MEMORANDUM

TO: Missouri Public Service Commission Official Case File
Case No. GR-2007-0178, Missouri Gas Utility, Inc.

FROM: David M. Sommerer, Manager - Procurement Analysis Department
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/s/ Dave M. Sommerer 08/16/07 — Project Coordinator
/s/ Lera L. Shemwell 08/16/07 — General Counsel's Office

SUBJECT: Staff's Recommendation for the 2005-2006 Actual Cost Adjustment Filing of Missouri Gas Utility, Inc.

DATE: August 16, 2007

The Procurement Analysis Department (Staff) has reviewed Missouri Gas Utility, Inc.'s (MGU or Company) 2005-2006 Actual Cost Adjustment (ACA) filing. This filing was made on November 3, 2006, for rates to become effective November 20, 2006, and was docketed as Case No. GR-2007-0178.

Missouri Gas Utility, Inc., a Colorado corporation, was incorporated October 13, 2004, originally as a wholly owned subsidiary of CNG Holdings, Inc. (Holdings), for the purpose of acquiring the assets and related rights to serve two gas utility service areas in Gallatin and Hamilton, Missouri. In December 2004, the common stock of MGU held by Holdings was distributed to the individual shareholders of Holdings as a property distribution. According to MGU, these ownership changes related to the Public Utility Companies Holding Act (PUCHA). From December 2004 through October 2005, Holdings and MGU were entities under common control through the same Board of Directors and were owned by the same shareholders. Ownership changed again in November 2005. Since then, MGU is again a wholly-owned subsidiary of Holdings. The original shares of MGU stock held by the common group were exchanged for additional shares of Holdings stock issued for that purpose, on November 1, 2005. Shareholders' percentage in each company remained the same as before the change.

Staff's review consisted of an audit and evaluation of the billed revenues and actual gas costs for the period of September 1, 2005, through August 31, 2006, included in the Company's computation of the ACA rate. A comparison of billed revenue recovery with actual gas costs will yield either an over-recovery or under-recovery of the ACA balance. Staff conducted a hedging review to determine the reasonableness of the Company's hedging practices for this ACA period. Staff also conducted a reliability analysis including a review of estimated peak day requirements and the capacity levels needed to meet these requirements. Finally, Staff reviewed MGU's gas purchasing practices to determine the prudence of the Company's purchasing decisions.

ANR Pipeline Company serves MGU which, during the 2005-2006 ACA period, provided natural gas to a maximum of 839 sales customers and one transportation customer in the north central portion of the state including communities of Coffey, Jameson, Gallatin and Hamilton in the counties of Harrison, Daviess and Caldwell.

BEGINNING ACA BALANCE AUGUST 31, 2005

The ending ACA balance for the prior year ACA Case No. GR-2006-0200 was established as $39,216 over-recovered, per the Order Adopting Staff Recommendations and Requiring Adjustment of ACA Balance, issued on October 17, 2006. However, the Company's support for the 2005-2006 ACA filing showed the beginning balance to be $35,355 over-recovered. The difference is $3,861, the amount of a prior year Staff adjustment, which the Company showed on its ACA calculation spreadsheet, but neglected to include in the formula that calculated the beginning balance of the 2005-2006 ACA period. Therefore, Staff proposes that MGU increase, by $3,861, the over-recovered beginning balance as of August 31, 2005.

INTEREST ON STORAGE BALANCE

The Company's ACA computations included interest on the storage balance. Staff found no provision in the Company's tariff to allow gas costs to include interest on the storage balance. Therefore, Staff proposes a $12,482 adjustment to exclude this interest from the ACA gas costs.

INTEREST ON UNDER OR OVER-RECOVERIES OF PGA/ACA COSTS

The Company's tariff (Sheet No. 46) prescribes the ACA approach for interest calculations. For each month, interest is computed based on the average of the accumulated beginning and ending monthly over- or under-recoveries of all PGA-related costs that exceed $50,000. The interest is credited to customers for any over-recovery, or credited to the Company for any under-recovery. Interest is computed at the prime rate minus two percentage points.

In its 2005-2006 PGA/ACA filing the Company reported $370 interest due to the Company. Staff's computations show that, on the Company's over-recoveries from customers, it should have accrued $322 interest due to customers. Therefore, the Staff proposes that the Company reverse its $370 interest due to the Company, and accrue $322 interest due to customers. The total effect of the Staff adjustment is $692 interest credited to customers.

HEDGING

Deliveries to MGU's city-gate were 8,490 MMBtu in November 2005, and 16,447 MMBtu in December 2005, and 11,289 MMBtu in January 2006, and 14,049 MMBtu in February 2006, and 9,583 MMBtu in March 2006. MGU purchased gas in each winter month for the deliveries, except for March 2006, when its delivery was made from storage withdrawals. The November and January deliveries were made only from flowing gas purchased for each delivery month while December and February deliveries came from both flowing gas purchases made in the same delivery month (46% for December and 99% for February) and also from storage withdrawals (54% for December and 1% for February). The fact that MGU started purchasing gas between November 2005 and February 2006 for November 2005 through March 2006 deliveries shows MGU's inadequate hedging practice for this time period.

Storage injection was the company's only means for hedging for this ACA period. Also, the Company did not maintain hedging documentation for this ACA period.

Staff has the following concerns with the Company's hedging practices:

1. MGU admits it had no formal hedging plan/policy for this ACA period. Instead, the Company states, "The company targets to have a minimum storage balance equal to 50% of the estimated normal monthly usage for each month, by the first day of that month" in it's response to Data Request (DR) Number 0016. MGU also states that its intent is to have its storage essentially full prior to submitting the PGA in October, and when full, storage will serve approximately 90% of the annual load (July 14, 2005 letter from MGU). Nevertheless, neither storage plan was followed. MGU could have ratably filled storage over the spring and summer to hedge for this ACA period. The Company's lack of storage injections during the summer months leading up to November 2005 for the 2005-2006 winter, because of its concerns for the run-up in natural gas prices in the late summer and fall, exposed the customers to potentially high market prices for the winter months. The fact that winter weather turned out to be warmer than normal and prices came down when MGU actually purchased gas in the winter months does not make this practice prudent. However, no dollar adjustment is proposed by Staff for MGU's hedging because Staff's evaluation of the costs to customers for the winter purchases versus the cost if the Company had injected natural gas into storage ratably throughout the injection season shows no material impact on customers for this ACA period. The Company simply got a break from a potentially disastrous market risk during the winter months, because the natural gas market prices fell.
2. MGU's July 14, 2005 letter to the Commission stated that it has been in the process of filling storage whenever the daily price at ANR SW Headstation is at or below $6.30/Dth. It also states that this is the level that will allow them to maintain the PGA at or below the current $7.29/mcf level established on January 1, 2005 when it began operations. MGU's gas purchasing decision to fill storage on a daily basis only when the daily price at ANR SW Headstation is at or below $6.30/Dth could subject the Company to market risk, because the Company could indefinitely delay filling storage if the price parameter is not met. MGU's current approved PGA rate should not be the deciding factor for the Company's lack of hedging for the upcoming winter months. There is a process in place allowing MGU to request a change to its PGA.
3. The lack of documentation of the Company's hedging makes it difficult for Staff to review the Company's gas purchasing practices. For example, it is virtually impossible for Staff to evaluate the reasonableness or prudence of the Company's hedging practice without being able to review the circumstances under which the Company triggers gas purchases.

4. The Company did not evaluate the amount of each month's requirements that are protected under warmer than normal, normal, and colder than normal weather scenarios. It is critical that MGU do this planning. Furthermore, as part of a prudent planning effort to secure adequate natural gas supplies for its customers under the different weather scenarios, MGU should structure its portfolio of contracts with various supply and pricing provisions in an effort to mitigate upward natural gas price spikes, and provide a level of stability of delivered natural gas prices. For example, if storage is not sufficient to maintain reasonable price protection, the Company should consider fixed priced gas supply contracts.

Therefore, Staff recommends, for the 2006-2007 ACA period and beyond, that the Company:

(a) Establish and maintain a current hedging policy based on month-specific normal weather requirements (with impacts of warmer and colder than normal scenarios).
(b) Start placing hedges early enough to hedge, for example, against potential hurricane-related price spikes during summer months.
(c) Document the reasoning for executing any hedging transactions or decisions, whether by means of storage, contracting or financial hedging instruments.
(d) Make the hedging documents available to the Staff for its reviews of subsequent ACA periods.
(e) Provide the hedging plan for 2007-2008 within 30 days.

RELIABILITY ANALYSIS AND GAS SUPPLY PLANNING

The Company is responsible for conducting reasonable long-range supply planning and the decisions resulting from that planning. One purpose of the ACA process is to examine the reliability of the local distribution company's (LDC) gas supply, transportation, and storage capabilities. For this analysis, Staff reviews the LDC's plans and decisions regarding estimated peak day requirements and the capacity levels to meet those requirements, peak day reserve margin and the rationale for this reserve margin, and natural gas supply plans for various weather conditions.

Staff has the following comments and concerns regarding the Company's reliability and gas supply planning information:

1. **Model Development for Peak Day Estimate and Monthly Estimates**

MGU used a deficient process to make its 2005/2006 ACA peak day estimate. MGU calculated the peak day estimate using a rule of thumb of one dekatherm per customer. There is no evaluation verifying that this is a reasonable method for estimating peak day requirements.

The MGU estimates of normal requirements for 2005/2006 are based on the previous year's estimates, prorated for the increase in customer count. MGU does not make any adjustments for weather. This leads to an inaccurate estimate because heating degree days (HDD) for November 2004 through March 2005 were 91% of normal. Thus, its estimates for normal are based on weather that is 9% warmer than normal.

For 2006/2007, MGU provides a more detailed analysis that considers daily usage per customer, heating degree days, and growth. It includes estimates for natural gas requirements for a peak day, normal winter weather, a warm winter and a cold winter. Thus, MGU is making efforts on a going forward basis to improve its estimates for peak day requirements and normal requirements.

2. **Concerns with MGU's Gas Supply Plans and Decisions**

MGU states that it targets having a minimum storage balance equal to 50% of the estimated normal monthly usage for each month by the first day of the month (2005/2006 ACA, GR-2007-0178, DR16). Previously MGU stated that its plan requires maintaining a minimum storage balance sufficient to cover the next 30 days of normal weather usage (2004/2005 ACA, GR-2006-0200, DR47, 78, 83). MGU also states that its intent is to have its storage essentially full prior to submitting the PGA in October, and when full, storage will serve approximately 90% of the annual load (July 14, 2005 letter from MGU).

For the non-winter months leading into this ACA period, the months of April through August 2005, net injections of natural gas occurred only in the month of April. MGU had net withdrawals for the summer months of May through August 2005. At the end of August 2005, storage was only filled to 5.4% of the maximum storage quantity. There were no net injections in September or October of 2005; there were net withdrawals in each of these months. MGU's storage was less than 2% full at the beginning of the winter season. MGU followed none of its stated storage plans or intentions going into the winter of 2005/2006. MGU's storage decisions going into the 2005/2006 winter appear to be driven by the price of natural gas rather than being driven by the need to procure sufficient storage volumes for the winter months' requirements or the need to mitigate price volatility during winter months.

Storage inventory levels at the end of October 2005 could only cover 1% of MGU's estimate of normal November through March requirements. MGU did not have enough natural gas in storage at the end of October to meet the requirements of a peak day.

MGU had net injections in November. By the end of November, MGU had sufficient gas in storage to cover a peak day. Natural gas in storage at the end of November could cover 30% of the remaining winter, December through March, normal requirements. The storage inventory level at the end of December could cover 17% of the remaining winter normal requirements (January through March).

Staff is concerned that MGU had two different storage plans for this ACA period and neither was followed. MGU has indicated that for the subsequent ACA period, the

2006/2007 period, storage was filled (July 6, 2006 letter from MGU). MGU states it re-examined its storage plans after the 2005-2006 winter so that injections would be made in April, May and June instead of waiting until August to fill storage. MGU states that for 2006/2007, storage was filled around June 23, 2006; MGU withdrew from storage for the summer months and topped off storage in October 2006 (02/23/2007 phone call). Staff will review the storage inventory volumes for 2006/2007 in that ACA review.

Storage is not the only means by which MGU can provide natural gas for peak day requirements. Flowing gas can meet 79% to 100% of the natural gas requirements. (Flowing gas could meet all but up to 246 Dth/day and this remaining amount of natural gas must be withdrawn from storage for peak day requirements.) Thus, flowing gas and minimal storage withdrawal could cover a peak day. However, when MGU does not have a sufficient volume of natural gas in storage, MGU must have firm supply contracts in place to provide a reliable source of flowing gas for a cold day.

The Company had a base NAESB contract for supply with Kerr McGee Energy for the winter period. However, the base contract does not include firm volumes. These must be set in separate agreements. MGU set these volumes periodically throughout the winter, but it had no firm volumes set in advance of the winter season, not even firm swing volumes. However, by the end of November, it had natural gas in storage to cover requirements for cold days. The cost of gas in storage is considered in the hedging review for this ACA period.

The winter of 2005/2006 turned out to be warm. November 2005 through March 2006 was 83% of normal. Each of these months, except December 2005, was warmer than normal. January 2006 was much warmer than normal, with HDD of 59% of normal. Seven days were colder than 50 HDD (average daily temperature of 15 degrees Fahrenheit) and no days in the 2005/2006 winter were colder than 60 HDD (average daily temperature of 5 degrees Fahrenheit). To put this in perspective, a historic peak day for this area is 80.5 HDD (average daily temperature of negative 15.5 degrees Fahrenheit.) Because of the warm winter, the lack of firm supply contracts and the minimal storage volumes going into the winter did not adversely impact reliability for this ACA period.

DOCUMENTATION OF GAS PROCUREMENT PLANS, POLICIES AND PROCEDURES

For this 2005-2006 ACA review, as for the prior year Case GR-2006-0200, the PSC Staff sent several data requests for MGU's plans, policies and procedures related to gas procurement. The Company again responded that MGU did not have formal policies and procedures for gas supply planning and procurement for this ACA period, and does not currently have a formal strategic plan. When the prior year Case No. GR-2006-0200 was closed, the Order Adopting Staff Recommendations and Requiring Adjustment of ACA Balance, issued October 17, 2006, ordered that "Missouri Gas Utility, Inc., shall document its gas procurement plans, policies and procedures and submit the documentation for Staff review by November 15, 2006." This has not been done.

The lack of a written plan means that knowledge of the Company's gas procurement plans and activities are known only by those who directly perform the tasks. Without documentation, necessary and protective procedures may erode over time. Staff is therefore concerned that MGU may be vulnerable to changes in many areas (i.e. staff turnover at decision-making level, interruption of supply, market volatility, contract revisions, regulatory changes.)

A planning document can:

1. Assist the Company in ensuring that its purchasing practices have been thoroughly evaluated and are performed consistently,
2. Be used as further support for the Company in awarding gas contracts,
3. Be useful in the event of turnover in gas procurement positions, and
4. Serve as further communication to auditors and regulatory bodies regarding the Company's gas supply practices. The document should include, at a minimum:
    - How does the Company intend to meet its customers' gas supply needs?
    - What are the Company's major gas procurement goals?
    - What strategies does the Company plan to use to meet the goals?
    - What potential situations might prevent the Company from meeting its goals?
    - What contingency plans has the Company made to deal with those situations?
    - Who is responsible for gas procurement plans, policies and procedures?
    - Who is authorized to make gas procurement contracts and transactions?
    - What documentation is required for personnel in gas procurement positions? How should performance and time reporting be documented? What should position descriptions include (i.e. responsibilities, prior experience and educational requirements)?
    - What vendors/sources does the Company expect to use to supply anticipated gas needs?
    - What criteria are considered in selecting vendors/sources of gas? How is each vendor's financial solvency and reliability verified and documented?
    - How should vendors' bids or verbal offers be documented? (Might a log provide evidence of verbal agreements in the absence of formal requests for proposals?)
    - What criteria are used for determining acceptable rates?
    - What is the procedure for entering into gas supply contracts?
    - What documentation should be maintained which supports the Company's gas purchasing decisions and contracts?
    - What reports and procedures are used to monitor quantities of gas purchased and in storage, and to verify that the available quantities are sufficient to meet estimated requirements?

- What is the procedure for making nominations and gas purchasing transactions? How do these procedures vary for first-of-the month nominations and daily changes to the nominations?
- What is the procedure for verifying and approving gas supply invoices before paying them?

Staff recommends that the Commission again issue an order requiring MGU to document the Company's gas procurement plans, strategies, policies, procedures and practices into a document or manual.

SUMMARY

The Staff has addressed the following concerns regarding Case No. GR-2007-0178 for Missouri Gas Utility, Inc., and recommends the following:

1. Staff audited and evaluated the billed revenues and actual gas costs for the period of September 1, 2005, to August 31, 2006, included in the Company's computation of the ACA rate and ACA account balance. Staff recommends that MGU adjust the ACA account balance in its next ACA filing to agree with the end balance in the "Staff Recommended" column of the table in the Recommendations section below.

2. Staff reviewed and evaluated the Company's hedging activities, and proposes that, for the 2006-2007 ACA period and beyond, the Company:
   (a) Establish and maintain a current hedging policy based on month-specific normal weather requirements (with impacts of warmer and colder than normal scenarios).
   (b) Start placing hedges early enough to hedge, for example, against potential hurricane-related price spikes during summer months.
   (c) Document the reasoning for executing any hedging transactions or decisions, whether by means of storage, contracting or financial hedging instruments.
   (d) Make the hedging documents available to the Staff for its reviews of subsequent ACA periods.
   (e) Provide the hedging plan for 2007-2008 within 30 days.

3. Staff is not proposing a dollar adjustments related to reliability and gas supply planning. However, Staff has expressed concerns regarding MGU's gas supply planning. MGU should review the Staff's concerns in the reliability analysis and gas supply planning section of this recommendation and respond with any additional actions items being taken by MGU to address Staff's concerns.

4. Staff reviewed MGU's gas purchasing practices, and proposes that MGU should document its gas procurement plans, policies and procedures as per the Order Adopting Staff Recommendations and Requiring Adjustment of ACA Balance, issued October 17, 2006, in the prior ACA review, Case No. GR-2006-0200.

RECOMMENDATIONS

The Staff recommends that the Commission issue an order requiring MGU to:

1. Adjust the ACA account balance in its next ACA filing to reflect the following Staff adjustments and to reflect the (over)/under-recovered ACA balance in the "Staff Recommended" column of the following table:

Description	Company's ACA Balance Per Filing	Staff Adjustments	Staff Recommended ACA Balance
Beginning Balance 9/1/05	$(35,355)	$(3,861)	$(39,216)
Cost of Gas	$628,142	$(12,482)	$615,660
Recoveries	$(654,292)		$(654,292)
Interest on Under- or (Over-)Recovery of ACA Gas Costs	$370	$(692)	$(322)
Company Adjustment Not in Ending Balance	$17		$17
Ending Balance 8/31/06	$(61,118)	$(17,035)	$(78,153)

2. Review the concerns and recommendations expressed by Staff in the Hedging section and respond to these concerns and recommendations within 30 days and submit the hedging plan for 2007-2008 within 30 days.

3. Review the concerns expressed by Staff in the Reliability Analysis and Gas Supply and Planning section and respond within 30 days with any additional actions items being taken by MGU to address Staff's concerns.

4. Document MGU's gas procurement plans, policies and procedures and submit the documentation within 30 days.

5. File a written response to the above recommendations within 30 days

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of Missouri Gas Utility, Inc.'s Purchased Gas Adjustment (PGA) Factors to be Audited in its 2005-2006 Actual Cost Adjustment	))))	Case No. GR-2007-0178

AFFIDAVIT OF DAVID M. SOMMERER

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

David M. Sommerer, being of lawful age, on his oath states: that as a Utility Regulatory Manager in the Procurement Analysis Department of the Utility Services Division, he has participated in the preparation of the foregoing report, consisting of 9 pages to be presented in the above case; that he has verified that the following Staff Memorandum was prepared by himself and Staff of the Commission that have knowledge of the matters set forth as described below; that he has verified with each of the Staff members listed below that the matters set forth in the Staff Memorandum are true and correct to the best of his knowledge and belief,

Annell Bailey:	Billed Revenues, Actual Gas Costs, and Gas Supply Planning
Lesa A. Jenkins:	Reliability Analysis and Gas Supply Planning
Kwang Y. Choe:	Hedging

that he has knowledge of the matters set forth in such report and that such matters are true to the best of his knowledge and belief.

David M. Sommerer

David M. Sommerer

Subscribed and sworn to before me this 16th day of August 2007.

D. SUZIE MANKIN
Notary Public - Notary Seal
State of Missouri
County of Cole
My Commission Exp. 07/01/2008

D Suzie Mankin

Notary Public