BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of Missouri Gas Energy's Purchased Gas Adjustment Tariff Revisions to be Reviewed in its 2000-2001 Actual Cost Adjustment	)))	**Case No. GR-2001-382**
In the Matter of Missouri Gas Energy's Purchased Gas Cost Adjustment Factors to be Reviewed in its 1999-2000 Actual Cost Adjustment	)))	**Case No. GR-2000-425**
In the Matter of Missouri Gas Energy's Purchased Gas Cost Adjustment Factors to be Reviewed in its 1998-1999 Actual Cost Adjustment	)))	**Case No. GR-99-304**
In the Matter of Missouri Gas Energy's Purchased Gas Cost Adjustment Tariff Revisions to be Reviewed in its 1997-1998 Actual Cost Adjustment	)))	**Case No. GR-98-167**

REPORT AND ORDER

Issue Date: August 2, 2007

Effective Date: August 12, 2007

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

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In the Matter of Missouri Gas Energy's Purchased Gas Cost Adjustment Tariff Revisions to be Reviewed in its 1997-1998 Actual Cost Adjustment	)))	**Case No. GR-98-167**

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APPEARANCES

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REGULATORY LAW JUDGE: Morris L. Woodruff

REPORT AND ORDER

SUMMARY

The Commission finds that its Staff has not demonstrated any imprudent decisions by Missouri Gas Energy regarding its release of capacity on the Kansas Pipeline, its hedging conduct for the winter of 2000-2001, or its storage utilization in that winter. Staff's proposed adjustments to MGE's ACA balances related to those issues are denied.

FINDINGS OF FACT

The Missouri Public Service Commission, having considered all of the competent and substantial evidence upon the whole record, makes the following findings of fact. The Commission in making this decision has considered the positions and arguments of all of the parties. Failure to specifically address a piece of evidence, position or argument of any party does not indicate that the Commission has failed to consider relevant evidence, but indicates rather that the omitted material was not dispositive of this decision.

Procedural History

In this consolidated proceeding, the Commission is considering Missouri Gas Energy's Actual Cost Adjustment for four years: Case Number GR-98-167 was established on October 17, 1997, for the purpose of tracking the over-recovery or under-recovery of MGE's natural gas costs for the Actual Cost Adjustment (ACA) period for 1997-1998; Case Number GR-99-304 was established on January 15, 1999, to review MGE's ACA for 1998-1999; Case Number GR-2000-425 was established on January 14, 2000, to review MGE's ACA for 1999-2000; and GR-2001-382 was established on January 9, 2001, to review MGE's ACA for 2000-2001. The Commission consolidated the four cases for all purposes on September 10, 2002.

There were originally four contested issues in this consolidated case relating to adjustments that Staff asked the Commission to make to MGE's ACA balances. The issues are as follows: (1) an adjustment based on the alleged imprudence of MGE's contract with Mid-Kansas Pipeline Company and Riverside Pipeline Company for the interstate transportation of natural gas; (2) an adjustment based on Staff's proposal to impute income to MGE for the release of capacity on the Kansas Pipeline; (3) a disallowance based on MGE's purchasing practices related to hedging; and (4) a disallowance based on MGE's use of storage capacity. In addition, MGE contested Staff's recommendation that it be required to revise a previously filed reliability report.

The first issue, regarding the alleged imprudence of the pipeline contract, was previously litigated in Commission Case Number GR-96-450, the case concerning MGE's 1996-1997 ACA. In its Report and Order in GR-96-450, the Commission found that Staff had failed to present competent and substantial evidence sufficient to raise a serious doubt about the prudence of the pipeline contract. For that reason, the Commission rejected Staff's proposed disallowance for the 1996-1997 ACA. The Commission, however, found that it could not determine whether a stipulation and agreement from a still earlier case would preclude prudence reviews regarding that contract in future ACAs. Kansas Pipeline appealed that aspect of the Report and Order.

While that first issue was subject to appeal, the Commission could not address that issue in this case. Rather than wait for the results of that appeal, the Commission decided to set aside the question of the prudence of the pipeline contract and proceed to hear the other issues. Subsequently, the Commission held hearings concerning the other three issues on May 12-15, 2003. During the course of testimony in that hearing, the parties discovered that Staff's witness had used incorrect numbers in calculating a proposed disallowance relating to MGE's use of storage gas in the winter of 2000-2001. The hearing was adjourned to allow the parties to reevaluate their positions in light of those changed figures. Further testimony was filed and the hearing was completed, on November 24, 2003. Staff and MGE filed initial briefs on January 15, 2004. They filed reply briefs and proposed findings of fact and conclusions of law on February 20, 2004.

The appeal of the issue of the prudence of MGE's interstate pipeline contract with Mid-Kansas Pipeline Company and Riverside Pipeline Company followed a convoluted path through the appellate courts until it was finally resolved by a decision of the Missouri Supreme Court issued on January 30, 2007.[1] The Supreme Court held that the Commission was precluded from considering the prudence of that contract by a stipulation and agreement approved by the Commission in an earlier case. In response to the Supreme Court's decision, Staff formally withdrew the contract prudence issue from this case in a notice of withdrawal of issue filed on May 18, 2007. The Commission is now free to decide the remaining issues.

<u>The Issues</u>

1. Kansas Pipeline Capacity Release

MGE leases capacity on several interstate pipelines to ensure its ability to move enough gas through those pipelines to meet its winter peak capacity demand. During the summer months, there is less demand for gas and MGE does not need as much pipeline capacity to move the needed gas. Even though MGE needs less capacity in the summer, when leasing capacity it must enter into a contract with the pipeline that reserves the maximum capacity for the entire year.[2] MGE compares this situation to a tenant leasing an apartment. The landlord will likely require a lease for a full year, even if the tenant will be on vacation for the month of July. A tenant leasing an apartment who knows that she will be on vacation for a month might try to sublease the apartment while she is away. Such a sublease would be analogous to a pipeline capacity release.

[1] *State ex rel. Riverside Pipeline Co. v. Pub. Serv. Comm'n,* 215 S.W.3d 76 (Mo. 2007).

[2] Langston Direct, Ex. 3, page 6, lines 3-4.

Staff alleges that MGE was imprudent in not releasing its excess capacity on Kansas Pipeline for the months of July through October 2000, and April through June 2001.[3] Assuming that MGE could have released its Kansas Pipeline capacity at a rate of 75 percent of the maximum FERC approved rate for the Williams Pipeline, another pipeline on which MGE holds capacity,, Staff contends MGE could have obtained $1,141,784 in additional revenue by releasing that unused capacity. Recognizing that under an existing incentive sharing mechanism related to capacity release, MGE was entitled to retain 30 percent of capacity release credits that exceed $900,000, Staff calculated that MGE's ratepayers would have received the benefit of $858,158 in additional revenue if the capacity had been released. Staff advocates a disallowance in that amount.[4]

In response, MGE established that it obtains revenue by releasing capacity on some of the other pipelines from which it draws gas, including the Williams system.[5] However, MGE has never obtained any revenue by releasing capacity on the Kansas Pipeline because there is no market for such capacity. In fact, there were no capacity release transactions on the Kansas Pipeline by any shipper, not just MGE, during the period from June 1997, through April 2001.[6]

There are two reasons why capacity release on the Kansas Pipeline is not marketable. First, the commodity charge for transporting gas on the Kansas Pipeline is substantially higher than the commodity charge on competing pipelines.[7] While MGE could

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[3] Sommerer Direct, Ex. 9, Schedule 4.

[4] Sommerer Direct, Ex. 9, page 6, lines 7-13, and Schedule 4.

[5] Langston Direct, Ex. 3, page 9, lines 7-8.

[6] Langston Direct, Ex. 3, page 14, lines 4-14, and Schedule MTL-3.

[7] Langston Direct, Ex. 3, page 11, lines 9-19, and Schedule MTL-1.

discount the fixed demand charge portion of the cost of shipping gas on the Kansas Pipeline in order to make a capacity release transaction, it cannot discount the commodity charge.[8] That means that capacity releases on other pipelines will be cheaper than a capacity release on the Kansas Pipeline, limiting the market for capacity release on the Kansas Pipeline. In addition, the Kansas Pipeline can under-price any possible capacity release on its pipeline by offering interruptible service for which the pipeline company can offer discounted commodity rates, as well has discounted demand rates.[9] As a result, there is no reason to believe that MGE could have obtained any additional revenue from the marketing of capacity release on the Kansas Pipeline, no matter how aggressively it marketed such capacity.

Indeed, in 2002, after it became aware that Staff intended to raise this issue, MGE attempted to market its idle capacity on the Kansas Pipeline in the manner advocated by Staff. Even when offering a 92 percent discount from the maximum demand rate, MGE found no interest in a release of that capacity.[10]

During the course of the proceedings, Staff seemed to recognize that there was no market for the release of capacity on the Kansas Pipeline. Staff then modified its argument to contend that MGE should have released its capacity on the Williams Pipeline, for which there was a market for capacity release, and instead ship the gas it needed on the Kansas Pipeline. The problem with Staff's argument is that, as previously indicated, the cost of shipping gas over the Kansas Pipeline's system is substantially more expensive than the cost of shipping that gas over the Williams Pipeline. Therefore, MGE would need to obtain

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[8] Langston Direct, Ex. 3, page 8, lines 13-16.

[9] Langston Direct, Ex. 3, pages 10-11, lines 16-23, 1-7.

[10] Langston Direct, Ex. 3, page 19, lines 5-7.

a fairly high price for its Williams capacity in order to offset the increased cost of shipping gas over the Kansas Pipeline's system.

In calculating its proposed disallowance, Staff arbitrarily estimated that MGE could have sold its Williams Pipeline capacity at 75 percent of the maximum demand charges.[11] In fact, the weighted average demand rate actually charged for all capacity releases on the Williams Pipeline during the relevant period was only 14 percent of the maximum demand charge.[12] Using the more realistic estimate that MGE's Williams Pipeline capacity could be released at 14 percent of the maximum demand charges, MGE would have experienced $600,000 in additional costs if it had shipped gas through the Kansas Pipeline system and released Williams capacity as Staff proposed.

2. Hedging Conduct for the Winter of 2000-2001.

This issue concerns events during the winter heating season of 2000-2001. That winter a combination of very cold weather and very high wholesale natural gas prices resulted in painfully high gas bills for consumers. Staff alleges MGE was imprudent by failing to sufficiently hedge its natural gas supply to protect its customers from spikes in natural gas prices. Staff advocates a disallowance of $130,137 to adjust for MGE's alleged imprudence.

Hedging, for the purposes of this case, describes an attempt by a natural gas local distribution company, such as MGE, to reduce the risk of variability in natural gas prices.[13] By engaging in hedging practices, the local distribution company is attempting to dampen the effect of price spikes in the market. Of course, when reducing risk by smoothing out the

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[11] Sommerer Direct, Ex. 9, pages 5-6, lines 15-23, 1-6.

[12] Langston Direct, Ex. 3, page 21, lines 8-12, and Schedule MTL-8.

[13] Transcript, page 59, lines 9-11.

highs in the market price, hedging may also have the effect of smoothing out the lows in those prices. In other words, reducing volatility in market prices may reduce the price consumers pay in some circumstances, and increase that price in other circumstances.

A gas company can engage in hedging through several different means. Physical hedging can be achieved by purchasing natural gas during the summer months when gas prices are generally lower and holding that lower-priced gas in storage for use during the winter months when the market price for gas is generally higher. Physical hedging can also be achieved by using fixed price contracts to lock in the price of gas before the winter season. A gas company can also hedge prices through non-physical means by purchasing financial instruments, such as futures contracts and options, that have the effect of fixing the price of gas.

Staff alleges MGE was imprudent because it did not have a "formal hedging plan or detailed analysis on what it would do in terms of hedging alternatives" before the start of the 2000-2001 winter heating season.[14] Because of this alleged imprudence, Staff calculated a disallowance based on an assumption that MGE should have hedged at least 30 percent of normal gas requirements for each month of the heating season.[15]

Staff initially proposed a disallowance of $614,365 for MGE's failure to hedge at least 30 percent of normal gas usage for the months of January and March of 2001.[16] However, during the initial portion of the hearing, Staff discovered that it miscalculated the amount of normal gas usage by using some incorrect assumptions. Staff recalculated its estimate of normal gas usage and found that MGE met Staff's 30-percent standard for

[14] Transcript, page 392, lines 1-5.

[15] Jenkins Direct, Ex. 12, page 9, lines 18-21.

[16] Jenkins Direct, Ex. 12, page 12, lines 15-18.

January, but not for March. Using the corrected estimate, Staff calculated a revised disallowance of $130,137, based on the company's failure to hedge 30 percent of normal gas usage for March 2001.[17]

For the month in which MGE did not hedge at least 30 percent of normal gas usage, Staff estimated a reasonable price at which the company could have hedged those volumes before the start of the heating season. Staff based its price estimate on an average NYMEX closing price for June 1 through October 30, 2000, for delivery in the target month. Staff then subtracted the hedged cost from the actual market price and multiplied the result by the volume of unhedged gas in excess of Staff's 30-percent standard. Through that calculation, Staff arrived at an amount that it contends represents the harm caused to MGE's customers by MGE's failure to hedge sufficient volumes of gas for that month.[18]

Staff admits that in the winter of 2000-2001, there was no existing regulatory or statutory requirement that MGE have a "formal hedging plan".[19] Indeed, the Commission did not promulgate a rule concerning hedging obligations by natural gas local distribution companies until December 30, 2003, when Commission Rule 4 CSR 240-40.018 became effective. There was no such rule concerning hedging in effect before the winter of 2000-2001.[20]

The mere fact that a rule did not exist does not mean that MGE had no obligation to consider a hedging plan. An obligation to hedge to reduce price volatility can be

[17] Jenkins Supplemental Direct, Ex. 36, page 5, line 22.

[18] Allee Direct, Ex. 15, pages 6-7, lines 12-23, 1-19.

[19] Reed Direct, Ex. 1, page 35, lines 24-35, (quoting the deposition of Staff witness Sommerer).

[20] Transcript, pages 340-41, lines 23-25, 1-2.

considered a part of the utility's obligation to act in a prudent manner. However, the exact extent of that obligation is not clear. Going into the winter of 2000-2001, there was no national or state industry or regulatory standard concerning how much of a utility's gas supply should be hedged. On the contrary, different states and different utilities engaged in widely varying hedging practices.[21]

While it was not required to have a formal hedging plan in place for the 2000-2001 winter heating season, MGE had instituted such a plan in the months leading up to that winter. On August 1, 2000, the Commission approved a stipulation and agreement signed by MGE, Staff, and Public Counsel.[22] The approved stipulation and agreement authorized MGE to fix the commodity price for 100 percent of MGE's natural gas supplies for the upcoming winter heating season. That would effectively fix the delivered cost to MGE's sales customers for the season.[23]

Unfortunately, that approved hedging plan never went into effect. The problem was that the plan included a market price trigger that natural gas prices had to reach before MGE could implement the plan and begin to purchase financial hedging instruments. At the time the agreement was filed, the market price of natural gas was $3.25 per MMBtu. The hedging plan would be triggered when the market price dropped to or below $2.25 per MMBtu for five consecutive business days. However, market prices for natural gas

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[21] Reed Direct, Ex. 1, page 36, lines 2-10.

[22] *In the Matter of Missouri Gas Energy's Fixed Commodity Price PGA and Transportation Discount Incentive Mechanism.* 9 Mo. P.S.C. 3d 223 (2000).

[23] Langston Direct, Ex. 3, page 30, lines 4-11.

continued to rise during the summer of 2000, contrary to historical trends. As a result, the market price trigger was never reached, and the hedging plan never went into effect.[24]

MGE proposed an amendment to the approved hedging plan to raise the market price trigger to allow the hedging plan to go into effect.[25] Staff, however, opposed raising the market price trigger because of a concern that such a change could lock-in high market prices if natural gas prices dropped in the future.[26] MGE also filed a request to re-implement a price stabilization fund that had been in effect for the three previous winter seasons. Staff opposed that request, and in an order issued on October 26, 2000, the Commission denied MGE's proposal to re-implement the price stabilization fund.[27] In doing so, the Commission directed MGE to "apply reasonable purchasing practices based upon its own evaluation of risks in its gas supply portfolio."[28]

Aside from the lack of a preexisting requirement that MGE have a formal hedging plan, Staff's calculation of a disallowance based on MGE's failure to hedge at least 30 percent of normal gas usage for each month of the winter heating season is not based on any industry or regulatory standard that existed at the time. In fact, Staff did not even formulate the 30-percent standard until the spring of 2002, long after the events at issue in this case.[29] Members of Staff simply consulted with each other while preparing this case

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[24] Langston Direct, Ex. 3, pages 30-31, lines 13-22, 1-7.

[25] Langston Direct, Ex. 3, page 31, lines 19-23.

[26] Langston Direct, Ex. 3, page 32, lines 23-28, quoting the deposition of Staff witness Sommerer.

[27] *In the Matter of Missouri Gas Energy's Tariff Sheets Designed to Renew for an Additional Year the Price Stabilization Fund*, 9 Mo P.S.C. 392 (2000).

[28] Id. at 393.

[29] Transcript, page 495, lines 2-7.

and selected 30 percent as a reasonable minimum.[30] Furthermore, Staff acknowledges that the 30-percent standard should not be viewed as an optimal level or as a precedent for future hedging levels.[31] Rather, Staff views it as a standard to be applied only to MGE and only for the 2000-2001 ACA period.[32]

If measured over the course of the entire winter heating season, MGE met Staff's 30-percent hedging standard for 2000-2001. In fact, for the entire heating season, MGE hedged nearly 40 percent of its normal gas requirements, as calculated using Staff's method.[33] Staff, however, calculated its disallowance based on separate monthly levels of hedging. Thus, while MGE met Staff's 30 percent standard for every other month that winter, for the month of March it hedged only 27.9 percent of normal gas requirements.[34] Staff's proposed disallowance is based entirely on MGE's failure to meet the 30 percent standard for that month.

Even if Staff's 30-percent hedging standard is accepted as a reasonable measurement of MGE's obligation to prudently hedge its gas costs, the application of that standard on a month-by-month basis is arbitrary. That is particularly true where, as here, the company had no prior notice that a 30-percent standard would be applied to its hedging decisions. A proper hedging plan is based on anticipated needs for the entire season, not just on monthly variations. As a result, the amounts hedged may appropriately vary from

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[30] Transcript, page 531, lines 2-9.

[31] Transcript, page 355, lines 2-9.

[32] Transcript, page 496, lines 2-6.

[33] Langston Supp. Rebuttal, Ex. 29, page 35, lines 20-22.

[34] Jenkins Supp. Direct, Ex. 36, schedule 5.

month to month.[35] If MGE had known that it was expected to hedge 30 percent in each month, it could have easily held extra gas in storage in February, when it planned to hedge 48 percent of normal gas usage,[36] and released it in March to meet the standard for both months.[37]

3. Storage Utilization in the Winter of 2000-2001.

Staff also takes issue with MGE's plan to use gas from storage during the winter of 2000-2001.

MGE, like most local distribution companies, contracts with the interstate pipeline companies to utilize the pipeline's storage capacity to store natural gas. At MGE's request, the pipelines inject gas, which MGE has purchased from a producer, into underground storage facilities. When it needs additional gas to meet the needs of its customers, MGE can withdraw gas from the storage facility and move it through the pipeline.[38] At other times, MGE may choose to simply move gas that it has purchased from the producer directly through the pipeline, without utilizing the stored gas. Such gas is known as flowing supply.[39]

Customer demand for natural gas is higher during the cold winter months when gas is used to heat homes and businesses. During the warm summer months, of course, demand for gas is lower. Therefore, during the summer, MGE, like other local distribution companies, purchases more gas than it needs to meet the immediate needs of its

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[35] Langston Direct, Ex. 3, page 44, lines 12-17.

[36] Transcript, page 601, lines 14-17.

[37] Transcript, pages 604-605, lines 24-25, 1-8.

[38] Langston Direct, Ex. 3, page 46, lines 6-18.

[39] Id. at page 49, lines 1-7.

customers and injects that extra gas into storage. That gas is then available to be withdrawn as needed during the winter months.[40]

Since overall demand for gas is lower during the summer months, the price for gas is usually also lower in the summer. Therefore, the cost of gas purchased and injected into storage in the summer is usually lower than the cost of purchasing that amount of gas in the winter. That means a company can use its supply of gas in storage as a hedge to decrease the amount of higher priced gas it must purchase during the winter.

Of course, the amount of gas MGE can store is limited by its contract with the pipelines. Those contracts also place certain restrictions on MGE's right to inject and withdraw gas from storage. For that reason, MGE must carefully plan its withdrawal of gas from storage during the winter months. If it withdraws too much gas from storage too early in the season, it might run short of storage gas later in the season, forcing it to purchase additional higher-priced flowing supplies, or worse, be unable to deliver enough gas to meet the needs of its customers on a particularly cold late winter day.

Staff alleges MGE was imprudent in planning its storage withdrawals for the winter of 2000-2001 because it planned to withdraw too much gas from storage during the relatively warm month of November, leaving less storage gas available for withdrawal during the colder month of January, forcing MGE to purchase more expensive flowing gas supplies during that month. MGE calculated its need for flowing gas based on the amount of gas needed to meet baseload demand for that month.[41] Baseload demand is the portion of gas usage that does not vary with outside temperature, such as usage for cooking, water

[40] Id. at page 46, lines 18-20.

[41] Langston Direct, Ex. 3, page 48, lines 11-13.

heating, commercial, and industrial processes.[42] Staff contends MGE should have planned to nominate enough flowing gas at the first of each month to supply gas requirements for the average warmest month, based on historical experience, thus including flowing gas to account for some of the average heat load usage. Because MGE did not do that in the winter of 2000-2001, Staff urges the Commission to reduce MGE's allowed gas costs by $2,924,398.[43]

MGE acknowledges that it planned to withdraw a relatively large portion of its storage gas during the month of November.[44] However, it explains that Staff's proposed gas withdrawal plan is overly simplistic and unworkable, except with the benefit of hindsight.

The problem with Staff's approach is that it would require MGE to nominate its first-of-month flowing gas supply requirement based on the average temperature during the month. Of course, the temperature on any given day during the month vary from the average. A first-of-month nomination obligates the nominating company to move a set amount of gas through the pipeline each day of the month.[45] If MGE were to nominate more gas into the pipeline than it could deliver to its customers, it would be out of balance and would have to either sell the gas into a low demand, hence a low price, market, or face substantial financial imbalance penalties from the pipelines.[46]

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[42] Jenkins Direct, Ex. 12, page 5, lines 21-23.

[43] Jenkins Supp. Direct, Ex. 36, page 14, lines 5-6.

[44] Langston Direct, Ex. 3, page 50, lines 1-4.

[45] Id. at page 49, lines 1-7.

[46] Id. at page 53, lines 13-23. See also, Transcript, pages 115-117.

This becomes a problem when the temperatures experienced during a month are particularly volatile, as they are in November, a transition month between autumn and winter. Temperatures, and resulting demand for gas, may vary widely from the historic average in November. If MGE nominated an amount of gas sufficient to meet average needs at the first of the month, then, on days when temperatures are high and demand for gas is low, it would have an over-abundance of gas flowing through the pipeline. This is a particular problem in November, at the start of the heating season, because available storage capacity tends to be full and there is nowhere to put the excess gas.[47] For that reason, MGE uses storage gas in November to manage this variability.[48]

With the benefit of hindsight, Staff's plan for nominating more flowing gas and using less storage in November to save more stored gas for use in January, would have worked reasonably well and would have saved money for MGE's customers in the winter of 2000-2001. That is true, however, only because, as we now know, November 2000 was the second coldest November in the past 40 years,[49] and because gas prices in January 2001 were higher than they were in November 2000. In November 1999, a warm year, Staff's plan would have saddled MGE with excess amounts of gas on 19 of 30 days. In November 2001, another warm year, MGE would have nominated excess amounts of gas on 22 of 30 days.[50] Furthermore, in years with costs and weather that are closer to normal, Staff's storage usage plan would have been more costly to MGE's customers than the plan used by MGE. That is so because Staff emphasizes use of flowing gas in November instead of

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[47] Transcript, pages 56-57, lines 24-25, 1-22.

[48] Langston Rebuttal, Ex. 4, page 19, lines 12-17.

[49] Transcript, page 445, lines 2-5.

[50] Langston Supp. Rebuttal, Ex. 29, Schedule MTL-43.

storage gas and in many years flowing gas is actually more expensive in November than it is in January.[51]

Staff also criticizes MGE for ordering less first-of-month flowing gas supplies for December 2000 because of an allegedly unsupported belief that prices would drop in December.[52] By doing so, MGE used more storage gas in December, leaving less available for use in January.

As previously indicated, November 2000 was a very cold month and natural gas prices were very high, reaching what was then a record high on November 22.[53] On November 27, the Monday following Thanksgiving, MGE had to make a decision about how much first-of-month flowing gas, at first-of-month prices, to nominate for the month of December. On that day, futures contract prices for natural gas began to decline and the National Weather Service was predicting warmer than normal weather for the next 8-14 days.[54]

Anticipating that gas prices would decline from their historic highs during the month of December, MGE decided to short its nomination of first-of-month flowing supplies for December by 20,000 MMbtus. By avoiding purchase of that gas at first-of-month prices, MGE planned to either use its lower cost storage to meet the gas needs of its customers, or to repurchase the shorted supplies of gas later in the month at a lower cost, and thereby reduce the cost that would be passed on to its customers.[55] Unfortunately, contrary to

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[51] Langston Rebuttal, Ex. 4, page 23, lines 5-11.

[52] Jenkins Direct, Ex. 12, pages 13-14, lines 23, 1-2.

[53] Langston Direct, Ex. 3, page 58, lines 13-20.

[54] Id. at pages 58-59, lines 20-23,1-9.

[55] Transcript, page 661, lines 22-25.

MGE's expectations, the record cold weather lasted into December and prices for gas continued to rise. As a result, MGE had to purchase additional flowing supplies beginning on December 11.[56]

MGE's decision to rely more heavily on storage withdrawals in December was doubly unfortunate because after it had made its decision to under-nominate flowing supplies on November 27, Williams Pipeline told MGE in Mid-December that it had used more gas from storage in November than it believed and consequently had less gas left in storage.[57] Because it had used more gas from storage in December, MGE was able to pull less gas from storage in January and had to purchase more flowing gas at a higher price.[58]

John J. Reed, a consultant employed by MGE, explained the basis for MGE's belief, at the time it nominated its flowing gas supplies on November 27, 2000, that natural gas prices were likely to drop in December. He indicated that gas prices had been higher than predicted levels for several months. In November, several trade publications predicted that prices would decline.[59] In addition, the weather forecast for the first part of December was for warmer than normal weather for the central United States.[60] Furthermore, Reed testified that many other gas companies around the country followed a similar gas nominating strategy based on an anticipated December drop in prices.[61] Reed offered the

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[56] Transcript, page 651, lines 5-8.

[57] Transcript, pages 671-672, lines 25, 1-9. No party alleged that MGE was in any way negligent in underestimating the amount of gas it had pulled from storage in November. An explanation of the discrepancy between MGE's estimated usage and Williams' usage report may be found on pages 267-273 of the transcript.

[58] Transcript, page 652, lines 1-3.

[59] Reed Direct, Ex. 1, page 30-31, lines 14-30, 1-14.

[60] Langston Direct, Ex. 3, page 59, lines 1-9.

[61] Reed Direct, Ex. 1, Pages 31-32, lines 16-29, 1-7.

opinion that, based on what MGE knew at the time, the company's decision to nominated less first-of-month flowing gas for December was prudent.[62]

4. Reliability Report

Staff indicated its dissatisfaction with the foundation of the reliability report prepared and filed by MGE for July 1, 2002, through June 30, 2003 and asks the Commission to order MGE to revise that report to address Staff's concerns.[63] MGE replies that the additional information that Staff would like to see in a reliability report applies to all LDCs in Missouri and, therefore, Staff should address its concerns in a rulemaking proceeding, rather than through an ACA order.[64] At the hearing, Staff agreed that it would like to see additional information in the reliability report submitted by all the gas utilities in the state, not just from MGE.[65]

CONCLUSIONS OF LAW

The Missouri Public Service Commission has reached the following conclusions of law.

Jurisdiction

MGE is a public utility, and a gas corporation as those terms are defined in Section 386.020(18) and (42), RSMo 2000. As such, MGE is subject to the Commission's jurisdiction pursuant to Chapters 386 and 393, RSMo Supp. 2006.

Burden of Proof:

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[62] Reed Direct, Ex. 1, page 32, lines 20-22.

[63] Jenkins Direct, Ex. 12, page 28, lines 15-18.

[64] Langston Direct, Ex. 3, pages 60-61, lines 22-23, 1-3.

[65] Transcript, page 496, lines 23-25.

Section 393.130.1, RSMo Supp. 2006, requires that all charges made or demanded by any gas corporation be just and reasonable. Section 393.150.2, RSMo 2000, provides that in any hearing involving a rate increase, the gas corporation proposing such rate increase has the burden of proving that the proposed increased rate is just and reasonable. The Commission has also held that the gas corporation has the burden of showing that the gas costs that it proposes to pass on to ratepayers through operation of its PGA tariff are just and reasonable.[66]

<u>The Prudence Standard:</u>

It is not, however, sufficient to state that MGE, as the gas corporation, has the burden of proving that its gas costs are just and reasonable. The fact that Staff is challenging the prudence of incurring some of those costs brings into effect an additional standard, the prudence standard. The Commission established its prudence standard in a 1985 case involving the costs incurred by Union Electric Company in constructing its Callaway nuclear plant.[67] In determining how much of those costs were to be included in Union Electric's rate base, the Commission adopted a standard for determining the prudence of costs that had been established by the United States Court of Appeals, District of Columbia, in a 1981 case.[68] The standard adopted by the Commission recognizes that a utility's costs are presumed to be prudently incurred, and that a utility need not demonstrate

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[66] *In the Matter of Tariffs filed by Western Resources, Inc., d/b/a Gas Service, a Western Resources Company, to Reflect Rate Changes to be Reviewed in the Company's 1992-1993 Actual Cost Adjustment,* 3 Mo. P.S.C. 3rd 480, 488 (1995).

[67] *In the Matter of the Determination of In-Service Criteria for the Union Electric Company's Callaway Nuclear Plant and Callaway Rate Base and Related Issues. In the Matter of Union Electric Company of St. Louis, Missouri, for Authority to File Tariffs Increasing Rates for Electric Service Provided to Customers in the Missouri Service Area of the Company,* 27 Mo. P.S.C. (N.S.) 183, 192-193 (1985).

[68] *Anaheim, Riverside, Etc. v. Fed. Energy Reg. Comm'n,* 669 F.2nd 799, 809 (D.C. Cir. 1981).

in its case-in-chief that all expenditures are prudent. "However, where some other participant in the proceeding creates a serious doubt as to the prudence of an expenditure, then the applicant has the burden of dispelling those doubts and proving the questioned expenditures to have been prudent."[69]

The Commission, in the Union Electric case, further recognized that the prudence standard is not based on hindsight, but upon a reasonableness standard. The Commission cited with approval a statement of the New York Public Service Commission that:

> . . . the company's conduct should be judged by asking whether the conduct was reasonable at the time, under all the circumstances, considering that the company had to solve its problem prospectively rather than in reliance on hindsight. In effect, our responsibility is to determine how reasonable people would have performed the tasks that confronted the company.[70]

Since its adoption, the Commission's prudence standard has been recognized by reviewing courts[71] and has been accepted by all parties as the standard to be applied in this case.

DECISION

After applying the facts as it has found them to its conclusions of law, the Commission has reached the following decisions regarding the issues identified by the parties.

1. Kansas Pipeline Capacity Release

The evidence demonstrated that there is no market for the release of capacity on the Kansas Pipeline. Furthermore, Staff's alternative allegation that MGE should have used its

[69] *Union Electric*, 27 Mo. P.S.C. (N.S.) 183, 193 (1985).

[70] *Union Electric*, at 194, quoting *Consolidated Edison Company of New York, Inc*., 45 P.U.R. 4th 331 (1982).

[71] *See. e.g. State ex rel. Associated Natural Gas Company v. Pub. Serv. Comm'n*, 954 S.W.2d 520, 529 (Mo. App. W.D. 1997).

capacity on the Kansas Pipeline to free up and market capacity on the Williams Pipeline is based on unsupported and unrealistic assumptions about the market value of that capacity. Therefore, MGE acted prudently in not making what would have been futile efforts to market the release of its capacity on the Kansas Pipeline. Staff has failed to present competent and substantial evidence sufficient to raise a serious doubt about the prudence of MGE's action. Therefore, the adjustment proposed by Staff will be denied.

2. Hedging Conduct for the Winter of 2000-2001.

In considering MGE's hedging conduct in the winter of 2000-2001, it is important to remember that the prudence of MGE's conduct must be evaluated based on what MGE knew or should have known at the time, not on 20/20 hindsight. Since the difficult winter of 2000-2001, the hedging practices of Missouri's gas utilities have become much more sophisticated and effective. Thanks to promulgation of new regulations and the wisdom gained from experience, those utilities now have a much clearer understanding of their authority and obligation to engage in hedging to protect their customers from price swings in the marketplace for natural gas.

In the fall of 2000, when MGE was making its decisions about the upcoming winter heating season, things were much different. The Commission had no rule in place upon which MGE could rely in making its hedging decisions. Although Staff criticizes MGE for not having a formal hedging plan in place before the start of the winter, MGE attempted to implement a formal hedging plan in 2000, but it soon became apparent that the price trigger contained in that plan would not be met. MGE made efforts to obtain approval of alternative hedging plans, but on October 26, 2000, just five days before the start of the winter heating season, the Commission rejected those efforts and simply admonished MGE to “apply reasonable purchasing practices based upon its own evaluation of risks in its gas supply portfolio.”

Staff attempts to quantify what it believes to be MGE’s imprudence by imposing a requirement that MGE hedge a minimum of 30 percent of its normal gas usage for each month of the winter. Staff created that specific requirement entirely after-the-fact and it is essentially arbitrary. Staff testified that the 30 percent monthly requirement seemed like a reasonable minimum requirement but there is no indication that 30 percent is more reasonable than 28 percent or 32 percent, or any other percentage. Yet the number chosen has a substantial impact on the amount of disallowance advocated by Staff. Similarly, Staff’s application of a 30 percent hedging requirement on a month-by-month basis attempts to impose a new, rigid requirement on MGE, long after MGE had any opportunity to meet such a requirement. MGE’s failure to anticipate Staff’s after-the-fact imposition of a 30 percent hedging requirement is not a basis for finding that MGE should incur a substantial disallowance for its actions. Staff has failed to present competent and substantial evidence sufficient to raise a serious doubt about the prudence of MGE’s action. Therefore, the adjustment proposed by Staff will be denied.

3. Storage Utilization in the Winter of 2000-2001.

The disallowance advocated by Staff is based entirely on hindsight. After the weather and gas prices experienced in the winter of 2000-2001, are known, it is easy to construct a storage utilization plan that would have minimized the costs incurred by consumers. For that particular winter, Staff’s plan to base planned storage withdrawals on average monthly temperatures would have met that goal. However, MGE demonstrated why Staff’s overly simplified approach would not be desirable, and could actually be more costly to consumers in most years. There is no reason to believe that MGE's storage utilization plan for the winter of 2000-2001 was imprudent.

Staff also argued that MGE's decision to under-nominate first-of-month flowing natural gas for December 2000 was imprudent, or at least unsupported. Again, with the benefit of hindsight, that decision was costly, but the prudence of a decision cannot be measured by its results. MGE explained in detail why it made the decision that it did in November 2000. There is no basis for a finding that MGE's decision was unsupported or imprudent. Staff has failed to present competent and substantial evidence sufficient to raise a serious doubt about the prudence of MGE's action. Therefore, the adjustment proposed by Staff will be denied.

4. Reliability Report

Staff asked the Commission to order MGE to make certain changes to its reliability report filed for July 1, 2002, through June 30, 2003. Staff's concerns about this specific reliability report have become moot due to the delay in issuing this Report and Order necessitated by the appeal of the GR-96-450 decision through the courts. MGE has filed subsequent reliability reports since it filed the challenged report and no practical purpose could be served by requiring it go back and revise the 2002-2003 report. Therefore, the Commission will not require MGE to revise that report.

5. Other Adjustments

For each of the four actual cost adjustment years addressed in this order, Staff proposed various adjustments and established account balances that were not disputed by MGE. The Commission will order MGE to comply with those undisputed adjustments and establish the appropriate account balances for each of those years.

IT IS ORDERED THAT:

1. The disallowance proposed by Staff regarding Kansas Pipeline capacity release is denied.

2. The disallowance proposed by Staff regarding hedging conduct for the winter of 2000-2001 is denied.

3. The disallowance proposed by Staff regarding storage utilization in the winter of 2000-2001 is denied.

4. Staff's request that MGE be required to revise its reliability report for July 1, 2002, through June 30, 2003, is denied.

5. MGE shall comply with all undisputed adjustments and establish the appropriate account balances for its 1997-1998, 1998-1999, 1999-2000, and 2000-2001 actual cost adjustments.

6. This Report and Order shall become effective on August 12, 2007.

BY THE COMMISSION

Colleen M. Dale
Secretary

(S E A L)

Davis, Chm., Murray, and Appling, CC., concur;
Gaw and Clayton, CC., dissent;
and certify compliance with the
provisions of Section 536.080, RSMo 2000.

Dated at Jefferson City, Missouri,
on this 2nd day of August, 2007.