utility will be able to perform many functions more cost-effectively than three utilities. Among other things, administrative and regulatory costs are consolidated; the gas supply departments have been consolidated; the drug testing programs are consolidated; training is done on a total company basis; and computer systems are consolidated. These facts should be taken into consideration when the benefits are weighed.

The acquisition of Iowa Gas and North Central continues to provide actual benefit to ratepayers. The remaining gas cost savings identified in Docket No. RPU-87-3, the additional gas cost savings, the non-gas cost savings and the former manufactured gas plant cost savings identified in this case, as well as the intangible savings strongly suggest that the total savings remain in excess of, or at least in relative proportion to, the cost of the acquisition adjustment. The Board finds that the acquisition adjustment should not be removed from rates. ^{FN2}

2. 13-Month Average Unamortized Balance

Consumer Advocate recommended the *388 Board reduce the test period 13-month average balance of the unamortized premium balance of the acquisition adjustment in rate base by the amount that has been expensed from June 1991 to May 1992. (Tr. 1347). Consumer Advocate argued that the reduction in the unamortized balance is a known and measurable change which should be recognized.

The Board finds merit in this recommendation. This is a known and measurable change and the acquisition adjustment is a static account that is not affected by changes outside of the known amortization. However, rather than use the 13-month average balance, the Board will use the actual ending balance in May 1992. That

method is in accordance with the way the Board has calculated post test year plant additions and will reflect a more accurate amount. As a result, the remaining balance in the unamortized acquisition adjustment will be even less than the \$9,988,268 alternatively recommended by Consumer Advocate.

3. Cedar Street Site Former Manufactured Gas Plant Site in Dubuque, Iowa

[8] Consumer Advocate objected to recovery of the former manufactured gas clean-up costs associated with the Cedar Street site in Dubuque, Iowa, stating Midwest Gas did not make efforts to evaluate its potential exposure when it purchased Iowa Gas and North Central Public Service Company. According to Exhibit 135, the external 1991 clean-up costs attributable to those sites are \$2,927,468 for the Dubuque I, or Cedar Street, site. According to Consumer Advocate, one consequence of the failure to investigate has been a shift of cost responsibility among customers. Former IPS-Gas and Iowa Gas customers would not have been responsible for clean-up of the Cedar Street site if the acquisition had not taken place and the purchase price might have been lower if the liability and its extent had been recognized. Consumer Advocate also raised a question about the transfer of the liability for the Cedar Street site. Consumer Advocate argued that since Donovan Companies did not own the Dubuque gas property at the time of the acquisition of Donovan by Midwest Energy, Midwest Energy could not have transferred the liability from Midwest Energy to Midwest Gas. (Tr. 1909).

Midwest Gas stated it made all reasonable efforts to investigate its potential liability prior to purchasing the property. (Tr. 1517). It is not clear whether the Cedar Street site liability was known to Midwest Gas at the time it purchased the property. (Tr. 1517, 1827). In addition, Midwest Gas argued the liability was properly transferred and the extent of the costs of remediation of former manufactured gas plant sites could not have been known at the time the property was acquired.

In reviewing the record, the extent of Midwest Gas's investigation prior to the purchase of the property is un-

clear. Midwest Gas witness Dreesman testified:

Q. On page 16 of his testimony, Dr Rasmussen says he is unclear why Midwest Energy Company and its advisors did not pursue the same caution about the sites of North Central Public Service Company and Iowa Gas as it did for its own sites. Do you agree this alleged discrepancy exists?

A. Midwest Gas was aware of some, but not all, of the Iowa Gas and North Central Public Service Company's manufactured gas plants before the purchase. Midwest Energy was also aware that manufactured gas plants might represent a potential environmental liability in the future, but the impact of that liability was not predictable and at that time, such potential liability did not appear to be material.

(Tr. 1517-18). When asked which sites Midwest Gas was aware of prior to the purchase, Midwest Gas witness Dreesman stated that was difficult to know. (Tr. 1824). Apparently, when IPS asked whether there were contingent liabilities, North Central said there were none. (Tr. 1824). Although there is conflicting evidence as to whether Midwest Gas should have anticipated the extent of its liability prior to the purchase of the Donovan Companies, Midwest Gas was clearly aware at the time of purchase that it would most likely be involved with the subsequent remediation of former manufactured gas plant sites within its system, including potentially the newly-acquired properties.

*389 The evidence shows that if Midwest Gas was not aware of its liability at the time it purchased the property, it should have been. Prior to the acquisition, an employee of IPS-Gas undertook a study to review IPS-Gas's potential former manufactured gas plant sites. An extensive report was completed in 1985. (Ex. 142). In addition, there was evidence of a legal memorandum and warnings from other utilities about the potential costs of remediation. (Ex. 138). Given the amount of information Midwest Gas had in 1985, it was on notice to investigate all potential liabilities prior to acquiring the property.

As to the question of whether the liabilities were prop-

erly transferred to Midwest Gas, the accounting entries for the transaction suggest that only the assets were transferred to Midwest Gas by Midwest Energy. (Ex. 133). In addition, there is a pattern in the evidence that Midwest Energy has made sales of former gas plant property and other properties acquired in the acquisition of the Donovan Companies and retained the profits for stockholders at the parent company level. There is nothing in the record to indicate there was any attempt to use those proceeds to offset any of the liabilities that Midwest Energy transferred to Midwest Gas.

Had Midwest Gas adequately investigated and anticipated its potential liability exposure, it may have obtained the Donovan Companies at a lower price which would have reduced the acquisition adjustment and benefitted its customers. In its assignment of property after the acquisition, it appears as if saleable assets were retained by the holding company while liabilities were assigned to the utility. The Board finds that a more equitable way to balance the interests of the stockholders and ratepayers in light of this issue is to reduce the unamortized balance of the acquisition adjustment by \$2,927,468, the external 1991 costs which have been incurred at the Cedar Street site in Dubuque. (Ex. 135). The annual amortization will be recalculated to reflect the increase in the amortization reserve from the test year and for the Dubuque site based on the remaining life of the acquisition adjustment. This is a reasonable way to balance the interests of ratepayers and stockholders.

IV. INCOME STATEMENT

A. FORMER MANUFACTURED GAS PLANT COSTS

1. Representative Amount

[9][10][11] Midwest Gas proposed to recover the costs of its activities related to the clean-up and remediation of several former manufactured gas plant sites through a deferred accounting mechanism. According to Midwest Gas, the external expenditures for remediation activities were \$417,848 in 1989, \$2,372,118 in 1990, \$3,117,586

in 1991, and are projected to be \$4,923,500 in 1992. (Ex. 136).

In addition to the arguments concerning the liabilities acquired through the purchase of Iowa Gas and the Donovan Companies which the Board discussed in the preceding section, Consumer Advocate argued if the Board uses the 1991 actual expenses as a representative amount of expenses to be collected, the amount should be reduced by the booked expenditures for pre-1991 EPA billings and the booked advance of a projected litigation liability. (Tr. 1553-54). Mid-Size objected to the recovery of any of the remediation costs, stating that the costs are not used and useful in providing utility service because former manufactured gas plant sites do not operate to provide utility service. Mid-Size also stated it is not possible to determine a representative amount and no current recovery should be allowed because it is impossible to accurately project costs given the potential for recovery from other parties and insurance carriers. (Tr. 1213).

There is consistent Board precedent for allowing the remediation costs to be collected from ratepayers. First, in *Iowa Electric*, Docket No. RPU- 89-3 (April 30, 1990), the Board found:

While these clean-up costs relate to previous delivery of utility service, the costs are current costs and are legitimate costs of doing business as a utility.

In *Iowa Southern*, Docket No. RPU-89-7 (September 14, 1990), the Board stated:

The sharing of the costs between shareholders and ratepayers proposed by Consumer Advocate will also be rejected. Clean-up of the former manufactured gas plants must be encouraged. Iowa has a strong public policy with respect to clean water and the elimination of hazardous wastes. The costs associated with the clean-up are current and legitimate cost of doing business.

Most recently in *Iowa Electric*, Docket No. RPU-90-7 (April 30, 1991), the Board allowed Iowa Electric to collect an amount in rates based on actual 1990 costs, where the test year was the 1989 calendar year.

Midwest Gas claimed it spent \$417,848 in 1989, \$2,372,118 in 1990, \$3,117,586 in 1991, and projected it would spend \$4,923,500 in 1992. (Ex. 136). Pursuant to IOWA CODE § 476.33(4) (1991), the Board shall consider verifiable data, existing as of the date of the commencement of the proceedings, respecting known and measurable changes in costs not associated with a different level of revenue that are to occur within 12 months after the date of the commencement of the proceedings. The test year in this case is 1990. A comparison of 1990 costs to the 1991 costs clearly demonstrates that the test year costs are inadequate. The use of test year costs in setting the revenue requirement would undoubtedly force Midwest Gas to file another rate case to update those costs. The Board believes it is most appropriate to use the 1991 actual external costs of \$3,117,586 as a more representative level of expense. The Board will not reduce that amount by the pre-1991 EPA billings nor the projected litigation liability, as recommended by Consumer Advocate. It appears Midwest Gas followed proper accrual accounting procedures for the Environmental Protection Agency (EPA) billings and it appears the litigation liability has been treated properly as a contingent liability. (Tr. 1841-42).

2. Disallowance of Costs

The question remains whether the portion of clean-up costs related to the Cedar Street site in Dubuque and other sites related to the acquisition of Iowa Gas and North Central should be disallowed. As discussed in the previous section of this order, Consumer Advocate objected to recovery of the former manufactured gas clean-up costs from the Cedar Street site in Dubuque, Iowa, and from other sites related to the acquisition of Iowa Gas and North Central, stating Midwest Gas did not make efforts to evaluate its potential exposure when it purchased Iowa Gas and North Central. (Tr. 1908-10).

The Board finds many of Consumer Advocate's arguments persuasive, but finds the appropriate remedy is the subtraction of the known 1991 remediation costs associated with the Cedar Street site from the unamortized balance of the acquisition adjustment, as discussed in the previous section of this order. The same costs will

be considered, however, in utilizing actual external 1991 costs for purposes of setting a representative amount for clean-up costs. By subtracting the amount of remediation costs attributable to the Cedar Street site from the unamortized balance of the acquisition adjustment, the Board believes it has fashioned an equitable method of balancing the interests of the ratepayers and shareholders. The Board does not believe any further reduction in the acquisition adjustment will be necessary solely because additional remediation funds may be expended in 1992 and subsequent years.

3. Deferred Accounting

Midwest Gas proposed a deferred accounting mechanism which would include a representative amount of remediation expenses. The entire representative amount would be expensed annually regardless of actual collection. The deferred account would be treated as a regulatory asset and the balance would be carried on the books from year to year. (Tr. 965, 976-78). Mid-Size also recommended the use of deferred accounting for the clean-up costs, with no current recovery of costs until costs could be reviewed in the next rate case. (Tr. 1213, 1232-37). Consumer Advocate opposed any proposal to set up deferred accounting, stating the retroactive ratemaking problems identified by the Board in past cases are not resolved by this proposal and deferred accounting results in overstatement of reported earnings. (Tr. 1287).

The Board will not accept Midwest Gas's nor Mid-Size's deferred accounting proposals. Neither proposal alleviates the concerns the *391 Board has expressed in past cases. The deferred accounting approach continues to present potential legal and administrative problems. Such a proposal should only be accepted in limited situations where the strong interests of important public policy concerns warrant departure from typical cost recovery procedures. The amount of previous clean-up costs Midwest Gas has accrued in the deferred account shall be eliminated from Midwest Gas's balance sheets. Midwest Gas shall discontinue the deferred accounting immediately. As time passes and the rapid growth of expenses begins to abate, the Board is relatively confident

that the inclusion of a representative amount as an expense will allow Midwest Gas adequate recovery of its expenses. As noted in the discussion of the acquisition adjustment, Midwest Gas has been aggressive in taking steps to reduce the clean-up costs. By allowing recovery of a representative amount in rates, Midwest Gas will continue to have an incentive to control those costs.

4. Third-Party Recoveries

There is a possibility that the costs associated with the clean-up of former manufactured gas plant sites may be covered by insurance policies held by Midwest Gas. A recent decision by the Iowa Supreme Court in *A.Y. McDonald Industries, Inc. v. Insurance Co. of North America, et. al.*, 475 N.W.2d 607 (Iowa 1991), makes this possibility more likely. Since the Board has determined that it is reasonable for ratepayers to absorb a significant portion of the cost of environmental clean-up through rates, it is also reasonable that a comparable portion of any third-party recovery for the environmental clean-up from insurance companies should offset ratepayer expenses. The Board believes Midwest Gas should be given an incentive to pursue actively third-party recoveries of its former manufactured gas plant clean-up costs. In order to accomplish that goal, the Board believes a sharing of those third-party recoveries between ratepayers and shareholders is appropriate when, and if, such recoveries from third parties are secured.

Thus, the Board will direct Midwest Gas to keep a cumulative record of its recovery of clean-up costs from ratepayers. The ratio of recovery to total clean-up expenditures could then be used to determine the appropriate sharing of any third-party recoveries. For example, if Midwest Gas incurs \$20 million totally in clean-up costs over the entire period but recovers only \$12 million in rates to cover these expenses, then 60 percent of any third-party recoveries should be returned to ratepayers and 40 percent should be retained by Midwest Gas. The starting point should be the effective date of temporary rates in Midwest Gas's last rate case, Docket No. RPU-90-6, since that is when Midwest Gas began collecting former manufactured gas plant clean-up costs in

rates. The Board does not intend for Midwest Gas to use a unit factor to determine the recovery from ratepayers. Instead, Midwest Gas would account for recoveries under the assumption that it either has or will annually recover the representative amount set in this case or in the prior case according to the periods of time those rates were in effect. This would mean that there would be four different representative amounts used in the determination of ratepayer recovery: 1) temporary rates for Docket No. RPU-90-6; 2) final rates for Docket No. RPU-90-6; 3) temporary rates for this case; and 4) final rates for this case.

This approach provides a strong incentive to pursue third-party reimbursement and return to the ratepayers the portion of costs underwritten by them. This approach is not intended to bind a future Board, but is offered as the intent of the current Board members and a suggestion for future Board members.

B. MERGER COSTS AND MERGER SAVINGS

1. Merger Costs

[12][13] As described in an earlier section, Iowa Resources and Midwest Energy, the holding company of Midwest Gas, merged into one holding company called Midwest Resources. The merger of the holding company was reviewed by the Board in Docket No. SPU-90-5. The merger of the Midwest Resources utility subsidiaries, IPS and Iowa Power, is currently pending before the FERC, having been previously reviewed by this Board in Docket No. SPU-91-10. Midwest Gas proposed to recover a *392 total of \$1,635,060 of the costs of the holding company and utility mergers which were allocated to Midwest Gas. Midwest Gas proposed that those costs be collected from ratepayers over three years, at an annual amortization amount of approximately \$545,020. (Ex. 19).

Consumer Advocate objected to the proposal, stating the costs of the merger of the holding companies are nonrecurring costs. Consumer Advocate and Mid-Size both argued the costs are expenditures made to facilitate the merger of the holding companies and are not neces-

sary to the provision of utility service and, therefore, not properly chargeable to ratepayers. (Tr. 1220, 1353). Mid-Size argued also that ratepayers have already paid for the consolidation of Iowa Resources' and Midwest Energy's natural gas operations. (Tr. 1221).

The Board will allow Midwest Gas to recover the costs of the holding company merger. The subsidiaries of the new holding company, including the utilities, are the beneficiaries of the merger of the holding companies. The merger costs allocated to the utilities, therefore, are associated with the provision of utility service. In past cases, the Board has allowed other holding company costs properly allocated to Midwest Gas to be included in rates. In addition, costs which are not directly involved in the provision of utility service, nonetheless, should be recoverable by the utility. For example, costs such as regulatory assessments and taxes are not directly associated with the provision of utility service, but are expenses of doing business. The merger of the holding companies was the initial step in bringing their two utilities together and allowed Midwest Resources to reduce costs which are allocated to the subsidiaries. (Tr. 1762). The Board finds that Midwest Gas should recover the allocated portion of the costs of the merger of the holding companies.

Midwest Gas also proposed to recover the proposed costs of merging the utilities. (Ex. 19, Sch. 1). That merger proposal was recently reviewed by the Board in Docket No. SPU-91-10. However, the Board will not now allow recovery of those costs. While they may be at some future time the appropriate subject for cost recovery, the numbers provided by Midwest Gas are at this time only estimates of costs. (Ex. 19, Sch. 4). The merger is still pending in some jurisdictions. It is premature to address these costs.

The parties do not dispute the fact that the holding company merger costs are one-time or nonrecurring costs. Midwest Gas proposed that the costs be collected over a three-year period to reflect the average time between rate cases similar to the treatment given rate case expense. (Tr. 1001). Consumer Advocate recommended that if cost recovery was allowed that the costs be collected over a period of time which would match the

period of time the merger savings are expected to be realized, or as a second alternative, at least ten years. (Tr. 1372-73).

The Board does not necessarily correlate the typical three-year rate case period and recovery of rate case expenses with these merger costs. However, because recovery over a longer period as suggested by Consumer Advocate would permit Midwest Gas to collect only 61.4 percent of its costs ^{FN3}, the Board believes ten years is too long. Instead, the Board finds a four-year time period for recovery will reasonably balance the competing interests.

2. Merger Savings

[14] Midwest Gas proposed that any savings resulting from the merger which were in excess of the merger costs be shared equally between customers and shareholders. (Tr. 1762). Midwest Gas provided testimony that the savings exceed costs by \$1,329,446 ^{FN4} and proposed that it be allowed to retain 50 percent of the net savings, or \$664,723. (Tr. 1001). Midwest Gas also proposed to continue to track merger related savings through the use of a data base system. (Ex. 40).

Consumer Advocate argued that the proposal would move the Board from cost-based rates and provide "monopoly" profits. (Tr. 302). In addition, Consumer Advocate stated any risk of the merger was already reflected in Midwest Resource's common stock price and this proposal would allow shareholders to be compensated twice. (Tr. 284). Consumer Advocate also argued consolidations should be influenced solely by the prospect of lower cost of service, not a reward above fair rates of return.

The Board has reviewed the savings proposal³⁹³ offered by Midwest Gas and will not approve it in current form. The Midwest Gas proposal presents unnecessary administrative complexity and would invite costly and difficult litigation since the net savings amounts would be difficult to verify on a recurring basis.

The Board will adjust expenses to reflect the \$1.8 million dollars in savings identified by Midwest Gas. (Ex.

19). The Board recognizes that the merger has resulted in significant savings to Midwest Gas customers and commends Midwest Gas for its efforts to date. Those savings will continue. As a policy matter, the Board believes it should, through its policies and procedures, encourage consolidations where ratepayers can benefit significantly as demonstrated here.

3. Management Efficiency

[15] The statutory provision for rewarding or penalizing utilities is found in IOWA CODE § 476.52 (1991). IOWA CODE § 476.52 states, in part:

If the Board determines in the course of a proceeding conducted under section 476.3 or 476.6 that a utility is operating in such an extraordinarily efficient manner that tangible financial benefits result to the ratepayer, the board may increase the level of profit or adjust the revenue requirement for the utility. The Board shall adopt rules for determining the level of profit or the level or the revenue requirement adjustment that would be appropriate.

The board shall also adopt rules establishing a methodology for an analysis of a utility's management efficiency.

Pursuant to that Code section, the Board adopted rules which establish a methodology for analysis of a utility's efficiency. IOWA ADMIN. CODE 199-chapter 29 (1992). In addition, the rules establish an adjustment to the return on common equity as an appropriate means of adjusting the level of profit. IOWA ADMIN. CODE 199-29.4 (1992). In IOWA ADMIN. CODE 199-29.3(1) (1992), the Board identified factors which the Board may consider when evaluating the utility. The rule states, in part:

When evaluating a utility, the board may consider any of the factors listed in this subrule and any additional relevant information. These factors will be guidelines for evaluating a utility's efficiency or inefficiency. No single factor or group of factors will be deemed conclusive evidence of efficiency or inefficiency. In considering these factors, the board may use data collected

under 29.5(476) to compare a utility, except a water utility, to other utilities providing the same service in the state. The board may consider:

a. The price per unit of service (including amounts collected subject to refund) by customer class and type of service

...

b. Operation and maintenance costs per unit of service . . .

c. Quality of service, as reflected by customer complaints shown in company and board records and measures of customer satisfaction.

d. Officer compensation.

...

e. The company's bad debt ratio.

f. Innovative ideas implemented by utility management.

g. Other factors the board determines to be relevant in an individual proceeding.

IOWA ADMIN. CODE 199-29.3(3) lists other factors which the Board may consider when evaluating the efficiency of a natural gas utility. Those factors include: total cost per unit of gas purchased by distribution companies from the pipeline and from other sources; residential and commercial sales volume in relation to investment; unaccounted-for gas as a percentage to total sales volume; and development of energy efficiency programs.

Midwest Gas witness Ehm provided testimony, adopted by Midwest Gas witness Wharton, concerning management efficiency actions and practices of Midwest Gas that he believed to be relevant to IOWA ADMIN. CODE 199-29.3(1). In his testimony at transcript pages 485-97, witness Ehm cited a lengthy list of efficiencies achieved by Midwest Gas.

Exhibit 6, Schedule 3, which is based on the *394 Board's May 1991 "Gas Management Efficiency Report" for 1989 operations shows that Midwest Gas ranks fourth out of seven utilities in operation and maintenance expense when gas volumes are used as the common denominator. When the number of customers served is used as the common denominator, Midwest Gas places first out of seven. Midwest Gas ranked third out of seven in the category of customers per employee. This figure has risen significantly since 1986. Midwest Gas placed second in terms of the percentage of lost gas to total sales over a two-year period. Consumer Advocate's Exhibit 115 shows Midwest Gas ranked third in the average cost of gas per Mcf. The exhibit also shows Midwest Gas ranked last in the average residential non-gas annual bill. Exhibit 115 is based on 1990 figures and provides a comparison from 1986 to 1990. Therefore, when compared to other utilities, Midwest Gas appears to have more indications than not of efficiency as measured by some of the factors in the Board's rules. The Board specifically finds the testimony concerning the consolidation, the decline in the bad debt ratio and the decline in customer complaints as indicators of significant efficiency in management.

It is important to note, however, that the 1990 figures and prior years' comparisons pursuant to the rules are based on Midwest Gas's operations prior to the merger of the holding companies. At the time the Board's management efficiency rules were adopted, the benefits which flow from appropriate mergers were in all likelihood not contemplated.

Pursuant to IOWA ADMIN. CODE 199-29.3(1) "g," the Board may consider other factors the Board determines to be relevant. The rules also state:

The reality of change, and the ability of management to anticipate and respond to those changes, greatly affect any judgment of management efficiency or inefficiency, and must be considered in establishing any rewards for efficiency or penalties for inefficiency.

The Board finds that the merger of the holding companies and the subsequent restructurings reflect management's ability to anticipate and respond to change and

are an important factor relevant to the Board's determination of Midwest Gas's management efficiency. The record shows the merger and restructuring will result in significant tangible financial benefit to ratepayers. Midwest Gas reported the savings attributable to the merger and restructuring exceed the costs of the merger of both the holding companies and the utilities by \$1,329,446. (Ex. 19). Although, as the Board noted earlier, a portion of these savings are estimates and some of the claimed savings may not be directly attributable to the merger, the evidence shows ratepayers will receive a tangible financial benefit because of the efforts of management to merge the holding companies and subsequently restructure their corporate activities. Tracking the savings through the use of a data base system, Midwest Gas found cost savings related to the elimination of duplicate positions and through economies of scale.

Another factor, albeit limited, which is relevant to the determination of whether Midwest Gas has demonstrated extraordinary management efficiency and which also results in tangible financial benefit to ratepayers is the construction of the Natural Gas Pipeline Company of America interconnection to serve the Des Moines metropolitan region. Construction of the pipeline will produce significant tangible financial benefit to ratepayers. Midwest Gas testified that customers will realize annual net savings of approximately \$5,969,404. *See*, Issue IV.D., Market Based Performance Adjustment.

Therefore, pursuant to IOWA CODE § 476.52 (1991), the Board finds Midwest Gas's extraordinary management efficiency has resulted in tangible financial benefit to ratepayers. The Board finds that it is appropriate to reward Midwest Gas for its management efficiency.

The Board will adjust the cost of common equity upward by 50 basis points as a management efficiency reward. The upward adjusted cost of common equity will be reflected as a separate item on schedules and will not be used by Midwest Gas for calculating AFUDC, in calculations for energy efficiency purposes or other regulatory purposes. The 50 basis point management efficiency award will produce approximately*395 \$423,000 prior to adjusting for income taxes or about \$714,000 in terms of revenue. These figures are both calculated on a

total company basis. The Board believes this is a reasonable amount given the extensive salutary efforts Midwest Gas has taken to benefit customers.

C. 1992 SALARY INCREASE

[16] Midwest Gas proposed to adjust test period salaried labor costs by the increases made effective in 1991 and 1992 and by the lower costs reflecting early retirements. (Tr. 836-37, Rev. Sch. AO). Consumer Advocate objected to the 1992 portion of the company adjustment, stating it was too far outside the test period and not known and measurable. (Tr. 1356-60).

The Board will adjust the test period costs as proposed by Midwest Gas. The 1992 five percent increase in salaried labor will be allowed as a permissible post test period adjustment, pursuant to IOWA CODE § 476.33(4) (1991). The 1992 salary increase and offsetting savings due to early retirement programs are events which can be ascertained and verified.

D. MARKET BASED PERFORMANCE ADJUSTMENT

[17][18] Midwest Gas proposed an adjustment to the revenue requirement to reflect a sharing of the savings resulting from the Natural Gas Pipeline Company of America (NGPL) interconnection to the Des Moines metropolitan market. (Tr. 1092). Midwest Gas called its proposal a "market based performance adjustment" (MBPA). The proposed adjustment to the annual revenue requirement would be \$1,492,351, an amount equal to 25 percent of the net annual savings which Midwest Gas claimed will be realized by Midwest Gas customers. (Tr. 1092).

Consumer Advocate objected to this proposal, stating the costs to be charged ratepayers under Midwest Gas's proposed adjustment are not costs of providing utility service. (Tr. 1911). The adjustment would be in addition to the "fair rate of return" shareholders will be allowed to earn on the pipeline investment by including the NGPL pipeline investment in the 13-month average rate base. Consumer Advocate claimed Midwest Gas's

proposal seeks Board approval of a 126 percent to 141 percent return on the \$3.485 million pipeline investment. (Tr. 1911). Consumer Advocate also stated the building of the interconnect was prudent, not innovative, and Midwest Gas did not take unique risks.

Mid-Size also objected, stating Midwest Gas should not be allowed a MBPA bonus. Mid-Size argued ratepayers will pay a return on the NGPL interconnection investment because it is included in rate base and stated the savings achieved by Midwest Gas are speculative and would increase Midwest Gas's return on common equity to an unreasonable level. (Tr. 1712). It asserted Midwest Gas's "basic utility duty" includes the purchase, construction, and maintenance of facilities to insure the safe, efficient, and reliable delivery of natural gas. According to Mid-Size, the proposed bonus would increase the return on common equity by 119 basis points. (Ex. 206, Sch. 3).

While the Board recognizes that the interconnection has produced significant cost savings, the Board will not accept Midwest Gas's proposed market based performance adjustment. As Consumer Advocate and Mid-Size pointed out, utilities are expected to act prudently and efficiently. IOWA CODE § 476.52 (1991). Midwest Gas is not the only utility to construct a pipeline and the construction of a pipeline should be viewed, for the most part, as a part of providing utility service. *See, Interstate Power Company, et al., "1990 Annual Review of Gas Final Report and Order," Docket Nos. ARG-90-150, et al. (October 21, 1991).* ^{FNS}

On the other hand, it is clear the interconnect has produced significant financial benefits to ratepayers and the Board wants to encourage utilities to respond to the changing conditions and circumstances in the natural gas arena by taking timely advantage of opportunities which benefit their customers when those opportunities occur. One method of recognizing management performance is the management efficiency mechanism pursuant to IOWA CODE § 476.52 (1991). In determining that a total 50 basis point adjustment is warranted as a management efficiency reward pursuant to that Code section, the Board gave limited consideration to Midwest Gas's construction of the interconnect as a factor.

See, Issue IV.B, Merger Costs and Merger Savings.

*396 E. INCOME TAX RATES

[19][20] Consumer Advocate proposed the use of a consolidated income tax rate to calculate the income tax component of the cost of service in this proceeding. (Tr. 368-69). Since Midwest Gas participates with its parent, Midwest Resources, and other affiliated interests in a consolidated income tax return in order to minimize income taxes, Consumer Advocate argued the Board should use the effective income tax rate in determining the revenue requirement in rate proceedings. Consumer Advocate pointed out that the previous Internal Revenue Service (IRS) private letter rulings and proposed tax regulations concerning this issue have been withdrawn. They were premised on the theory that ratemaking recognition of the tax savings from the use of the effective rate would violate the tax "normalization" requirements. (Tr. 362, Ex. 108). In addition, Consumer Advocate argued that Midwest Resources uses the revenue from utility ratepayers to realize tax savings for the affiliated group, but proposes to deny ratepayers any share of the actual tax savings.

Midwest Gas argued that its affiliated firms would be placed at a competitive disadvantage through the use of an effective income tax rate. (Tr. 426). According to Midwest Gas, the adjustment is in direct conflict with precedent that has been established by the Board and other regulatory authorities. See, *Iowa Public Service Company*, Docket No. RPU-87-3, and *Iowa Power Inc.*, Docket Nos. RPU-87-2 and RPU-88-10. In addition, Midwest Gas argued calculating the tax as proposed by Consumer Advocate would give the reduction in income taxes which results from the tax losses of non-utility subsidiaries to the utility company's ratepayers and would force shareholders to subsidize permanently the cost of service provided by the utility. (Tr. 415).

In past decisions the Board has found that a utility's tax liability should be calculated on a "stand-alone" basis. These decisions were based, at least in part, on the IRS determination that the calculation of tax liability for ratemaking purposes on a consolidated basis would vi-

olate normalization principles. However, the IRS letter rulings and proposed rules had been withdrawn as of April 25, 1991. (Tr. 362, Ex. 108). Because the IRS withdrew its rulings, state regulatory agencies are revisiting this issue. See, *Re: Potomac Electric Power Company*, 124 PUR4th 1, 21-25 (1991); *Re: Western Massachusetts Electric Company*, 114 PUR4th 1, 25 (1990). The issue presented to the Board is a difficult one. As the Maryland Public Service Commission noted:

More specifically, whether or not to recognize consolidated tax savings involves two competing principles. It is a rule of general application that the rates charged for a regulated utility service should reflect only the cost associated with providing utility service; they should not reflect costs associated with other businesses run by the utility. Application of this principle to the situation at hand would indicate that we accept the "stand-alone" determination of federal income taxes reflected in the cost of service. On the other hand, it is also true that utility rates should not reflect expenses in an amount greater than actually incurred. Application of this principle would indicate that tax savings should be taken into account so as to avoid providing an allowance for income tax in excess of the actual liability, provided that the tax savings are recurring and, therefore, appropriate for test year ratemaking.

Potomac Electric Power Company at 23.

Based on consideration of all arguments and of the strongly competing principles, the Board has decided that it will not deviate from its precedent and will maintain its "stand-alone" policy. A major determinant in this decision is the state legislation which was enacted in 1989. In IOWA CODE § 476.71 (1991), the legislature mandated that utility and affiliate operations remain financially separate. That section states in part:

It is the intent of the general assembly that a public utility should not directly or indirectly include in rates or charges any costs or expenses of an affiliate engaged in any business other than that of utility business unless the affiliate provides goods or services to the public utility. The costs that are included should be reasonably necessary and appropriate for utility business.

The legislation clearly is intended to prevent *397 cross-subsidization. While ratepayers should not subsidize nonutility services, the affiliate companies should also not be required to subsidize utility operations. The costs and expenses incurred which produced the tax losses of the affiliate companies were borne by the stockholders rather than ratepayers. If the Board allowed the benefits of those losses to go to the ratepayers, stockholders would be forced to subsidize the utility cost of service. The decision whether to cross the line between utility service and affiliate companies should not be determined by whether it is beneficial to ratepayers. For these reasons, the Board concludes it is appropriate to continue to recognize Midwest Gas's "stand-alone" method of accounting for income taxes.

V. COST OF EQUITY

[21][22][23] The U.S. Supreme Court, in its decision in *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591, (1944), held:

The rate-making process under the Act, i.e., the fixing of "just and reasonable" rates, involves a balancing of the investor and the consumer interests. Thus we stated in the *Natural Gas Pipeline Co. Case* that "regulation does not insure that the business shall produce net revenues." But such considerations aside, the investor interest has a legitimate concern with the financial integrity of the company whose rates are being regulated. From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and the dividends on the stock. By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise so as to maintain credit and attract capital.

Id. at 603 (citations omitted). Various models have been developed to estimate the return necessary to attract equity capital. In *Duquesne Light Company and Pennsylvania Power Company v. David M. Barasch* 488

U.S. 299, 109 S.Ct. 609 (1989), the Supreme Court noted no one method was imposed on public utility commissions in reaching their conclusions. This Board has relied upon the discounted cash flow (DCF) model, with secondary emphasis on the risk premium model. See *Iowa Southern*, "Final Decision and Order," Docket No. RPU-89-7 (September 14, 1990), pp. 28-33; *Iowa-American Water Company*, "Final Decision and Order," Docket No. RPU-90-10 (October 21, 1991). The principles stated in those orders will be relied on by the Board for guidance in this case regarding the cost of equity. However, the Board will make its decision based on the specific facts and arguments presented in this case.

The only component of the rate of return in dispute was the return on common equity. Midwest Gas calculated a 14.0 percent cost of equity, using two methods for measuring cost of equity: 1) discounted cash flow (DCF) and 2) risk premium. In his DCF method, Midwest Gas witness Vander Weide used a quarterly DCF model, with a five percent reduction to price as an adjustment for flotation costs. His main DCF results were:

- a. 13.7 percent for Midwest Resources;
- b. 14.2 percent for his *Value Line* gas distribution group; and
- c. 14.3 percent for his Standard & Poor's gas distribution group.

In the risk premium analysis, witness Vander Weide used a risk premium of 4.5 to 5.5 percentage points. (Tr. 60). Adding this to the most recent Moody's A-rated bond rate of 8.84 percent produced a cost of equity under the risk premium approach from 13.34 percent to 14.34 percent. (Ex. 38).

Consumer Advocate proposed an 11.3 percent cost of common equity. The proposal was based upon a DCF analysis of Midwest Resources and supported by company specific "risk premium" analyses of other Iowa-based utilities or utility holding companies. (Tr. 257-83, 289-301; Ex. 101, Sch. A-J; Ex. 102, Sch. A-C; Ex.

103, Sch. A-E). Consumer Advocate witness Habr asserted that if a continuous DCF model is applied to witness Vander Weide's combination utility proxy group (Ex. 1, Sch. 5-7), a median cost of equity of 11.5 percent results.

*398 Consumer Advocate also calculated the cost of equity for a group of witness Vander Weide's gas distribution companies using the continuous DCF model instead of Midwest Gas's quarterly model. The result was 13.3 percent for the group using Midwest Gas witness Vander Weide's May 1991 IBES forecasts for growth. When updated with Zacks' February 1992 forecasts, the average cost of equity was 12.76 percent. An average of 12.28 percent resulted if companies with significant non-gas revenue were dropped from the group. (Ex. 120).

Mid-Size proposed a 10.89 percent return on common equity, using the Federal Energy Regulatory Commission (FERC) DCF model in analyzing four sets of natural gas distribution companies. Mid-Size witness Dahlen's analyses did not include Midwest Resources and the estimates ranged from 10.35 percent to 10.89 percent. (Tr. 1708-10, 1714-17, 1732-36; Ex. 206, Sch. 2-4).

Midwest Gas is an operating division of Iowa Public Service Company, which is a wholly owned subsidiary of Midwest Resources. Only Midwest Resources' stock is publicly traded. Therefore, for its main analysis, the Board will analyze Midwest Resources. The Board will also look at the DCF analysis of proxy groups of utility companies as an initial check on the DCF analysis. In

the past the Board has found reason to look at combination electric/natural gas groups as a proxy in checking the cost of equity for a combination company such as Iowa Public Service. That approach was premised on the theory that a comparable investment for an investor would be in another combination utility or its parent. However, Midwest Gas witness Vander Weide has made a persuasive showing in this case that it is also appropriate to look at groups of natural gas companies as a check on Midwest Gas since those companies have comparable risks. Midwest Gas is a natural gas company and has different risks than combination electric/natural gas companies. (Tr. 55-56). Finally, the Board will look at the results from risk premium analyses as another check on the DCF analysis.

A. DCF ANALYSIS

While the Board has previously found the FERC model a useful compromise between the continuously compounded DCF model and annually discrete models, the testimony of Midwest Gas's witness Vander Weide has persuaded the Board that the annually discrete model also has merit. The Board takes note that FERC has discontinued its annual generic cost of equity determination based upon the FERC DCF model. The Board will look at the results of both the FERC and the annually discrete DCF models. The annually discrete model is as follows:

$$K = [D_0(1 + G)/P] + G, \text{ where}$$

| | | |
|--|---|---|
| K | = | the cost of equity capital to be determined |
| D ₀ | = | current indicated dividend |
| P | = | stock market price |
| G | = | growth rate |
| The Board will not use Midwest Gas's quarterly DCF model. Both Consumer Advocate and Mid-Size appear to be correct in asserting that Midwest Gas's quarterly DCF model provides for double recovery of interest on dividends already paid. | | |

1. Dividend

Midwest Resource's most recent quarterly dividend contained in the record is \$0.39 paid on a quarterly basis, or \$1.56 on an annual basis. (Tr. 261, Ex. 1, Sch. 4). The Board will use the figure \$1.56 in its analysis.

*399 2. Price

Midwest Gas used a simple average of the high and low stock prices for the three-month period ending May 31, 1991. The source used by Midwest Gas is Standard and Poor's *Stock Guide*. The price is \$19.583 for Midwest Resources. (Tr. 52; Ex. 1, Sch. 4). Consumer Advocate used an average daily closing price for the period November 7, 1990, through June 28, 1991. The price is \$19.13 for Midwest Resources, and Consumer Advocate updated that price for December 20, 1991, through February 12, 1992, to \$20.125. The Board will use the most recent average of \$20.125 provided by Consumer Advocate.

3. Growth Rate

Midwest Gas used the May 1991 consensus analysts' estimates of future earnings per share (EPS) growth reported by Institutional Brokers' Estimate System (IBES), which is 4.83 percent for Midwest Resources. Midwest Gas provided the January 1992 IBES update of 4.47 percent. (Ex. 39). Consumer Advocate advocated a growth rate of 3.1 percent, the midpoint of the 2.9 percent to 3.3 percent range it estimated. The 2.9 percent is an estimate of internal growth for Midwest Resources using a representative retention ratio. The 3.3 percent is based on Midwest Resources dividend growth rate for the nine-year period ending in 1990. (Tr. 261-69; Ex. 101, Sch. C). Mid-Size used the July 5th 1991 *Value Line* estimate for dividend growth for each of the gas distribution companies used. (Tr. 1709; Sch. 2-5).

The Board will continue to look at both historical growth estimates and forecasted growth estimates. The historical growth rate used by the Board is 2.51 percent for Midwest Resources. This is the average of 3.485

percent, the ten-year least squares growth estimate of dividends per share, and 1.544 percent, the average of ten years internal growth. (Ex. 101, Sch. 3, p. 1). However, in general, the Board believes forecasted growth rates are better predictors of future growth than historical growth rates. In his testimony at transcript page 50, Midwest Gas witness Vander Weide supported his use of the IBES growth forecasts stating:

The IBES consensus growth rates (1) are widely circulated in the financial community, (2) include the projections of reputable financial analysts who develop estimates of future EPS growth, (3) are reported on a timely basis to investors, and (4) are widely used by institutional and other investors. For these reasons, I believe these consensus estimates are unbiased estimates of the investors' expectation of each firm's long-term dividend growth prospects and, accordingly, are incorporated by investors into their return requirements. Consequently, in my opinion, they provide a sound estimate of investors' long-term dividend growth expectations.

The Board is persuaded they are the better gauge of investors' expectations of growth. (Tr. 51). In this case, that is particularly true given the necessity of hypothesizing the historical growth rates of two companies since merged.

Midwest Gas also supported its position by citing a study, James Vander Weide and Willard Carleton's "Investor Growth Expectations and Stock Prices: the Analysts versus Historical Growth Extrapolation," *The Journal of Portfolio Management*, Spring, 1988. That study showed regression results containing the consensus analysts' forecasts exceeded the regression results containing the historical growth estimates. According to witness Vander Weide, this is consistent with the hypothesis that investors use analysts' forecasts, rather than historically oriented growth calculations in making buy and sell decisions. (Tr. 51).

The Board will rely primarily on the January 1992 IBES update of 4.47 percent provided by Midwest Gas in its analysis. (Ex. 39).

4. Flotation Costs

[24] Midwest Gas used a five percent downward adjustment to the DCF price as an allowance for flotation costs, thereby increasing the DCF cost of equity estimated and adding 0.46 percent to his cost of equity estimate for Midwest Resources. (Tr. 215). Midwest Gas contended a flotation adjustment was appropriate even if common stock was not issued in the test year and believes the adjustment should apply to all common equity, including retained earnings.

*400 Consumer Advocate argued if Midwest Gas's flotation cost adjustment of 46 basis points were applied to Midwest Resources' consolidated net utility assets of about \$1.5 billion, then Midwest Resources would perpetually receive flotation costs of \$4,865,000 annually before taxes. The latest Midwest Resources common stock issue had a one-time cost of less than \$2 million. (Tr. 231, 234). According to Consumer Advocate, if a flotation cost adjustment is going to be made, then a secondary market transaction cost adjustment also needs to be made.

The Board has held that a flotation adjustment may be warranted in some cases. For example, in *Peoples Natural Gas Company*, Docket No. RPU-86-11 (March 30, 1987), the Board accepted a flotation adjustment advocated by Consumer Advocate. An adjustment seemed especially germane when there was a recent or planned issuance of common equity, as evidenced in this case. However, as witness Vander Weide pointed out, there are issuance costs associated with all issues of common

stock whether issued recently or sometime ago. The issuance costs of all debt issues are recovered over the life of those issues. Unlike debt, however, stock has a perpetual life making it inappropriate to recover these costs through amortization over a definite period. Therefore, recognition should be given to the need for a carrying charge to be applied to the issuance costs.

Midwest Gas is correct in arguing that the primary disagreement between Midwest Gas and the Consumer Advocate regards the size of, rather than the need for, a flotation adjustment. The proposed adjustments range from zero to five percent. The five percent adjustment to price used by Midwest Gas is too much and does not take into account a needed secondary market transaction cost adjustment. As noted above, it is reasonable to reflect some flotation costs. The Board believes that as an alternative, it is reasonable to make a two percent flotation adjustment. If a two percent adjustment is made, the result is an adjusted DCF price of \$19.72, and if no adjustment for flotation is made the price is \$20.29.

5. DCF Results

Utilizing this data produces the following results for Midwest Resources:

| | No flotation | | 2.0% flotation | |
|-----------------------|--------------|-------|----------------|-------|
| | D/P | K | Adj. D/P | K |
| Annually Discrete DCF | | | | |
| - Historical growth | 7.95 | 10.46 | 8.11 | 10.62 |
| - Forecasted growth | 8.10 | 12.57 | 8.26 | 12.73 |
| FERC DCF | | | | |
| -Historical growth | 7.85 | 10.36 | 8.01 | 10.52 |
| - Forecasted growth | 7.93 | 12.40 | 8.09 | 12.56 |

Midwest Gas also provided analysis for a combination electric/natural gas proxy group using the FERC DCF model. (Ex. 1, Schs. 5-6). The results were 10.5 percent using historical growth estimates and 12.2 percent using forecasted growth estimates. (Ex. 1, Schs. 5-6). Based upon an annually discrete DCF model, these figures are, respectively, 10.57 and 12.35 percent. With a two percent flotation adjustment, the FERC model results, respectively, become 10.62 percent and 12.34 percent. The annually discrete DCF results become 10.73 and 12.51 percent.

Mid-Size provided analysis of gas distribution proxy groups using the FERC DCF model and *Value Line* forecasted dividend growth. The results were 10.35 to 10.89 percent.

B. RISK PREMIUM ANALYSIS

[25] The Risk Premium model is based on the premise that common equity carries a higher risk than debt and, for this reason, investors require a higher expected return. According to this theory, some estimate of expected risk premium is added to the current market determined debt yield to produce an estimate of the current equity return requirement. Controversy exists on the exact form of the model and the debt rate to *401 use, and especially on the estimate of the risk premium. The capital asset pricing model (CAPM) is a variant of the risk premium approach.

Midwest Gas provided testimony that the short run risk premium may rise as interest rates fall. (Tr. 218-20). The Board understands the rationale behind this argument, and, in light of the current low interest rates, will give more weight to the upper part of the 2.5 to 3.5 percentage risk premium range it has heretofore employed.

The risk premium method used by Midwest Gas is similar to the method used by the Board. See, *Iowa Electric Light and Power Company*, Docket No. RPU-89-9 (October 25, 1990); *Iowa-American Water Company*, Docket No. RPU- 90-10 (October 21, 1991). The difference is in the magnitude of the risk premium itself. Us-

ing the updated 8.84 percent estimate for the yield on debt, plus adding a risk premium range of 250 to 350 basis points, supports a cost of equity estimate of about 11.34 to 12.34 percent. (Ex. 38).

[26] As another check, the Board reviewed the recent return on equity decisions of other public utility commissions for natural gas distribution utilities. (Ex. 63). The 1991 average return on equity was 12.48 percent and the 1992 average to date is 12.92 percent. The overall average was 12.51 percent for 1991 and 1992. (Ex. 63). The Board notes that it is important that decisions of other commissions not be relied upon exclusively because of the potential circular effect. However, these facts are useful as a secondary check on the Board's decision. The Supreme Court said in *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591 (1944), "the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks." While the return averages should not be used as the sole means of determining the return on common equity for Midwest Gas, a review of the returns of other gas distribution utilities is useful as a check of whether Midwest Gas's return is commensurate with the returns of other gas utilities.

C. RETURN ON EQUITY

The DCF analyses of Midwest Resources supports a cost of equity range of 10.4 to 12.7 percent. Our preference for the forecasted growth estimates suggests the upper end of this range. DCF analysis of the combination proxy group supports a cost of equity range of 10.5 to 12.5 percent. Midwest Gas witness Vander Weide's DCF analysis of gas distribution groups provided results of 14.2 to 14.3 percent. These, however, reflected an excessive adjustment for flotation and that his particular quarterly DCF model overestimates the cost of equity. The Board's risk premium analysis suggests a range of 11.34 to 12.34 percent. While the DCF analysis remains the Board's primary approach, testimony in this proceeding raises significant doubts about its continued reliability.

Therefore, based on the various methods discussed in this order, the range is somewhere between 12.7 percent on the high side and 10.4 percent on the low side. Taking all of these methods into consideration and taking into consideration the particular facts of this case, the Board believes the proper cost of equity for Midwest Gas to be in the upper range of the DCF analysis and the risk premium check. The Board finds 12.25 percent as a reasonable determination of the cost of equity. The DCF analysis, with or without the flotation adjustment, and the risk premium analysis all support 12.25 percent.

VI. CLASS COST OF SERVICE

A. ALLOCATION OF ACCOUNT 920 FOR "SUPPLY ALLOWANCE" EXPENSE

[27] Midwest Gas proposed to allocate the "supply allowance" portion of administrative and general salaries, Account 920, using a throughput allocator. (Tr. 587). According to Midwest Gas, this method distributes a one cent per MCF cost reflective of the role gas distribution systems play in acquiring gas supplies, securing and coordinating transportation, contractual arrangements, and other activities involved in maintaining relationships with interconnected pipelines and other suppliers. (Tr. 587). Midwest Gas stated these costs cannot be precisely measured, and its proposal is a reasonable recognition of the principle of matching of costs and benefits.

*402 Mid-Size argued Midwest Gas has no support for removing these expenses from account 920 and allocating on the basis of throughput. Also, according to Mid-Size, the reclassification of these expenses to a new undefined and unsupported cost category is arbitrary. Instead, these costs should be left as a part of Account 920 and allocated on supervised operation and maintenance (O&M), excluding gas. (Tr. 1722-23).

After considering the arguments of the parties, the Board will accept Midwest Gas's proposal. Exhibit 34, Table 6, page 3, persuades the Board that it is reasonable to allocate an amount of these costs to transportation customers. Given the increase in activity in trans-

portation transactions, Midwest Gas's proposed level of allocated costs is relatively conservative yet reasonable.

VII. RATE DESIGN

A. CONSOLIDATED PURCHASED GAS COST

[28][29] Northern Natural Gas Company, Natural Gas Pipeline Company of America, and ANR Pipeline Company supply natural gas to the Iowa customers of Midwest Gas. Midwest Gas proposed to consolidate its three current purchased gas adjustments (PGA) for the three interstate natural gas pipelines serving Midwest Gas's service territory into one. (Tr. 865). Consumer Advocate urged the Board to reject the proposed consolidation of the purchased gas costs, stating the purchased gas costs reflected in the PGA of an area served through a particular pipeline supplier is based upon the cost of the gas delivered into the area. According to Consumer Advocate, in order to achieve cost-based rates, it is appropriate to retain the current PGA structure because Midwest Gas's combined PGA would yield higher gas costs for Northern customers while ANR and NGPL customers would experience lower gas costs. (Ex. 155, Sch. A). Mid-Size argued Midwest Gas's proposal would have the effect of creating subsidies as well as allowing cost recovery from customers who neither caused nor benefitted from the costs.

After considering the arguments of the parties, the Board has determined that it is inappropriate to approve a consolidated purchased gas adjustment filing at this time. The Board's rules require the filing of separate PGAs. IOWA ADMIN. CODE 199-19.10(1). The purpose is to allow each adjustment to reflect the cost of gas for serving a particular area. Although there is not a significant cost difference between pipelines in this case, larger cost differences may exist for other companies. However, the Board believes there ultimately may be some merit to the proposal. In order to begin to investigate the feasibility of a combined PGA filing, the Board will require Midwest Gas to offer a PGA filing using the pipelines on a consolidated basis solely for comparison purposes at the time it files its regular PGA reports pursuant to IOWA ADMIN. CODE

199-19.10(3). The first report will be filed on or before September 1, 1992, and the reporting requirement will continue on a monthly basis for the following 12 months. The additional filing can then be used for comparative purposes to better determine the ramification of the proposal at a later time.

B. UNMETERED GAS LAMPS

[30][31] Midwest Gas proposed a special tariff which would apply to those few applications where new gas lights would be added which would not be metered. (Tr. 873). When, due to location, it is more economical to tap existing service lines as they enter a service address rather than extend an appliance line from the customer's side of the meter, Midwest Gas proposed that the tap be allowed and that service to the gas light be unmetered. (Tr. 913-14). The specific rate for these lights is based on Midwest Gas's projections of "single mantle" lamp usage. (Tr. 912). Since it is more economical to tap existing service lines in certain instances, the Board will approve the proposed tariff.

C. CUSTOMER CLASSES AND CUSTOMER CHARGES

[32] For rate design purposes, Midwest Gas proposed to treat the "small interruptible," "large interruptible," "firm transportation," and "interruptible transportation" classes as one class, rather than four separate classes. (Tr. 1725). Mid-Size argued that the four classes should be treated as four separate classes when rates are designed. (Tr. 1726). Mid-Size argued combining four classes of customers for rate design purposes*403 ignores the cost of serving each class of customer. (Tr. 1726). Mid-Size reiterated its position that rates should be cost based and costs should not be arbitrarily transferred from one class of customers to another.

The Board finds Midwest Gas's proposal to treat those classes as one separate class for rate design purposes of non-gas costs is reasonable. The gas cost portion of rates reflects the different characteristics of these classes. However, there is no evidence to suggest that it is necessary to treat non-gas costs separately for the dif-

ferent classes. Similarly, Midwest Gas's proposal bringing customer charges more in line with actual costs is approved. The adjustment to the customer charges is reasonable and will not cause rate shock.

D. NEGOTIATED TRANSPORTATION PRICING PROVISION

[33][34] Midwest Gas proposed a Negotiated Transportation Pricing Provision tariff which would permit Midwest Gas to enter into 12-month agreements, with 60-day notice of cancellation, with its transportation customers and, also, would permit the transportation price to be negotiated from time to time.

Consumer Advocate urged the Board to disallow the proposed negotiated tariff provision for transportation, stating there is no basis upon which to conclude approval of the tariff would make captive ratepayers better off. (Tr. 1915). Consumer Advocate also argued the proposed tariffs would allow subsidized discounts to competitive customers at the expense of captive customers. (Tr. 1936). In addition, Consumer Advocate argued the Board must have sufficient cost and sales data before approving a tariff or else it cannot determine the tariff results in "just and reasonable rates." Although Mid-Size supported flexible transportation pricing, it charged the proposed tariff is unworkable in several respects. First, Mid-Size argued there is a potential for the Midwest Gas to extract monopoly profits and discrimination could result by one customer being flexed while a competing customer pays full margin or more than full margin. (Tr. 1730). In addition, Mid-Size contended it is unlikely that customers will enter into flex agreements without knowing the price and term of such agreements. Finally, Mid-Size pointed out the proposed ceiling above the maximum authorized rate may violate Board rules. (Tr. 1730).

The Board will allow Midwest Gas to implement the tariff. The ability to offer the negotiated tariff will allow Midwest Gas the opportunity to meet the competitive forces in the current gas markets and to maximize contributions from transportation customers to recover fixed costs. It is reasonable to conclude the eligible cus-

tomers will contribute a greater amount to fixed costs which will be used to reduce the necessary contributions from captive customers. Also, a possible result of offering this tariff is that interstate pipeline companies may offer additional discounts.

The Board is cognizant of the concerns raised by Consumer Advocate and Mid-Size. The possibility of unfair subsidization and discrimination exist under this tariff. However, until Midwest Gas begins implementation, the concerns are in the abstract. The Board will require Midwest Gas to provide reports concerning all activity under this tariff. In this way, the activity can be closely monitored and complaint proceedings can be initiated if the concerns materialize. The reports are to be filed by Midwest Gas with the Board on the fifteenth day of each succeeding month after the tariff is initially implemented and shall include the following:

1. the identity of the customer (by account number, if necessary);
2. the volume of gas sold to the customer in the last year on a monthly basis;
3. the volume and price of gas sold per day per customer under the tariff.

E. OPTIONAL SERVICE ELECTRIC GENERATION TARIFF

[35][36] Midwest Gas proposed an Optional Service Electric c Generation Tariff which would allow Midwest Gas to negotiate a price for its potential customers which fall within the electric generator classification. Midwest Gas contended the result of implementing these tariffs would be a greater contribution to fixed costs from eligible customers. Consumer Advocate pointed out that IPS and Iowa Power would consume *404 the majority of usage that would be eligible for the optional service. In effect, Consumer Advocate stated the tariff proposal would allow Midwest Gas to sell the cheapest supply of gas to its affiliated utilities at a negotiated price. (Tr. 1614).

Mid-Size stated the proposed tariff is both discriminat-

ory and preferential in that it is only available to electric generators, and they would be the only potential beneficiaries. (Tr. 1728). According to Mid-Size, the proposed rate is preferential to Midwest Resources in three ways. First, the proposed tariff provides that Midwest Gas could retain one-half of the margin in excess of a base margin level. Second, Iowa Power and IPS Electric would have greater opportunity to sell electricity to the extent that the generation costs of Iowa Power or IPS Electric reduce their marginal costs of generation. Third, the proposed tariff allows Midwest Gas to flex as low as \$0.02/MMBtu with a ceiling of two times the current large volume interruptible transportation rate. (Tr. 1728). Mid-Size suggested the availability provision of the proposed tariff should be changed to overcome the potential for discriminatory and preferential rate problems by making the tariff available to all customers. In addition, Mid-Size suggested the proposed tariff should contain specific language which prohibits discrimination against any customer and which prohibits a preferential rate to Iowa Power or IPS Electric and requires that any and all rates charged which are lower than non-flex rates should be reported to the Board. (Tr. 1728-29).

The Board will also allow Midwest Gas to implement this tariff. It is similar in many respects to the negotiated transportation pricing tariff. However, the Board is concerned, under this tariff, that Midwest Gas could engage in self dealing by negotiating a low price with its affiliate companies, IPS-Electric and Iowa Power. Midwest Gas responded to this concern by stating that IPS-Electric needs to use economically priced fuel sources for electric generation and pointed out that the Board has the ability to review the transactions. Midwest Gas also stated it would expand the availability of the tariff to other customers. As proposed, the tariff is now only available to interruptible customers using gas solely for electric generation. The Board will require Midwest Gas to not limit the availability of service from the tariff to interruptible customers who are solely electric generation customers and to expand its availability to other customers who meet the other requirements of the tariff. Midwest Gas shall also provide reports of all activity on this tariff so that the Board and others can monitor the

use of the tariff and initiate complaint proceedings if the tariff is being implemented inappropriately. The reports will be filed on the fifteenth day of each month after implementation and shall include the following information:

1. The dispatcher's price quote list for each day gas is sold pursuant to this tariff;
2. The volume and cost by source of gas sold per day per customer under the tariff;
3. The volume and price of gas sold per day per customer under the tariff in the preceding year on a monthly basis;
4. The length of time the customer has been doing business with Midwest Gas;
5. The negotiated rate Midwest Gas charged the customer and the volume of gas it was applicable to on a monthly basis;
6. The volume of gas sold to the customer during the month that was not sold at a negotiated rate;
7. The customers (by account number, if necessary) which have exercised the option to revert to pricing under the fixed tariff rate prior to the expiration of the required 12-month period;
8. If customers reverted to fixed tariff rates, the reports will include the dollar value returned to Midwest Gas and the associated volumes; and
9. Any instances where Midwest Gas refused to transport gas for its customers because the customer and Midwest Gas did not agree on a price.

F. SMALL VOLUME FIRM GAS HEAT PUMP AND AIR CONDITIONING RATE (SMR), SEPARATELY METERED GAS HEAT PUMP/AIR CONDITIONER RATE (SMC), FIRM COMPRESSED NATURAL GAS RATE (CNG), AND INTERRUPTIBLE COMPRESSED NATURAL GAS RATE (CNI)

*405 [37][38] Midwest Gas stated the proposed tariffs apply to relatively new products which could provide environmental benefits as well as load factor improvements. (Tr. 872). Approving the tariffs would have little impact at this time, but could be reviewed in future proceedings to reflect additional sales growth and cost of service. Consumer Advocate stated it is impossible to tell whether the proposed tariffs are cost based because the tariffs do not identify costs or projected sales. (Tr. 1317). According to Consumer Advocate, if revenues from the tariffs exceed costs, Midwest Gas would earn more than its authorized rate of return.

These proposed tariff represent new uses of gas. The company has little or no experience with any of these new gas consumption technologies. It is expected that the tariffs will have little cost or revenue impact at this time. The Board will approve the tariffs and impose a reporting requirement on Midwest Gas. Midwest Gas will be required to file reports on a six month basis which describe all sales taking place under these tariffs. In that way, a complaint can initiated if there appears to be any problems with implementation of these tariffs.

The Board notes that the approach it has taken for these tariffs and the others in the preceding two subsections is reflective of the rapidly changing and increasingly competitive gas markets. The Board believes, as a matter of regulatory policy in a fast-changing market, it is not reasonable to wait until all the expense and revenue data are known before a new tariff can be approved. The Board believes the approach it has adopted here protects the interest of the captive ratepayers while providing needed flexibility to the utility. The Board is prepared to review this policy if abuse or unwise implementation is demonstrated by the utility.

I. FINDINGS OF FACT

1. The post-July 1, 1990, expenses of the Rock Valley Energy Efficiency Project are classified as energy efficiency expenditures for purposes of IOWA CODE § 476.6(19) (1991).
2. Rock Valley Energy Efficiency Project expenditures

incurred on or after July 1, 1990, may be considered in an energy efficiency proceeding pursuant to IOWA CODE § 476.6(19) (1991).

3. It is reasonable to reduce test year expenses and rate base by the amount of the Rock Valley Energy Efficiency Project expenditures incurred prior to July 1, 1990.

4. It is reasonable to continue to reflect the acquisition adjustment balance in rate base.

5. It is reasonable to reduce the unamortized test period balance of the acquisition adjustment balance in rate base to reflect the known and measurable amount ending balance at the end of May 1992.

6. It is reasonable to reduce the unamortized test period balance of the acquisition adjustment in rate base and the annual amortization to reflect the 1991 external former manufactured gas clean-up costs related to the Cedar Street site in Dubuque, Iowa.

7. It is reasonable to adjust test period costs to reflect a representative amount of former manufactured gas clean-up costs equal to the total external 1991 actual clean-up costs.

8. It is unreasonable to recover the former manufactured gas clean-up costs through a deferred accounting mechanism.

9. It is reasonable to adjust test year expenses by the amount of expenses related to the merger of Iowa Resources and Midwest Energy.

10. It is unreasonable to adjust test year expenses for the estimated expenses related to the merger of Iowa Public Service and Iowa Power.

11. It is reasonable to adjust test year expenses by the amount savings related to the merger and subsequent restructuring of Iowa Resources and Midwest Energy.

12. It is unreasonable to adopt Midwest Gas's proposal to share the savings of the holding companies' merger.

13. Midwest Gas is operating in such an extraordinarily

efficient manner that tangible financial benefits result to the ratepayers.

14. It is reasonable to grant a management efficiency reward in the amount of 50 basis points.

15. It is reasonable to adjust test year expenses to reflect 1992 salary increases and early retirements.

16. It is unreasonable to grant Midwest Gas *406 a market based performance adjustment.

17. It is unreasonable to use effective income tax rates to calculate the income tax component of the cost of service.

18. It is reasonable to set the return on common equity at 12.25 percent.

19. It is reasonable to allocate the supply portion of administrative and general salaries, Account 920, using a throughput allocator.

20. It is unreasonable to approve a consolidated purchased gas adjustment filing at this time.

21. It is reasonable to approve a special tariff for unmetered gas lamps.

22. It is reasonable to treat the "small interruptible," "large interruptible," "firm transportation," and "interruptible transportation" classes as one class for purposes of rate design.

23. It is reasonable to approve the negotiated transportation pricing provision.

24. It is reasonable to approve the optional service electric generation tariff.

25. It is reasonable to approve the small volume firm gas heat pump and air conditioning rate.

26. It is reasonable to approve the separately metered gas heat pump/air conditioner rate.

27. It is reasonable to approve the firm compressed natural gas rate.

28. It is reasonable to approve the interruptible compressed natural gas rate.

IX. CONCLUSIONS OF LAW

The Board has jurisdiction of the parties and the subject matter in this proceeding, pursuant to IOWA CODE ch. 476 (1991).

X. ORDERING CLAUSES

IT IS THEREFORE ORDERED:

1. The proposed tariffs filed on July 15, 1991, by Midwest Gas, a Division of Iowa Public Service Company, identified as TF-91-294 and TF-91-295, and made subject to investigation as part of this proceeding are declared to be unjust, unreasonable, and unlawful.

2. On or before the expiration of 45 days from the date of this order, Midwest Gas, a division of Iowa Public Service Company, shall file a revised state cost allocation study, a revised class cost-of-service study, and revised tariffs setting schedules of gas rates in compliance with the findings in this order, the terms of the settlement agreement approved by the Board on February 27, 1992, and summary attachments and schedules attached to and incorporated by reference. The compliance tariffs shall become effective upon approval by the Board.

3. On the fifteenth day of each month, beginning the first month after compliance tariffs are approved by the Board and each month thereafter, Midwest Gas shall file a report concerning the Negotiated Transportation Pricing Provision and the Optional Service Electric Generating Tariff, as described in the body of this order.

4. On the first day of each month beginning on September 1, 1992, Midwest Gas shall file a purchased gas adjustment filing on a consolidated pipeline basis, in addition to the required purchased gas adjustment filings which are not filed on a consolidated basis.

5. Six months from the date of this order and continuing on a six-month basis thereafter, Midwest Gas shall file a report concerning the Small Volume Gas Heat Pump

and Air Conditioning Rate, Separately Metered Gas Heat Pump/Air Conditioning Rate, Firm Compressed Natural Gas Rate, and Interruptible Compressed Natural Gas Rate, as described in the body of this order.

6. Motions and objections not previously granted or sustained are denied or overruled. Any argument in the briefs not specifically addressed specifically in this order is rejected either as not supported by the evidence or as not being of sufficient persuasiveness to warrant comments.

DISSENT

[39][40] I concur in all of the issues discussed in this order except Division IV, section E, "Income Tax Rates." I dissent regarding the issue of "Income Tax Rates." Because the IRS has withdrawn its private letter ruling and proposed rulemaking, the Board can now decide this issue without being concerned that its decision could cause a violation of tax normalization requirements.

The benefits of Midwest Gas's decision to file a consolidated tax return should be enjoyed by both ratepayers and shareholders, not just *407 shareholders. It is unfair to include an amount in rates for taxes that are not actually paid to the Internal Revenue Service. In fact, the utility and affiliates do not operate separately and ratepayers should benefit from the organizational structure of which Midwest Gas is a part particularly when rates include the expense of creating the organizational structure. Rates should reflect the benefits associated with the participation of Midwest Gas in the consolidated income tax return of Midwest Resources and its affiliates.

In this decision, the Board has granted a management efficiency reward to Midwest Gas based, in part, on the benefits to ratepayers from the merger of the holding companies. One of the benefits of being part of a holding company structure is the ability to participate in a consolidated tax return in order to minimize tax liability. The inclusion of income tax expense calculated on a "stand alone" basis eliminates this benefit and results in a subsidy to the non-utility participants in the consolidated

ated return from the ratepayers which translates into additional income to the stockholders. Without the participation of the affiliates having income, there is no economic benefit for the tax losses of the non-utility participants in a consolidated tax return. It is unreasonable to charge ratepayers for a fictitious tax liability. A more balanced approach to this tax issue would be to recognize the effect of filing a consolidated return as a reduction to the utility's tax liability. Ratepayers would benefit and the effect on the affiliates with losses is un-

changed. The effective income tax liability from the consolidated tax return should be used in setting rates in this proceeding.

/s/Emmit J. George, Jr.

Dated at Des Moines, Iowa, this 15th day of May, 1992.

Midwest Gas
Index of Schedules Attached to the Final Decision and Order.
Docket Number RPU-91-5

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|---|---|
| Schedule A - 1 Page: | Revenue Requirement Calculation |
| Schedule B - 1 Page: | Adjusted Total Rate Base |
| Schedule C - 1 Page: | Rate of Return |
| Schedule D - 1 Page: | Adjusted Income Statement |
| Schedule E - 4 Pages: Adjustments to the Rate Base | |
| Schedule F - 6 Pages: | Adjustments to the Income Statement |
| Schedule G - 1 Page: | Calculation of Interest Synchronization |
| Schedule H - 1 Page: | Calculation of Acquisition Adjustment |
| Schedule I - 4 Pages: | Calculation of Manufactured Gas Plant Cleanup, Merger Costs and Savings |
| *408 Schedule A, Final Rates, Revenue Requirement, p. 408. | TABLETABULAR OR GRAPHIC MATERIAL SET FORTH AT THIS POINT IS NOT DISPLAYABLE |
| TABLETABULAR OR GRAPHIC MATERIAL SET FORTH AT THIS POINT IS NOT DISPLAYABLE | *410 Schedule C, Final Rates, Rate of Return, p. 410. |
| *409 Schedule B, Final Rates, Rate Base, p. 409. | TABLETABULAR OR GRAPHIC MATERIAL SET FORTH AT THIS POINT IS NOT DISPLAYABLE |
| | *411 Schedule D, Addjusted Income Statement, p. 411. |

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*412 Schedule E, Final Rates, Adjusted Rate Base, pp.
412-415.

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*416 Schedule F, Final Rates, Final Rates, Income
Statement, pp. 416-421.

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*422 Schedule G, Final Rates, Interest Synchronization,
p. 422.

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*423 Schedule H, Final Rates, Acquisition Adjustment,
p. 423.

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*424 Schedule I, Final Rates, FMGP and Merger Costs
and Savings, p. 424-427.

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FORTH AT THIS POINT IS NOT DISPLAYABLE

FOOTNOTES

FN1 The purpose of this synopsis is to provide readers a brief summary of the decision. While the synopsis reflects the order, it shall not be considered to limit, define, amend, or otherwise affect in any manner the body of the order including the findings of fact and conclusions of law.

FN2 Two adjustments will be made, however, to the acquisition adjustment as subsequently discussed.

FN3 Based on a present value analysis assuming a five percent discount rate and recovery over ten years.

FN4 Including both the actual holding companies merger costs and the estimated utility companies merger costs.

FN5 As a result, the question of how to allocate the MBPA becomes moot.

*428 EDITOR'S APPENDIX

PUR Citations in Text

[IOWA] Re Iowa Electric Light & P. Co., 112 PUR4th 374, Docket No. RPU-89-3, Apr. 30, 1990.

[IOWA] Re Iowa Electric Light & P. Co., 118 PUR4th 179, Docket No. RPU-89-9, Oct. 25, 1990. . Pp [IOWA] Re Peoples Nat. Gas Co., 82 PUR4th 637, Docket No. RPU-86-11, Mar. 30, 1987.

[U.S.Sup.Ct.] Duquesne Light Co. v. Barasch, 1989, 488 U.E. 299, 98 PUR4th 253, 253, 102 L.Ed.2d 646, 109 S.Ct. 609.

[U.S.Sup.Ct.] Federal Power Commission v. Hope Nat. Gas Co., 1944, 320 U.S. 591, 51 PUR NS 193, 88 L.Ed.2d 333, 64 S.Ct. 281.

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