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 et al.

INITIAL BRIEF OF
MISSOURI GAS ENERGY

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I. SUMMARY

This case was established by the Commission for the purpose of reviewing Missouri Gas Energy's ("MGE") prudence in regard to its natural gas procurement decisions for a one year period as a part of what the Commission calls the "ACA" or Actual Cost Adjustment process. That process is established through tariff provisions for each natural gas utility. Through consolidations, this case now covers four ACA years, but the issues explored in this brief relate to just one of the four years.

The Staff of the Commission ("Staff") raised questions about how MGE acted in certain situations during the ACA period of 2000-2001, suggested different approaches that allegedly could have been taken, and alleged that the ratepayers were damaged to the extent of millions of dollars. MGE denies that its decisions were imprudent and disputes that there was any damage to ratepayers from those decisions.

It is important to remember that this case has been separated into two distinct parts as a result of a prior Commission order. The Staff allegation of imprudence involving the level of Kansas Pipeline Company ("KPC") capacity charges applicable to the four years, which is essentially the same issue raised by the Staff and previously rejected by the Commission in Case No. GR-96-450, has been "put on hold" by the Commission pending court review of that decision. That review is presently in the Missouri Court of Appeals, Western District. The result of that bifurcation, as pointed out previously by MGE to the Commission, is that a decision on the issues the Commission chose to hear in this part of the proceeding cannot produce what is legally a "final order" since the order would not finally and completely dispose of all of the issues in the case.

There were four issues shown in the list filed with the Commission prior to the commencement of the hearings. The first of those four also involves KPC and capacity charges but it is a different issue than what was considered in Case No. GR-96-450. This new issue involves capacity release revenues the Staff claims could have been generated by MGE if it had taken certain steps to advertise the capacity. The essence of Staff's primary claim on this issue is that by posting (i.e., advertising) the temporarily idle capacity for sale on KPC's electronic bulletin board, MGE would have found a buyer who would have paid $858,158 for it.

While the claim may appear plausible, the facts show there has never been a market for that capacity and that MGE was aware of this in deciding not to "advertise" in the manner Staff claims. MGE proved there has never been a single capacity release on KPC during its entire existence, much less one comparable to the size of the one Staff alleges could have occurred. The Staff admits that it does not know of anyone who would have been a buyer of the capacity at any price MGE could have legally offered. In short, as will be demonstrated in greater detail in this brief, there is absolutely no factual basis for Staff's claim of damage to the ratepayers because the claim assumes, without any factual support, that MGE could have done what no one else has ever been able to do and at a totally unrealistic price.

The second issue involves whether the Commission should essentially create a specific standard for the level of "hedging" that gas companies will be required to follow. Staff alleges that MGE should have hedged (essentially purchased in advance at a set price) a minimum of 30 percent of its monthly winter gas volumes in each of the five winter months of the ACA period. This brief will explore the numerous problems with

Staff's changing approaches to this issue, not the least of which is that the standard wasn't even developed until after the winter was over. That, of course, made it impossible for anyone to even attempt to comply with it. The first time the Staff calculated its proposed disallowance, it came up with a figure of $614,365. (Ex. 36, p. 5) The second time around, the Staff changed the proposed disallowance to $130,137 due to a change in its approach to calculating normal demands. (Ex. 36, p. 5) Contrary to the Staff allegations, the evidence shows MGE acted within the range of prudent behavior in regard to the level of hedging of natural gas prices for that winter. MGE had a documented and Commission-approved hedging plan in place prior to the winters of 1997-1998, 1998-1999, and 1999-2000. It worked collaboratively with Staff and the Office of Public Counsel to establish an appropriate plan for the winter of 2000-2001 and a settlement agreement was filed with the Commission in May 2000 that contained two separate price protection mechanisms. The Commission approved the settlement in August 2000, but due to unprecedented high gas prices at that time, MGE was prevented by the specific terms of the approved agreement from implementing either of those plans. MGE nevertheless took additional steps to attempt to modify those approved mechanisms to allow for implementation of a price protection plan, but those steps were not supported by the Staff. MGE nevertheless utilized its storage and fixed price purchases to hedge approximately 38% of its normal winter volumes; more than the level called for on a seasonal basis by the Staff's proposed standard. The facts show that MGE acted within the range of prudent behavior with regard to hedging for the winter of 2000-2001, so the Commission should reject the Staff's proposed disallowance.

The third issue unnecessarily involves the Commission in actively managing how natural gas that MGE keeps in storage is delivered during the winter. As with the proposed new 30% standard for hedging discussed above, for purposes of this case the Staff developed another after-the-fact approach on how storage gas should be apportioned each month during the winter. The Staff proposed several different approaches to this topic, changing them as the case progressed. The first proposed disallowance was $8,051,049. MGE discovered very near the end of the initial hearings held in May 2003 that the Staff had not been using appropriate "warmest month" demand numbers for November and December 2000 in its proposed disallowance calculations. MGE showed that if just those two numbers were changed to reflect actual demand experienced in the very recent past, Staff's spreadsheet would have calculated the disallowance at only $182,159. (Ex. 28, p. 13) In the face of that, the Staff proposed an entirely new approach in supplemental direct testimony filed October 3, 2003 that resulted in a different amount for the proposed disallowance.

Although Staff came up with different approaches, the bottom line is that the Staff failed to demonstrate that MGE's decisions regarding how much storage gas it used each month were imprudent, given what was known by MGE at the time those decisions were made. Further, the use of a "mechanistic" or "formulaic" approach to determining monthly storage withdrawals as advocated by the Staff creates another whole set of problems that the Staff has not justified as being worth the risks and costs inherent in its application.

MGE's gas supply portfolio for the winter of 2000-2001 unquestionably met the challenges of an extraordinarily cold period in November and December 2000 – the

coldest consecutive two months on record. On an objective basis, none of MGE's customers were left without service, there were no operational constraints, and MGE was not penalized by any of the interstate pipelines serving it. MGE had a time-tested plan on how to operate and manage its supplies going into the winter. When it was hit with unexpected and unprecedented events beyond its control, both natural and man-made, MGE did what it was supposed to do to keep a reliable supply of natural gas flowing to the customers who demanded it. Therefore, for the reasons detailed in this brief, the Commission should reject the Staff's proposal to penalize MGE for not following one of Staff's various and unproven notions -- created after-the-fact -- on the best way to ration storage gas through the winter.

Finally, the fourth listed issue exists because of Staff's stated desire to have the Commission order MGE to supply additional information from a previous reliability report filed in another case. There is no dollar disallowance associated with this issue. For the reasons discussed later in this brief, MGE believes that this issue has very little relevance to the ACA periods under review here and is more appropriately addressed, if necessary, in a Commission rulemaking.

All of the issues raised by the Staff in this case, except for the one last mentioned, necessarily require the Commission to examine decisions made by MGE personnel to determine if the decisions were prudently made. This is not a situation where the Commission can rule simply because, in hindsight, a different decision would have produced different results. Instead, the prudence standard used by the Commission requires it to engage in a careful process of examining the evidence as to what was known or reasonably knowable by MGE at the time the decision had to be

made, and whether that decision was within a range of what prudent business people would have done if called upon to make a decision at the same time. The *results* of the decisions are not what the Commission must use to determine prudence, as the following discussion of the prudence standard will demonstrate.

II. THE PRUDENCE STANDARD

To appropriately judge the prudence of decisions made by a utility's management, there must be a recognized standard against which the decisions are measured. In each of the issues discussed here, there is no statute or administrative rule prescribing a specific conduct for MGE that has even allegedly been violated. In addition, there is not even an indication – and certainly no evidence in the record -- that there is any "accepted industry practice" that has allegedly been violated, either. Thus, in this case, the Staff has only challenged the "prudence" of a handful of the thousands of MGE decisions in the relevant time periods by essentially asserting that the Staff – in hindsight -- might have done a few things differently. That is not enough to meet the prudence standard.

Prudence is a concept that has certain well-established principles. Those legal principles must be followed by the Commission in order for its decision to withstand judicial review. MGE's witness John Reed reviewed the concepts for the Commission in his direct testimony. (Ex. 1, pp. 2-11)

Origin and Aspects of the Prudence Standard

Mr. Reed explained that the concept of "prudence" in regard to a review of decisions made by regulated public utilities comes from a U.S. Supreme Court case in the early part of the last century, just after regulated public utilities had come into

existence. In ***Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Commission***, 262 US 276 (1923), Justice Brandeis explained that

> There should not be excluded from the finding of the [rate] base, investments which, under ordinary circumstances, would be deemed reasonable. The term is applied for the purpose of excluding what might be found to be dishonest or obviously wasteful or imprudent expenditures. Every investment may be assumed to have been made in the exercise of reasonable judgment, unless the contrary is shown.

From this, Mr. Reed explained, come two fundamental principles of ratemaking. The first is that only reasonable or prudent expenditures are to be included in a utility's rates. The second is that a utility's expenditures are presumed to be prudent until it can be demonstrated that the expenditures were imprudent through clear evidence of utility misconduct. (Ex. 1, p. 3)

Mr. Reed also explained that the concept of prudence has been studied by the National Association of Regulatory Utility Commissioners (NARUC) who have expressed it in terms of four principles for a utility commission to follow:

1) a presumption of prudence;

2) a rule of reasonableness under the circumstances;

3) a proscription against hindsight; and

4) a retrospective, factual inquiry.

The first principle means there is a presumption of prudence to the utility's actions. In other words, another party must come forward with evidence to show that a utility's conduct in a given situation was imprudent. This Commission has agreed with

that, and applied that principle in several cases.[1] Generally, the Commission has adopted a "reasonable care" standard. In ***In Re Union Electric Company***, 27 Mo.P.S.C. (N.S.) 183, 194 (1988). It articulated the standard by saying that

> ... the company's conduct should be judged by asking whether the conduct was reasonable at the time, under all 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.

The second principle requires that the action of the utility's management be evaluated in light of what was known, or reasonably knowable, at the time the decisions in question were made. As such, the Commission must evaluate whether the decisions were appropriate given the information available at the time. In other words, while the ***results*** of management conduct can be used to rebut a presumption of prudence, results of management conduct cannot be relied upon to determine whether that ***conduct*** was prudent. (Ex. 1, p. 4)

The third principle closely follows the second one, Mr. Reed said. Since the utility's action must be judged based on the reasonableness of the circumstances that existed at the time, using hindsight to evaluate a utility's actions will not result in a decision that will be approved by a reviewing court. To support this, Mr. Reed quoted from a presentation of the National Regulatory Research Institute that says the "prudence standard establishes the basis for evaluation in terms of 'bad decisions'

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[1] "Utilities seeking a rate increase are not required to demonstrate in their cases-in-chief that all expenditures were prudent ... However, where some other participant in a proceeding creates serious doubt as to the prudence of an expenditure, then the applicant has the burden of dispelling these doubts and proving the questioned expenditure to have been prudent." ***In Re Union Electric Company***, 27 Mo.P.S.C. (N.S.) 183, 192 (1988).

rather than 'bad outcomes' (no 20/20 hindsight)," meaning that information available after a decision was made is irrelevant to the prudence evaluation. (Ex. 1, p. 5)

The last principle developed by NARUC is that a commission must develop a record of the facts – not opinions — at the time the utility's decision was made. This is the record that should be used to evaluate the utility's decision.

Prudence Applies to Decisions, Not Costs

Mr. Reed summarized these principles as essentially supporting two related themes:

1. The prudence standard applies to decisions, not to results; and
2. Costs cannot be imprudent, only actions.

Thus, the first theme distinguishes between actions and results. If management uses available information to make reasonable decisions within the then-current framework, the decision is prudent regardless of the outcome. The second theme follows the first in that it means costs are only "imprudent" if they arise out of imprudent management actions or decisions. (Ex. 1, p. 6; Tr. 101)

It is also important to remember, Mr. Reed stressed, that there can be a broad range of reasonable and appropriate decisions in any given situation. (Tr. 69) In addition, "in times of unprecedented occurrence, the range of reasonable behavior is typically more broad as compared to times of relative stability." (Ex. 1, p. 6; Tr. 69) In other words, there is more than one appropriate response to a given problem and the range of reasonable conduct is wider during extraordinary situations. Further, it is important for any applicable standards to be communicated to the utility in advance of

the utility being judged by those standards. (Ex. 1, p. 7) Both of these principles play an important part in this case.

Missouri Natural Gas Prudence Decisions

The Commission issued a decision in 1995 in which it articulated the standard it seeks to apply in the type of case presented here. Since it has already said how it would apply the standard in a case such as this, it would be informative to review exactly what the Commission said:

> The incurrence of expenditures or accrued liabilities on the part of local distribution companies in exchange for the physical delivery of natural gas results from action or inaction on the part of individuals in the employ of the local distribution company at some point in time. It appears to the Commission that it needs to clarify the parameters of gas cost prudence reviews. The Commission is of the opinion that a prudence review of this type must focus primarily on the cause(s) of the allegedly excessive gas costs. Put another way, the proponent of a gas cost adjustment must raise a serious doubt with the Commission as to the prudence of the decision (or failure to make a decision) that caused what the proponent views as excessive gas costs. The Commission is of the opinion that evidence relating to the decision-making process is relevant only to the extent that the existence of a prudent decision-making process may preclude the adjustment. ... The critical matter of proof is the prudence or imprudence of the decision from which the expenses result. (Emphasis supplied).

In Re Western Resources d/b/a Gas Service, 3 Mo.P.S.C.3d 480 at 489. One of the Staff witnesses acknowledged that the ***Western Resources*** case set the standard, and that the standard was clear. (Tr. 376).

Therefore, throughout the deliberations in this case, the Commission must focus on the ***decisions*** that were made by MGE and what was known or reasonably knowable to MGE at the time the decisions were made. For example, the Commission cannot fault MGE because the weather turned out to be colder or warmer than the available weather predictions and thus demands placed on the system by its customers

were greater or less than expected. The Commission must also consider that there are likely to be a ***range of decisions*** that can be made in any given situation and therefore only substantiated costs, if any, which would be associated with conduct below a minimally-acceptable level of conduct, should be considered for disallowance.

With that framework on how the evidence must be evaluated, we turn to the substantive issues presented in this case.

III. KPC CAPACITY RELEASE

Factual Background

Issue number 1 in the Statement of Issues filed in this case says that MGE reserves capacity (i.e., space within a pipe) on several interstate pipelines in order to meet peak customer demands in the winter. One of those pipelines is KPC. Staff pointed out that MGE did not use its reserved capacity on KPC in the summer months of the 2000-2001 ACA period (i.e., July through October 2000 and April through June 2001). (Ex. 1, p. 50)

MGE's decision to temporarily not use the capacity is ***not*** the issue raised by Staff, though. The issue raised is whether MGE should have advertised and (presumably) found someone else to pay for at least some of that idle capacity. Specifically, Staff stated in its May 31, 2002, Memo that MGE could have released its Riverside I contract on KPC on a non-recallable basis, thereby maximizing the capacity's value in what is called the "capacity release" market.

What is Capacity Release?

To MGE's knowledge, there has not been a litigated case before the Commission in which "capacity release" has previously been an issue. Therefore, the process itself

or the technical jargon involved may be unfamiliar to some. MGE's witnesses went into some detail about what it involves and that detail is summarized here.

The concept of "capacity release" was explained in the direct testimony of MGE's witness, Mr. Langston. (Ex. 3, pp. 5-9) In simple terms, "capacity" refers to the space within an interstate pipeline that is available for transporting natural gas. "Release" refers to transferring the right to use that capacity to someone else. Therefore, a capacity release transaction is where someone who contractually holds capacity for shipping natural gas on a pipeline (i.e., a "shipper") sells it to a third party for some period of time. (Ex. 3, p. 5) A capacity release is analogous to a tenant subleasing an apartment or office space that the tenant temporarily does not need. (Ex. 3, pp. 5-6; Tr. 323)

MGE has no ownership interest in the KPC pipeline; it is only a "shipper" on that pipeline. Contractual rights and FERC tariff provisions control that situation. (Tr. 322-323) MGE's right to transport its gas on KPC arises from a contract. MGE must contract with KPC (i.e., the owner or landlord, to follow the earlier analogy) to get needed capacity on the pipeline. MGE's contract with KPC is a long-term contract regulated by the FERC. (Tr. 377) The Commission determined in Case No. GR-96-450 that there was no evidence of any MGE imprudence in agreeing to the long-term contract. Use of the KPC pipeline to serve the Kansas City area pre-dates even the existence of MGE. MGE uses the contracted KPC capacity in winter in order to bring natural gas to Kansas City to serve MGE's customers. (Tr. 322)

According to Mr. Langston, KPC, like most other interstate pipelines, requires shippers to purchase capacity for the entire year rather than to just purchase capacity

for selected time periods. (Ex. 3, p. 6) Following the lease analogy used earlier, this means, for example, that a shipper must sign a lease for "the apartment" for 12 months or longer, even if the shipper knows it will spend the month of July on vacation and "the apartment" will be vacant or unused for that month. There are times of the year, specifically during the summer months, when demand for natural gas by customers is at its lowest level. (Ex. 3, p. 6) This naturally produces pipeline capacity that is temporarily not needed because customers are not using their furnaces in the summer to heat their homes. Thus, idle pipeline capacity exists sometimes simply because of the way the FERC has set the rates for some interstate pipelines and the usage patterns of customers.

The evidence shows that MGE had not been using the KPC pipeline in the summer months for several years because of this overall lack of demand for gas in the summer. (Tr. 323)

The FERC created the capacity release process. It allows a shipper to offer its reserved but temporarily idle capacity to other parties when the shipper does not need it for its own purposes. (Tr. 323) The FERC has mandated that all interstate pipelines such as KPC provide a "capacity release" procedure within their tariffs. (Ex. 3, p. 6)

Two Methods of Capacity Release

Mr. Langston explained that there are essentially two methods by which capacity can be "released" to a third party. They are private negotiation and open bidding. (Ex. 3, p. 6) Under the private negotiation method, a shipper can negotiate directly with the third party and establish the quantity of capacity to be transferred, the price, the length of time for the temporary transfer, and other specific conditions such as load factor and

whether or not the capacity may be recalled by the shipper under certain specified conditions. (Ex. 3, p. 6)

In contrast, the open bidding process involves a posting on the electronic bulletin board of the interstate pipeline that a certain amount of capacity is available from the shipper and the general terms and conditions under which the shipper is willing to make the release. Third parties can then electronically place a bid in response to the computer posting. The bidder (assuming there are any) who offers the highest price for the transportation gets the capacity. (Ex. 3, p. 7)

Once the terms and conditions have been established for a capacity release through either negotiations or open bidding, the interstate pipeline will send a contract to the third party. The third party and the pipeline will then enter into a contract to document the transaction to take place. (Ex. 3, p. 8)

Difference Between Demand and Commodity Charges

In general, Mr. Langston explained, the only component of the overall transportation rate that is either negotiated or bid upon in a firm capacity release is the demand charge. "Demand charge," "reservation charge" or "capacity charge" are synonymous terms referencing the *fixed* monthly charge that is required to be paid by a shipper to the interstate pipeline. The charge is payable whether any gas is transported or not. (Ex. 3, p. 8) In contrast, pipeline commodity charges are the *variable* charges that a shipper is required to pay for each dekatherm the shipper actually flows through the pipeline. Thus, commodity charges, unlike demand charges, are only paid when gas is actually flowed on the pipeline. Both demand and commodity charges are established by the FERC and set out in the pipeline company's tariff. (Tr. 322)

While the *amount* of capacity reserved is usually a matter of contract between the shipper and the pipeline, the tariff sets the *rate* to be charged by the pipeline for each quantity of capacity reserved. For example, MGE contractually reserves the right to ship 46,332 dekatherms (Dth) per day on KPC. (Tr. 322) That amount, multiplied by the specific charge per Dth found in KPC's FERC-approved tariff for reserving such capacity, produces the amount MGE must pay KPC each month.

Again, this situation is analogous to someone paying rent on an apartment. (Ex. 3, p. 5-6; Tr. 323) The landlord expects a rent payment from the tenant every month whether the tenant is actually spending every day and night in the building. On that same basis, the pipeline is authorized by the FERC to make a charge for the amount of capacity that has been reserved, whether the shipper actually transports any gas or not in a given month.

It would be wrong, however, to assume that parties can obtain any price they want for temporarily idle pipeline capacity under the FERC-approved procedures for open bids or negotiations. Mr. Langston explained that the demand charge (or fixed portion) is the *only* rate component that is negotiated or bid upon during a capacity release transaction. This is because the *commodity* (or variable portion) of the rate cannot be discounted by a releasing shipper. (Ex. 3, p. 8) Therefore, for all capacity release transactions between *firm* shippers, while the capacity or reservation charges may be discounted, the pipeline's maximum commodity rate and fuel charges are non-negotiable and effectively form a "price floor" for the transaction. In the case of KPC, as was shown by the evidence, that produces a "price floor" that is higher than the rate of

several pipeline alternatives that are available in the same market in which KPC operates.

Once firm capacity has been released to a third party as a result of either an open bidding process or a private negotiation, the interstate pipeline will charge the person to whom the capacity has been released the following rate components:

a) the designated demand rate (derived either from open bidding or negotiation)

b) the applicable maximum commodity charge as set in the pipeline's tariff

c) the applicable tariff fuel charges for moving the gas across the interstate pipeline system, and

d) any applicable pipeline surcharges.

Once the pipeline has received payment for the capacity release transaction from the third party, then the demand charge portion paid by the third party is credited against the shipper's bill for demand charges from the interstate pipeline. (Ex. 3, pp. 8-9) In this manner, the shipper is able to offset at least some of the on-going demand charges with revenue from the third party.

What Is Staff's Position?

The essence of the Staff's proposed disallowance on this issue assumes that MGE would have been able to achieve such a capacity release for its reserved capacity on KPC. Staff's argument for a disallowance is essentially that MGE should have advertised the temporarily unused KPC capacity as being for sale as a capacity release transaction. Staff also made an alternative argument that will be discussed later involving a proposed release on the Williams pipeline but actually transporting the gas on KPC. As will be shown, neither has merit when the facts are examined.

In making its primary argument, Staff has inherently assumed that MGE's act of posting its idle summer capacity on KPC's electronic bulletin board would have resulted in a party purchasing that capacity at the price Staff suggests. So it really presents two fact questions for the Commission to examine: (1) What is the likelihood that some third party would have bought MGE's idle KPC capacity if it had been posted, i.e., advertised? (2) What is the likelihood that that entity would have actually paid the amount the Staff assumes?

While the Staff made little or no effort to substantiate its claim with facts showing such a transaction was probable or even remotely likely at the price it assumed, MGE presented evidence that shows virtually no chance of any such sale occurring based on actual market experience. From the prudence perspective, the question is whether it was reasonable for MGE to assume, from the facts it knew or that were knowable at the time it decided not to make a posting, that it was a waste of effort to post the capacity for release in the first place.

MGE's Experience with Capacity Release

MGE is served by several interstate pipelines. These include Williams, Kinder Morgan, Panhandle Eastern (PEPL) and KPC. (Ex. 3, p. 9) The Staff witness said that Williams is "by far" the pipeline with the largest market share in Kansas City, serving about 70 percent of the load. KPC represents somewhere between three and seven percent of the total. (Tr. 377)

Mr. Langston testified that MGE obtains capacity release revenues on both the Williams and Kinder Morgan pipelines. (Ex. 3, p. 9) He said that MGE generally does not have capacity available for release on PEPL since, unlike other pipelines serving

MGE's service territory, PEPL allows its shippers to contract on a seasonal rather than annual basis. (Id.) Therefore, MGE can and does routinely engage in postings of capacity releases and does create revenues from capacity release transactions when others temporarily purchase the capacity.

However, KPC presents a different situation from the other pipelines serving MGE when it comes to the topic of capacity release. KPC is like Williams and Kinder Morgan in that it has a year-round fixed demand charge. Theoretically, then, it would be possible for capacity releases to take place on KPC. But the facts show that there has never been a single capacity release on KPC by any shipper, whether through an electronic posting or a negotiated sale. (Ex. 3, p. 9) This is not due to something that MGE did or did not do. It is the result of the FERC-approved rate structure of KPC and the interstate pipelines with which KPC competes. MGE was well-aware of that when it made the decision not to post the capacity during the ACA period. Mr. Langston testified that there are two factors that make it nearly impossible for MGE to find anyone willing to accept MGE's release of its KPC capacity.

The first of the two factors is that KPC has relatively high FERC-mandated commodity rates. (Ex. 3, p. 11; Schedule MTL-1) Remember that the commodity rate is the rate applied to actual volumes shipped on the pipeline, as opposed to the fixed demand charge that is assessed whether or not any volumes are shipped. Also, remember that while capacity (fixed) charges may be discounted by the shipper, commodity (variable) charges cannot under the FERC procedure, thus establishing the "price floor" discussed earlier. Mr. Langston testified that KPC's FERC-authorized commodity rate is *three times higher* than Kinder Morgan's and 2.4 times higher than

Williams'. (Ex. 3, p. 11) Therefore, a third party considering the purchase of released capacity has to look at the reality of how much it will have to pay to actually transport the gas on KPC, even with a discounted capacity charge. With a relatively high KPC commodity rate, Mr. Langston said it is uneconomical for third parties to obtain released capacity from shippers on KPC. (Ex. 3, p. 10)

Staff's witness, Mr. Sommerer, said in prepared testimony that he "did not disagree" that KPC's commodity rates were higher than competing pipelines in the area. (Ex. 10, p. 3) On the witness stand, he said "I agree with Mr. Langston's characterizations and testimony that variable charges on KPC are quite a bit higher than the other pipelines in the area." (Tr. 380)

Mr. Langston explained that MGE is not the only shipper with firm capacity on KPC that has capacity available for release. United Cities Gas Company and Kansas Gas Service, both of which are local distribution companies such as MGE, are also firm shippers. (Ex. 3, p. 14) Therefore, for capacity releases on KPC, any posting by MGE would necessarily compete directly with postings from the other firm shippers who would also have capacity to release in the summer.

MGE also competes directly with KPC itself when it comes to the availability of capacity on the pipeline. This is because FERC gives the pipeline the ability to offer a different type of service from the firm service MGE requires. (Ex. 3, p. 10) The pipeline can offer *interruptible* service. With that service comes the pipeline's unique ability to discount *both* the demand and commodity rates. (Ex. 3, pp. 10-11) So this means KPC is authorized by FERC to sell *interruptible* capacity on its pipeline at a much cheaper

rate than released *firm* capacity can be obtained from MGE or other firm shippers on KPC. (Ex. 3, p. 12)

Remember that Staff's disallowance is premised on the sale of idle *summer* capacity. This means that someone wishing to purchase that capacity would only be able to use it during the summer. During the summer, interruptible service is nearly as effective as firm service since demand on the pipeline is at its lowest level and the likelihood of interruption is very low. (Ex. 3, p. 12) The lowest price at which MGE could release capacity on the KPC system would be $0.0625 per dekatherm, plus fuel charges. (Id.) Mr. Langston testified that KPC itself can, and does, offer service at rates lower than that. (Id.) KPC has sold interruptible capacity at prices that are only one-third of the absolute lowest level for which MGE could have released its firm capacity. (See Schedule MTL-2 and Ex. 3, p. 13) This provides yet another reason why there is no market for MGE's capacity on KPC.

Additionally, there are other interstate pipelines that serve the same market as KPC. Therefore, there are shippers on those other pipelines (such as Williams) that can offer capacity going into the same market -- the Kansas City area. Those other pipelines, as indicated earlier, have substantially lower commodity rates compared to KPC. (Ex. 3, p. 12) In short, MGE is certainly not the only potential source of released capacity on KPC and, as a result of the FERC-approved rate structure of KPC, MGE's KPC capacity is the least attractive alternative to anyone seeking capacity into Kansas City. (Id.)

The second factor discussed by Mr. Langston is that there are severe operational limitations inherent with MGE's capacity on KPC that make it administratively and

operationally difficult, and thus costly, for other parties to utilize. (Ex. 3, p. 9; Ex. 3, pp. 15-17) The Staff has never directly challenged this assertion, and in fact, may have admitted this when Mr. Sommerer said during questions by the Commission that Williams, as an alternative, was "more flexible." (Tr. 379) Mr. Sommerer did acknowledge the restraints in his rebuttal testimony but concluded that MGE was obviously "able to deal with them" and implied that MGE would presumably aid a third party in dealing with them. (Ex. 10, pp. 4-5) Mr. Langston, however, pointed out Mr. Sommerer's misconception by saying that

> Mr. Sommerer fails to understand that once capacity is released, MGE has absolutely no control over that capacity, either operationally, physically or financially. Therefore, MGE would not, and could not, operate, nominate or schedule that capacity for the third party as that would be the sole responsibility of the shipper acquiring the released capacity. (Ex. 5 NP, p. 21)

Later, on the witness stand, Mr. Sommerer said "we understand there are restrictions, certain operational restrictions on KPC." (Tr. 382) MGE offered additional proof on this point. In fact, an independent third party with national gas marketing experience reviewed MGE's capacity on KPC prior to this ACA period and indicated that the capacity had no value for numerous reasons, including the lack of flexibility and inherent operational limitations. (Ex. 3, p. 15-16)

The net result of these factors which have been discussed (all of which are outside the control of MGE) is that KPC's relatively high commodity rate makes it uneconomic for third parties to obtain released capacity from shippers on KPC at all, much less from MGE in particular. The facts clearly show it is more economical for third parties to either purchase interruptible capacity directly from KPC because the price is lower, or, if the third party needs firm capacity, to purchase released capacity on other

pipelines with lower variable costs that also serve Kansas City. All of this means that MGE's capacity on KPC that could be offered for release is effectively the least attractive alternative in the market. (Ex. 3, p. 12)

Releases of KPC Firm Capacity Do Not Exist

MGE provided a letter from KPC documenting the fact that there has never been a capacity release on that pipeline for as long as it has been a FERC-regulated pipeline. (Ex. 3, Schedule MTL-3) Mr. Sommerer even attached a copy of this letter to his own direct testimony. (Ex. 9, Schedule 2-2)

After learning that the Staff was going to make an issue out of not posting idle capacity on KPC, MGE has made postings on the KPC bulletin board. These postings were made subsequent to the 2000-2001 ACA period, starting in March 2002, and continue to this date. (Ex. 3, p. 18) In those postings, MGE's capacity was offered at extremely discounted rates and on both a recallable and non-recallable basis. (Ex. 3, Schedule MTL-7) No responses have ever been received from any of these postings. (Ex. 3, p. 18)

As mentioned earlier, there are two other firm shippers on KPC: Kansas Gas Service and United Cities Gas. (Ex. 3, p. 14) Both of these are local distribution companies such as MGE that have to meet the demands of residential customers in cold weather, so they would be comparably situated to MGE in that regard. As substantiated by the letter from the owner of KPC, those companies have never had a capacity release of their KPC capacity, either.

The KPC letter was supplied to the Staff by MGE in May of 2002 in a response to a late March 2002 Staff data request. The Staff asked for documentation showing MGE

had attempted to "either post or negotiate a pre-arranged capacity release" on KPC during the 2000-2001 ACA period. MGE responded by saying that it did not make any postings on the KPC bulletin board during the ACA period, but had done so subsequently to no avail. (Ex. 9NP, Schedule 2-1) Indeed, MGE even posted the KPC capacity at a 92 percent discount off of the maximum rate, and still could not release it. (Ex. 3, p. 19) MGE indicated to the Staff in the data request response there had been verbal conversations with third parties about capacity, but none had ever expressed an interest in the KPC capacity. Most, MGE said, were interested in capacity on the Williams system. (Ex. 9NP, Schedule 2-1).

As a result of the KPC letter and the data request response, the Staff knew at the time it filed its recommendation in GR-2001-382 that there had never been a capacity release on KPC in the five years that it had been an interstate pipeline, and that MGE had never even received a bid when it did post the capacity starting in 2002. (Tr. 326)

The Alleged Williams Alternative

We have explored the facts underlying the Staff's primary claim of imprudence on this issue, being MGE's lack of postings on the KPC bulletin board in the ACA period. The Staff included an alternative approach to its allegation of imprudence. Staff alleged that MGE could have utilized its KPC capacity in the summer but posted an equivalent amount of capacity for release on the Williams pipeline, and presumably generated some revenue that way. Essentially, as described by Mr. Sommerer on the witness stand, "you try and package some Williams capacity on a non-recallable basis and market it that way." (Tr. 381) He suggested that by marketing idle Williams capacity MGE could presumably "achieve enough of a credit in that market to overcome the

additional cost you would have by flowing replacement gas on KPC." The Staff quantified this issue by assuming that MGE would have found a buyer willing to pay 75% of the Williams maximum reservation charge rate for such released capacity. (Tr. 328) In other words, the Staff assumes that a third party would be willing to buy the capacity at a 25% mark-down or discount from the full Williams tariff capacity charge.

MGE provided evidence that the Staff's alternative approach is completely unrealistic. It would not be economic, and thus not make any sense for MGE to pursue such a scheme. Mr. Langston testified that there was simply "no way" MGE could have obtained 75% of the maximum Williams rate in any such transaction on Williams. (Ex. 3, p. 20) He supported this statement with a schedule showing the weighted average reservation rates actually charged for all capacity releases on the Williams pipeline for the ACA period. (Ex. 3, Schedule MTL-8) It is unquestionable that the weighted average rate obtained was not 75% or anything even close to that. The facts show the actual weighted average rate was only 14% of the maximum tariff rate. (Ex. 3, p. 22) In other words, the actual transactions took place at an 86% mark-down or discount from the maximum. If the realistic rate of 14% is substituted for the unrealistic 75%, the result is that Staff's proposal would not have produced any savings at all. Instead, it would have cost the ratepayers $600,000 in additional costs. (Ex. 3, p. 22)

MGE actually made postings on the Williams bulletin board during this ACA period in an attempt to release its Williams capacity. (Ex. 3, p. 22) It did not get 75% of the Williams maximum rate. It did not get 14% of the Williams maximum rate. It got nothing because no one even bid on its Williams capacity. (Ex. 3, p. 22)

When Mr. Sommerer was questioned by Commissioner Gaw as to whether there was any calculation of the amount that would have to be obtained by MGE on Williams in a capacity release in order to overcome the KPC costs, Mr. Sommerer said "I have not calculated that specific number." (Tr. 382) All he could offer in the way of explanation is that if MGE received 14 percent of the maximum Williams tariff rate by bidding or negotiation, "it clearly is uneconomic." At an assumed level of 75 percent, however, he said MGE would get a credit of about $800,000. "So it is somewhere in between that 75 percent credit level and the 14 percent ... I don't think it is in the record in this case." (Tr. 383)

So the threshold question is whether MGE could reasonably be expected to be successful in obtaining a buyer for posting 46,332 Dth of capacity for release on Williams. The Staff did not provide any examples of comparable sales that prove MGE could have released its capacity if it had been posted. In contrast, MGE has posted its capacity on the Williams electronic bulletin board on both a recallable and non-recallable basis. Both types of postings were made because Mr. Sommerer claimed that non-recallable capacity was more valuable. (See Exhibit 3, Schedules 10 and 11) However, the unchallenged facts show that no matter whether it was posted as recallable or non-recallable, MGE has **never** received a bid on an open posting for its Williams capacity on the Williams electronic bulletin board. (Ex. 3, pp. 22-23)

So the answer to the threshold question is a resounding "no" -- there is no evidence MGE would have even received a response to a posting of this firm capacity on the Williams pipeline, because none has ever been received before.

The secondary question is how much revenue might be expected if one assumes what is highly improbable -- that someone would even offer to purchase it in the first place. Again, the Staff did not provide any examples of comparable sales or revenues or any factual justification for its arbitrary assumption that 75% of the maximum rate was achievable. Indeed, when questioned on the origin of the 75% figure, Mr. Sommerer as much as admitted that it was arbitrary since he said it "was at some level between maximum FERC rates [which would be 100%] and a 50% discount." (Ex. 4NP, p. 43)

Mr. Sommerer failed to take into account in his proposal that the only non-recallable releases on Williams during that summer were very small in terms of volume (i.e., less than 500 Dth/day) and many were also the result of long-term capacity release agreements signed in 1997. Mr. Sommerer admitted that those transactions would not be comparable to what he was suggesting for MGE. (Ex. 4, p. 44) In summary, then, the *only reasonable conclusion* is that MGE's posting of 46,332 Dth of Williams capacity as a substitute for posting KPC capacity would not have produced any bids. Secondly, even if you assumed away the significant threshold problem, the facts show that the most revenue that could be expected would be from approximately 14% of the maximum Williams rate. As MGE's witness testified, and as Mr. Sommerer agreed, only achieving 14% of the Williams maximum would not only produce an uneconomical transaction, and thus be a waste of time to pursue, it would actually cost the ratepayers more money.

Why Now?

Mr. Sommerer acknowledged that there were several prior ACA periods in which MGE did not utilize the KPC capacity in the summer. Thus, the Staff has been aware

for several previous ACA years that the KPC capacity was not being used in the summer months. (Tr. 324-325) This is the first ACA period, however, in which a disallowance has been recommended that is even remotely connected to its not being used. Mr. Sommerer claimed in his deposition that it took several years' worth of "data" before he became convinced that the pipeline was not being used in the summer. (Tr. 324)

Argument

There are two main reasons why the Staff's proposed disallowance on this issue should be rejected by the Commission. The first is that the Staff simply has failed to produce any credible evidence that MGE was imprudent in deciding not to post the KPC capacity for release during the ACA period. The second is that federal law bars the Commission from disallowing what MGE pays in KPC capacity charges because that would be an unlawful "trapping" of federally-approved costs.

Staff Has Failed to Prove Its Case

It is difficult to imagine a Staff disallowance proposal resting upon a flimsier evidentiary foundation. It is also disturbing that the Staff forced MGE to go to trial and write briefs on an issue that the Staff should have abandoned at a much earlier stage in the proceeding. It was apparent early on that Staff had no facts whatsoever to support its claims. The same factual situation had existed for several years (i.e., no use by MGE of the KPC pipeline in the summer) but that apparently did not raise any concern. The Staff even knew when it filed its recommendation for a disallowance in this case that there had never even been a single capacity release in the federally-regulated

history of KPC. But that obviously did not prevent the Staff from blithely suggesting that there could have been such a transaction and at an artificially inflated price.

Mr. Sommerer appeared to grudgingly admit under questioning by Commissioners that his issue has no factual basis when he said: "I think the first idea has become somewhat improbable based upon what I've seen and in data requests that MGE has now made the attempt, they've tried to release the capacity." (Tr. 381)

It should by now be abundantly clear that MGE was not imprudent in deciding that the posting of summer capacity on KPC for release would be a useless act. The decision not to post the capacity was based on Mr. Langston's familiarity with KPC and the surrounding circumstances and the knowledge that capacity releases were not taking place on the pipeline because it was the most economically unattractive alternative of any in the Kansas City market. MGE had a rational, fact-based reason for believing that postings would not have produced capacity release revenue on the KPC system. This continues to be MGE's belief since the fact circumstances have not changed. (Ex. 3, p. 17)

MGE clearly knew at the relevant time that KPC capacity was operationally more restrictive and administratively more burdensome relative to capacity on comparable pipeline alternatives. This fact also made KPC unattractive to potential bidders.

Staff has openly admitted that it knows of no one who actually wanted the capacity and was prevented from getting it because MGE did not make a posting on that pipeline's electronic bulletin board during the ACA period. (Tr. 326-327) Thus, the Staff cannot show there was any actual detriment to ratepayers from MGE's decision. There was no real missed opportunity. These facts substantiate MGE's position that,

because it knew there has never been a comparable capacity release on KPC, posting it would simply have been a waste of time.

Staff also assumed a price that would have been paid for that capacity by the assumed and unknown buyer in order to allegedly quantify "ratepayer harm." To provide a factual basis for that part of its argument, the Staff had to at least demonstrate there were comparable real-world capacity release transactions at Staff's assumed price. Staff, however, was unable to point to any comparable transactions during the ACA period, and thus failed to prove that anyone actually would have purchased the capacity at any price that could have been offered by MGE.

The evidence presented by MGE clearly shows there is no market now for this particular capacity, there was no market for it in summer months of 2000 and 2001, and there never has been any market for the capacity in the summer. In short, the evidence clearly shows the Staff is wrongfully assuming a sale could have taken place when none has ever occurred before. The Staff's failure to produce evidence of any willing buyer of the capacity at any price, or evidence that there has ever been a comparable transaction by any of the other holders of firm capacity on that pipeline, clearly demonstrates that Staff has not created "serious doubt" that any imprudence occurred. Moreover, Staff has failed to prove that MGE missed a valid opportunity to obtain capacity release funds. Staff's proposal rests *entirely* on speculation and unproven and unrealistic assumptions.

Putting the issue in terms of the prudence framework, the question becomes whether it was reasonable at the time for Mr. Langston to decide it was useless to go to the effort to post the KPC capacity for release (or perform the Williams alternative)

during this ACA period. The only competent and documented evidence on this issue clearly shows that it was a perfectly reasonable and rational decision. Viewed another way, Staff has not produced any evidence that MGE was imprudent in deliberately ignoring a valid opportunity to create revenue because it has not demonstrated there was any such real opportunity that was missed. Therefore, the Staff's proposed disallowance should be rejected for lack of evidentiary support.

Preemption Bars This Disallowance

Despite the fact that there is no factual basis for a finding of imprudence on this issue, the legal principle of "preemption" also acts to bar any disallowance of KPC capacity charges. It appears that what is really troubling the Staff here is the level of capacity charges that MGE is required to pay KPC because the essence of Staff's proposal is to reduce the net amount of those charges paid by MGE and passed on to ratepayers. The problem is that KPC's cost levels are not within the control of MGE – they are <u>not</u> something that MGE management decisions can change. Just as this Commission determines the rates that MGE is permitted to charge its ratepayers, the FERC determines the rates that MGE must pay KPC. MGE pays these dollars to KPC purely and solely because they are the dollars that the FERC-approved tariff requires MGE to pay to KPC for the capacity. MGE has no discretion as to whether it pays the charges.

The FERC is an agency of the federal government charged by federal law with setting rates for the transportation of natural gas by interstate pipelines. Under the Supremacy Clause of the U.S. Constitution and what has come to be known as the "filed rate doctrine" those rates cannot be "second-guessed" or "trapped" by other

agencies. See, e.g., ***State ex rel. Associated Natural Gas Company v. Public Service Commission***, 954 S.W.2d 520, 530-531 (Mo.App.W.D. 1997) and ***State of Missouri ex rel. Midwest Gas Users' Assn. v. Public Service Commission***, 976 S.W.2d 485, 489 (Mo.App. W.D. 1998).

The filed rate doctrine, as enunciated by the courts, means that a state commission cannot disallow a utility's recovery in rates of FERC-approved costs associated with the procurement of gas from wholesale suppliers. It operates to prevent a state regulatory commission from "trapping" FERC-approved costs by preventing a distributor such as MGE from fully recovering those costs from its retail customers.

Although the Staff has artfully "packaged" its proposal as resting on a choice MGE made as to whether or not to post its KPC capacity for release, the essence of the disallowance would make MGE's shareholders absorb part of the costs that it pays to KPC, under FERC-approved tariffs, for the right to transport natural gas on KPC. By any reasonable definition, that is an attempt to "trap" those federally-approved costs, and that is unlawful under the filed rate doctrine, even it if occurs indirectly.

IV. HEDGING CONDUCT

This issue, number 2 in the Issue List as filed on April 29, 2003, concerns "hedging" and ultimately whether the amount and manner of hedging that MGE did for the winter of 2000-2001 was prudent. In the context of the prudence standard, the Staff has not alleged any of MGE's specific hedging decisions were imprudent. Instead, it claims there was no formal, documented hedging "plan" in place prior to the winter. (Ex. 1, p. 33) The Staff admitted there was no requirement for such a plan, or a recognized standard as to how much hedging is considered prudent, in place prior to the winter of

2000-2001. Faced with no pre-existing standards, the Staff created one of its own but cautions that it is appropriate only for this particular case. The Staff says the minimum standard it wants to apply here is 30% of "normal" winter volumes, calculated monthly rather than seasonally.

Many problems with that standard were explored in the course of the proceeding. The main problem is that this "30% standard" was developed *after the fact*, so no one knew what it was in time to be able to *attempt* to comply with it, even assuming the Staff picked an appropriate number. That makes it a classic example of unconstitutional "retrospective" or "ex post facto" action; i.e., making some conduct a crime only after the conduct has taken place. It also means that application of that 30% standard in this case would be a prohibited "hindsight" review.

The evidence shows that MGE was prudent and that MGE acted reasonably with regard to hedging for that winter based on what its management knew or reasonably could have known at the relevant times. There was a Commission-approved hedging plan in place for MGE before the winter but events beyond MGE's control made implementation of that plan impossible. Staff refused to support alteration of the plan to make it possible to implement the approved plan prior to the winter. The evidence shows, however, that even without the ability to operate under a Commission-approved plan, MGE ultimately hedged approximately 40% of the normally expected winter volume.

Another aspect of this issue to be explored in this brief is that *initially* the Staff recommended a disallowance of $614,365. In the final part of this proceeding, after an

additional six months to reexamine the data, the Staff changed its proposal to recommend a disallowance of $130,137.

As with the KPC capacity release issue, this is also a subject matter area that has not been previously litigated before this Commission and it has its own set of technical terms. Accordingly, the Commission needs a firm understanding of the facts in order to reach an appropriate decision that will comport with the prudence standard.

What is Hedging?

There are several different ways that a local distribution company such as MGE can purchase natural gas or otherwise fix a price for the gas it purchases and there are different ways that "hedging" can be achieved. For purposes of this case, the parties generally treated "hedging" as the advance purchase of natural gas or financial instruments so that, going into the winter months, the price was known. As a result, the parties treated natural gas purchased by MGE and injected into storage as "hedged" because the price of that gas was known in advance of the winter. Storage is a "physical" hedging mechanism, meaning that gas can be injected into storage facilities in the summer months when natural gas prices are typically lower and then withdrawn in the winter to serve higher customer demand when natural gas prices are typically higher. (Ex. 4, p. 29)

Another example of "hedging" would be gas purchased by MGE through "fixed price" contracts, meaning that the price per unit is set and known at the outset. Finally, "hedging" also encompasses the use of financial instruments (e.g., futures contracts and options) that have the effect of fixing the price for the gas. These would be considered "non-physical" hedges because typically no gas is actually transferred from

buyer to seller. The use of financial instruments to hedge also usually carries a separate and incremental cost for the transaction itself. Thus, it presents the separate issue of whether MGE can lawfully recover that expense as a "gas cost" under its Commission-approved purchased gas adjustment tariff provisions without explicit approval to do so. (Tr. 351)

Non-hedged gas would then be defined for these purposes as gas purchased during the winter at a variable or "indexed" price, meaning that this gas would be subject to market price variations – both up and down.

MGE's witness Mr. Reed has nationwide experience and expertise in matters of prudence and hedging. (Ex. 1, p. 1; Tr. 64) Mr. Reed said, in this case, that hedging was essentially describing an attempt to reduce the variability for risk surrounding price changes for natural gas. (Tr. 59) He compared it to insurance against price increases or decreases being greater than expected. (Id.) He explained that hedging is essentially a "judgment call" that there is a consumer preference for stability over the lowest possible price. (Id.)

Do Customers Even Want Hedging?

An unspoken and unproven fundamental premise of the Staff's case on this issue is that hedging is something that should be done. As Mr. Reed's testimony made clear, there is an underlying question of fact whether customers even want gas companies to engage in hedging. He testified that research done for regulatory commissions has indicated that it is very difficult for commissioners to use their judgment as a surrogate for consumer judgment as to the preference for hedging. (Tr. 61) Many customers, he said, when given a choice, prefer not to be hedged. (Id.) He recounted the fact that in

states that have fixed-price or lock-in options, a substantial portion of the customers chose not to opt for the fixed price. They'd actually prefer to ride the market up and down. (Tr. 65) This appears to be a result of the fact that the fixed price option is more expensive. (Tr. 65) Mr. Reed recounted the real-world parallel of gasoline stations. He pointed out that you do not see gasoline stations hedging the volatile price of gasoline. That is because they recognize that customers choose to buy gasoline on a competitive basis at the prevailing price. (Tr. 149)

Regulatory commissions have run the gamut from saying they want no hedging at all to commissions that want the entire price hedged for the entire season, at least for core customers. (Tr. 66-67) In California, for example, Mr. Reed said the gas companies have been instructed to avoid hedging within the regulated business. (Tr. 66) Pennsylvania has established a guideline calling for 25%. (Tr. 122) So there is still a very fundamental unanswered question as to whether there is any appropriate level for hedging in the first place, much less at the 30% level suggested by Staff here.

Staff's Allegation of Imprudence

Mr. Sommerer's direct testimony said that "It is the Staff's policy that if an LDC did not have a reasonable plan in place to address price volatility for the winter of 2000-2001 and did not meet an absolute minimum of 30% hedging for each month of the heating season (either through storage or fixed prices) a disallowance would be quantified." (Ex. 9, p. 12) Obviously, "a reasonable plan" can mean different things to different people. When questioned as to the *specific* allegation of imprudent conduct, Mr. Sommerer's response was that MGE did not have a "formal, documented hedging plan" in place for the winter of 2000-2001. (Ex. 1, p. 33) These were the same words

contained in the Staff recommendation. (Ex. 3, p. 28) "Formal" and "documented" do not exactly provide much in the way of specific guidance either.

Comparing MGE's planned hedged volumes and 30% of Staff's calculation of "normal" customer requirements in each winter month, Staff initially proposed a disallowance of $614,365 for not meeting the 30% threshold in January and March of 2001. When it filed supplemental direct testimony in October 2003, the Staff continued to use the 30% per month test but changed its approach to how it calculated "normal" demand. That change moved the amount of the proposed disallowance downward to $130,137. This revised amount is based on MGE not meeting Staff's 30% test in March 2001. (Ex. 36, p. 5; Ex. 29, p. 34)

No Valid Basis for 30% Standard

The Staff's application of a 30% test in this case – whether applied seasonally or monthly -- is inconsistent with how the Commission applies the prudence standard. As Mr. Reed explained, under the Commission's statement of the prudence standard, a utility's conduct is to be judged on information available to the utility and the circumstances in existence at the time the decisions were made or the actions were taken. (Ex. 1, p. 34) Therefore, in order for MGE's hedging conduct to be deemed imprudent by the Commission, the Staff has to demonstrate with competent and substantial evidence that:

a) there was a statutory or Commission requirement, or that minimally prudent conduct required that MGE have a formal, documented hedging plan in place prior to the winter; and

b) the hedging standard equates to a minimum of 30% of normal natural gas volumes to be hedged each month; and

c) there was sufficient time allowed for MGE to implement such a strategy; and

d) MGE's conduct for the winter did not meet the statutory or Commission-approved standard.

It is clear from the evidence that Staff failed to prove the existence of a single one of these elements.

At no time prior to the winter of 2000-2001 was there a statutory or Commission requirement that MGE have a documented, formalized hedging plan or that MGE hedge a minimum of 30% of its natural gas requirements for the winter of 2000-2001. (Ex. 1, p. 35; Tr. 340-343; Ex. 4, p. 31) The Commission's own *Natural Gas Commodity Task Force* stated in its final report on the commodity price spikes in the winter of 2000-2001 that "neither the state of Missouri nor the Commission had any formal policy of broad applicability in place regarding the use of financial instruments for gas supply cost hedging purposes prior to the winter of 2000-01 beyond the application of the prudence standard." (Id.) Mr. Sommerer admitted there was no requirement by rule or statute that MGE have a documented hedging plan in place prior to the winter. (Id.) There was no recognized standard in the utility industry that established 30% per month as minimally prudent conduct. (Ex. 1, p. 36)

The Staff admitted that it never communicated to MGE or any other gas company in Missouri, prior to the winter of 2000-2001, that a gas company should have in place a formal, documented plan that called for hedging at a minimum level of 30% per month. (Ex. 4, pp. 30-31; Tr. 341) In other words, the Staff didn't make anybody aware that the

standard it was going to propose solely for this ACA period existed *prior* to the time that it was going to take effect. (Ex. 1, pp. 36-37; Ex. 4, p. 30) Ms. Jenkins said that the Staff does not tell companies how or how much to hedge going into a winter. (Tr. 499)

The Staff admitted that it did not even create the 30% test until after the winter of 2000-2001 was over. (Tr. 342) It was the product of an internal Staff meeting sometime in the spring of 2002. (Ex. 1, pp. 37-38; Ex. 4, p. 31-32) By definition then, Staff is applying a hindsight review that is not in compliance with how the Commission applies the prudence standard. (Id.) The Staff strongly implied in its May 31, 2002, memorandum that the 30% test was arbitrary and inappropriate by stating that it "should not be viewed as an optimal level nor as precedent for future hedging levels." (Ex. 1, p. 39; Tr. 495) This means the Staff may very well come up with a totally different standard for the next ACA period. Ms. Jenkins said that was a possibility and noted it was possible the Staff would even change its position with regard to the storage use issue. (Tr. 485-486)

Staff acknowledged during cross-examination that the Commission's new rulemaking, 4 CSR 240-40.018, is the first general pronouncement by the Commission regarding hedging that is applicable to all LDCs in Missouri, and that it contains no such 30% standard. (Tr. 339-342) That new rule took effect December 30, 2003.

The Staff is inconsistent in choosing to whom and how it will apply the 30% monthly standard. Staff apparently chose not to apply it to Laclede Gas Company because it signed a stipulation with Laclede, filed in September 2000, that specifically gave authority to Laclede to vary the amounts it hedged each month, "including zero for certain months." Staff therefore publicly acknowledged in that document that it would

look at the total volumes Laclede hedged over a winter season rather than the specific level each month as it is doing with MGE. (Ex. 2, p. 8; Ex. 3, pp. 44-45; Ex. 4, pp. 29-30)

Not only is the 30% figure itself arbitrary, its application on a monthly rather than a seasonal basis is also. Staff has proposed a disallowance for those months in which MGE's planned hedged volumes did not exceed 30%, but Staff did not calculate any offsetting credit for those months in which MGE's planned hedged volumes actually exceeded 30%. This is inappropriate because Mr. Langston testified that physical and financial hedging is not conducted on a month-to-month basis during the winter heating season, but rather done prior to the winter for the *entire* season. (Ex. 3, p. 44) Changes in temperature, changes in customer demand, pipeline operational issues, prices in the natural gas market and other events outside the control of a gas distribution company undoubtedly cause the actual amount of volumes hedged to vary significantly from month to month. (Ex. 3, p. 44) That would make the rigid application of Staff's proposed standard to each calendar month unrealistic, unreasonable, and unfair.

When Staff first calculated the recommended disallowance on this issue, it determined that MGE had hedged 29.5% of normal demand for January 2001. So that means MGE missed Staff's newly proposed and previously unannounced standard by just one-half of one percent! (Tr. 599) That razor-thin margin produced over 65% of the original proposed disallowance amount. Similarly, the first time it was calculated, the Staff said MGE missed the 30% test by 3.3 percentage points in March of 2001, having hedged 27.7% of normal demand. That margin of error was responsible for the other $212,167 of the original disallowance proposal of $614,365. Staff's recalculated

disallowance proposal shows it is based on MGE having hedged 27.9% of normal in March 2001. (Ex. 36NP, Schedule 5)

In contrast, MGE's planned hedge volumes for February 2001 were calculated as being over 48% -- more than 18 percentage points *greater* than the Staff minimum. (Tr. 601) But the way the Staff applied its proposed standard, this produced no credit or recognition at all. This is because Staff gave MGE no credit whatsoever if the hedge went above 30% in any month. It only sought a disallowance if it dropped below 30%. (Tr. 601-602) Exhibit 27 HC shows that, using Staff's original approach, if MGE had been given credit for months in which it exceeded Staff's 30% test, not only would there have been no disallowance proposed, there would have been a $3.34 million savings to customers as a result of MGE's hedging plan. (Tr. 603) Mr. Reed also pointed out that the Staff's asymmetrical approach directly contradicts the prudence standard. (Tr. 153) He said that in a prior application of the prudence standard, the Commission used a symmetrical approach that gives even-handed treatment. (Tr. 153-154)

This discussion demonstrates how there is no flexibility or tolerance at all built into the Staff's test and the unfair result if it is applied on a monthly rather than a seasonal basis. It shows how it also operates exactly *opposite* to the concept that was contained in the contemporaneous Laclede hedging settlement, since there the Staff allowed Laclede to vary the amounts hedged in each month, even down to zero.

There is still another example of the arbitrary nature of Staff's monthly application of its proposal. Staff witness Allee admitted that if MGE had known of the proposed 30% standard before it was brought up in this case, MGE could have avoided the disallowance altogether simply by changing planned monthly numbers without changing

the total amount hedged. (Tr. 605-606) This highlights the arbitrary nature of the Staff's approach and an important point made by Mr. Reed. He said that "Without first establishing the rules of the game, it is unreasonable to condemn a utility's conduct, and it is egregious to attempt to apply a standard after-the-fact based on hindsight review." (Ex. 1, p. 40)

MGE's History With Hedging

MGE had a Commission-approved hedging plan in place for the winter of 2000-2001 – it just was not allowed to use it. MGE worked collaboratively with the Commission Staff and Office of Public Counsel over many months to establish an appropriate hedging plan prior to that winter. (Ex. 3, p. 29) A settlement designed to establish a hedging plan was filed in May 2000, and approved by the Commission in August 2000, that included two separate price protection mechanisms. (Ex. 3, pp. 28-30) These two price protection mechanisms were a Fixed Commodity Price PGA and a Price Stabilization Fund.

MGE was prevented from implementing either of the price protection mechanisms in accordance with the terms approved by the Commission due to unprecedented high levels of natural gas prices and Staff's reluctance to move forward with a hedging program for MGE in such a price environment. (Ex, 3, p. 29) In other words, although approved, the plans never could take effect by their own terms due to events beyond MGE's control. (Id.) Mr. Langston noted that this was because there was an unprecedented rise in natural gas prices from the time the stipulation was filed (April 2000) until the Commission approved it by order dated August 1, 2000. (Ex. 3, p. 30) Natural gas prices continued to rise after Commission approval. (Ex. 3, p. 31)

MGE acted reasonably at the point when it became known that neither price protection mechanism in the settlement could be implemented. (Ex. 3, pp. 31-38) It contacted Staff and OPC and attempted to modify the approved mechanisms to allow a fully-hedged portfolio to be in place prior to the winter. Modifications to the price protection mechanisms required Staff and OPC approval, though. (Id.) MGE proposed modifications to the hedging settlement designed to reflect then-current market conditions but they were not supported by Staff. MGE proposed increasing the trigger price of the Fixed Commodity Price PGA to reflect then-current market prices. MGE also proposed shortening the term of the Fixed Commodity Price PGA so that it only covered the winter of 2000-2001 (the original term was for a two-year period). MGE also proposed modifying the Price Stabilization Fund to purchase call options to cover 70% of volumes for only December through February (originally November through March). These are documented in Exhibit 3, Schedule MTL-12.

Staff admitted in data request responses and on cross-examination that it did not support modification of the hedging settlement's price protection mechanisms which would have permitted a greater level of financial hedging because it was afraid of locking-in high natural gas prices and then having prices fall. (Ex. 3, p. 32-33) Now, in this proceeding, Staff is criticizing MGE for not hedging to a greater degree because natural gas prices actually increased, even though MGE's ability to hedge and be assured of cost recovery was limited by Staff's failure to support modifications to the FCP Settlement.

MGE had a valid reason to want the assurance of cost recovery for hedging expenditures. Prior to the winter of 2000-2001, the Commission had specifically

authorized MGE to utilize financial instruments to hedge its natural gas supply portfolio for several years. Those authorizations came with very specific parameters as to how much money could be spent, the specific amount of volumes to be hedged, and a specific price cap for the price of the financial instruments. (Ex. 1, pp. 41-42)

As part of the hedging settlement, it was agreed that MGE would seek to re-implement the Price Stabilization Fund that had previously been supported by Staff, approved by the Commission, and utilized by MGE in the prior three winters. (Ex. 3, p. 34) This mechanism would have been consistent with those previously approved by the Commission and it also contained strict language on the amount of money and volumes and other terms that were permitted. (Ex. 3, p. 35) The high levels of gas prices in the market precluded MGE from complying with the parameters established, so MGE was precluded from implementing that plan. (Ex. 3, p. 36) MGE sought Staff concurrence to modify the parameters to allow hedging to take place, but Staff opposed that. (Ex. 3, p. 37) The Commission issued an order on October 26, 2000, denying the re-implementation of the Price Stabilization Fund. (Id.) That order effectively said that MGE should do what it considered to be reasonable and the Commission would look at those actions later in a prudence review. (Ex. 3, p. 39) Unlike the past, this order contained no specifics as to how much MGE was authorized to spend or how much in the way of volumes it was authorized to hedge. (Id.)

Absent the specific financial hedging authorization and hedging cost recovery approved by the Commission in the FCP Settlement, MGE had no additional or blanket authorization to conduct financial hedging and recover the associated costs. (Ex. 3, p. 41; Ex. 4, pp. 35-36) As noted, this was a totally different fact situation than had existed

for the previous several years under Commission-approved programs with specific parameters. Indeed, prior to the winter of 1997-1998, MGE did not utilize financial instruments to hedge the price of natural gas since it did not have Commission authority to do that or the authority to recover the costs. (Ex. 3, p. 38)

Staff also demonstrated by its actions that it thought specific tariff authorization was appropriate. Prior to the October 26 order, Staff proposed tariff language that would have clarified that MGE had authority to conduct financial hedging prior to the winter of 2000-2001; however, the Commission's order did not address, and thus, did not approve, Staff's proposed language. Therefore, no such authority was granted. (Ex. 3, p. 39; Ex. 4, pp. 35-36; Tr. 352) MGE found itself on October 26, 2000 – five days before the official start of the winter heating season when natural gas prices were already at an all-time high – with a pair of specific Commission-approved hedging programs that could not be implemented due to those price levels and without any other specific authority to conduct financial hedging in the manner it previously had. (Ex. 3, p. 41) The timing of the resolution of the Price Stabilization Fund forced MGE to make financial hedging decisions that would be considered very late in the process compared to a more planned approach that could have been implemented earlier in 2000. (Ex. 3, p. 43)

MGE Conducted Itself Reasonably Without Specific Authority to Hedge

Even with unprecedented high natural gas prices and the failure of Staff immediately prior to the start of the winter of 2000-2001 to support modifications to the price protection mechanisms previously approved by the Commission, MGE actually hedged over 38% of its normal winter requirements. (Ex. 4, pp. 32-33) There were no

shortages of supply experienced on MGE's system in the face of record cold temperatures. MGE made its natural gas purchases in arms-length transactions at prevailing market prices, which *by definition* is prudent conduct. (Ex. 3, p. 42) In that regard, it is important to note that the Staff has not claimed that *any* specific purchase made by MGE in the ACA period was imprudent.

Mr. Reed summarized it by saying: "In the absence of a specific prudence standard and in the absence of industry standards for this issue, MGE's conduct does not even approach a level that could fairly be described as imprudent." (Ex. 1, p. 41)

Staff's Revised Calculation

As indicated earlier, the Staff revised its calculation of the disallowance as the case progressed. When it filed supplemental direct testimony in early October 2003, Staff modified the disallowance proposal to a new number: $130,137. The reason that number changed is that Ms. Jenkins, sometime in the six month period during which the hearing was in recess, decided to change the basis on which she calculated MGE normal monthly natural gas demand. (Ex. 29, p. 35) MGE's reaction to that change, and the reasons why the calculation is inappropriate, are discussed in the Storage Utilization issue below because it also impacted that issue.

Her change in approach to calculating normal demand also had the effect of changing her calculation of how much MGE hedged for the ACA period. It caused the number to increase. Where MGE had previously said that MGE had hedged approximately 38% of normal volumes under her approach, her change in October 2003 had the effect of increasing that to nearly 40%. (Ex. 29, p. 35) It had, however,

absolutely no effect on the fundamental problems with Staff's 30% test discussed herein.

Summary

In summary, the Staff's 30% per month test cannot lawfully be applied to MGE because it violates the Commission's prudence standard. It is an after-the-fact test being applied in hindsight. No one even had a chance to comply with it because no one knew it existed. This fatal flaw is apparent without even getting into the details of constitutional provisions against retrospective action by the state. (Mo. Const. Art. I, section 13) The evidence shows it is also flawed both in concept and application.

The Staff has not made any specific claims of imprudent hedging decisions in the ACA period. MGE bought gas at market prices, which is prudent by definition.

If the Commission wishes to implement specific hedging requirements for gas companies and communicate those standards in advance so the companies at least have the opportunity to comply with the requirements, it certainly may do so. It can also continue the earlier process of approving specific hedging plans for specific companies as long as those plans are approved sufficiently in advance of the winter to allow them to be implemented. Announcing the hedging requirements after the winter has already passed – which is essentially what the Staff did here -- is not the way to properly go about that task. Therefore, Staff's proposal to disallow $130,137 should be rejected by the Commission.

V. STORAGE UTILIZATION

Overview

This is what was listed as issue number 3 in the issue list. Generally, the issue raised by the Staff concerns MGE's use of storage gas in November and December 2000 and one decision on how much flowing gas to purchase in December.

When you think about it, the job of every gas company to arrange for enough gas to satisfy its customers' needs over an entire winter is a complex and difficult task. It's complex and difficult because of the *unknown* and *unknowable* factors.

In the detailed discussion of this issue, MGE will show that the Staff has unreasonably second-guessed in hindsight the results of MGE's management of its storage gas. The Staff witness, who has no formal training or work experience in actually managing gas supplies (Tr. 430-431), used an accounting spreadsheet, inappropriate statistics and data, and the application of constantly changing approaches, to judge after the fact how MGE should have "properly" allocated its storage gas through the winter months of 2000-2001. Basically, Staff claims MGE utilized too much of its storage inventory in November and December 2000, which in turn, required the reliance on greater flowing supplies in the latter portion of the winter. Staff also claims that MGE's decision to order less first-of-month (FOM) flowing supplies for December 2000 than originally planned was imprudent. (Ex. 1, p. 13) Both these claims will be explored in detail.

First though, in order to highlight the "moving target" that has been the Staff's approach to this issue, let's simply turn to how the Staff has quantified this issue as the case progressed. The first time Staff did its calculations for a proposed disallowance, it

said the number was $8,051,049. Disagreeing with both the Staff approach, its use of inappropriate data and assumptions, and demonstrating the flaws in each, MGE pointed out that by simply substituting two *actual* monthly demand numbers in Ms. Jenkins' spreadsheet for her inappropriate estimates, her result changed from $8,051,049 to only $182,159. In view of that fact, the Staff wanted additional time to study and verify that result, so a six-month recess was taken in the hearing. When Staff filed new testimony in October 2003, Ms. Jenkins acknowledged that $182,159 was the mathematical result (Ex. 36, pp. 7-8; Tr. 719; Ex. 29, p. 5), but revealed that she didn't want to use those actual recent customer usage numbers or the result they produced. So she changed her approach, calculated a new set of *estimates* for MGE's monthly demand, and the second time around the recommended disallowance became $2,924,398. (Ex. 36, p. 14)

In response, MGE demonstrated that Ms. Jenkins' most recent approach did not make any "real-world" sense at all, because it very clearly resulted in MGE using only 79% of its contracted storage in a normal year. (Ex. 29, p. 23) There is absolutely no valid reason for MGE to intentionally plan on under-utilizing 21% of its contracted storage in a normal year, which is what her most recent approach does. (Ex. 29, p. 23) Further, she relied upon inaccurate estimates of "warmest month" demand that MGE demonstrated to be of questionable validity and unreliable indicators of demand. (Ex. 29, p. 26)

Considered in its totality, the evidence shows there is no recognized, single-best way to plan or apportion storage gas throughout the winter. The Staff itself used three different approaches. (Ex. 29, pp. 33-34) Natural gas prices and temperatures both

fluctuate and it is impossible to predict what either is going to do with any degree of accuracy over longer periods of time than just a few days. So while it is easy for the Staff to create after-the-fact criticism, the evidence shows MGE acted reasonably in relying on the information it had from time to time as a winter with unprecedented prices and cold temperatures unfolded before it. The Staff has not presented any evidence that a single MGE decision was imprudently made when the facts known or knowable at the time are considered. Therefore, under the Commission's prudence standard, no disallowance is supportable on this issue.

Factual Background

Definitions

As with the other issues, an understanding of some of the terms used in this issue is essential for the proper evaluation of the arguments.

Natural gas is different from electricity in that large quantities of it can be stored for future use. Typically, natural gas is stored in underground caverns that are geologically suitable to allow gas to be injected and withdrawn from them. (Ex. 3, p. 46) MGE does not own storage facilities but rather contracts to use facilities owned and operated by and connected to interstate pipelines. (Id.) Pursuant to the tariffs of those pipelines and individual contracts, MGE has the right to a specific amount of storage capacity in the caverns and the right to inject or withdraw gas into or out of these facilities at specific times of the year. Natural gas is normally injected into storage facilities during the summer months (April through October) and then withdrawn as needed during the winter months (November through March). Generally, then, "storage

gas" is gas that has been previously purchased and injected into storage for withdrawal as needed in the winter. (Id.)

There are four primary reasons that local gas distribution companies contract for natural gas storage service: reliability, operational flexibility, price stability and economics. (Ex. 1, p. 13) Storage is purchased to provide reliable natural gas supplies during times when supplies from other sources are difficult or impossible to obtain due to weather, excess demand, or *force majeure* conditions. (Ex. 1, p. 14) Therefore, storage gas can supplement flowing volumes to maintain reliability. It also provides flexibility in dealing with the swings in customer demand, both up and down, that can be experienced from day to day. (Id.) In that sense, it can act as a "shock absorber." (Ex. 1, p. 18) It is a physical hedge against what can be high winter prices for natural gas since the normally lower priced gas injected into storage earlier can be withdrawn during the winter. (Ex. 1, pp. 14-15) It also is economic in that it allows a utility to reduce the amount of pipeline capacity it otherwise might need. (Ex. 1, p. 15)

First of month (FOM) "flowing supplies" is a term used to describe supplies of natural gas MGE purchases to serve the current month's expected consumption and represents volumes that will <u>not</u> be withdrawn from storage. (Ex. 3, p. 49) These supplies, generally flowing from natural gas wells through the interstate pipelines (and <u>not</u> through storage facilities), are nominated (i.e. contract details are finalized and put in place) prior to the start of a calendar month for delivery on a *consistent* daily basis over the entire month. An example would be a contract entered into at the end of May in which MGE obtains a steady flow of 10,000 dekatherms of gas each day for the entire month of June.

Much of this issue has to do with the interplay between FOM flowing supplies and storage withdrawals. In other words, how much of each do you plan on using in a particular month, and then what happens when your customers use more or less than you planned overall because the temperatures were warmer or colder than normal?

MGE's Storage Plan

As Mr. Langston explained, you can start into the winter with a plan as to what mix of FOM flowing supplies and storage gas you are going to use under the assumption of normal weather, but as soon as the weather actually turns warmer or colder than normal, you have to continually make adjustments as you go along because whatever happens in the first month affects the remainder of the winter. (Tr. 648) No storage utilization plan can be followed exactly due to the numerous external factors the company will face throughout a winter heating season. (Ex. 1, p. 19)

MGE therefore starts the winter with a "baseline" plan assuming normal temperatures, but that plan will necessarily change as actual temperatures vary above and below that normal level. So if temperatures are normal in November and December, you can follow the plan. If they are different, you have to make changes to the plan. (Tr. 648-649)

MGE's "baseline" storage utilization and flowing supply plan going into the winter of 2000-2001 was generally the same plan that MGE had utilized the two previous winters (i.e., 1998-1999 and 1999-2000). (Ex. 4, pp. 9-11; Tr. 99) MGE has been providing those plans to the Staff all along. (Id.) Although the plans have essentially been the same since 1998, and the Staff has conducted yearly ACA audits in which they were presumably examined, the Staff never indicated to MGE prior to filing its

recommendation in this case that MGE's baseline storage plan was unreasonable. (Ex. 4, pp. 10-11; Tr. 99)

The plans MGE has historically used all show the highest level of planned storage withdrawals taking place in the month of November. The next-highest level of planned storage withdrawals would be in January. (Ex. 4, pp. 9-11) MGE does this intentionally because MGE experiences significant temperature variability in November. (Ex. 4, p. 19; Tr. 55) MGE demonstrated in Ex. 3, Schedule MTL-14 that it experiences a substantial variation in the actual weather relative to the normal weather during the winter months. (Ex. 3, p. 51) This is especially true in November, which can exhibit more variability around the average temperature than January. (Ex. 3, pp. 51-52; Tr. 55) When considering 30 years of heating degree data, November experiences the greatest range of heating degree day variation from coldest to warmest weather within any of the winter months. (Ex. 5NP, p. 8) Storage gas provides the needed flexibility to appropriately manage this variability. (Ex. 4, p. 19) The normal operational use for storage in November is for withdrawals since substantial additional gas volumes cannot be injected into storage facilities that are essentially full. (Ex. 4, p. 19; Tr. 57) Typically, MGE has very little ability to inject more gas into storage in November. (Tr. 57)

Because the flowing supplies come into the system at a constant daily volume, the overall concept is to schedule a certain amount of flowing supplies, and then let the storage gas act as the "shock absorber" to pick up larger usage necessitated by weather-induced demand. But actual storage utilization will never match the storage utilization plan because weather changes from year to year, month to month, and day to day. (Ex. 4, p. 24) In most years recently, MGE's actual storage utilization in November

turned out to be less than the planned volumes due to warmer than normal weather. (Id.) MGE did not need to change its plan because of that, though. The plan was sufficient to deal with both warmer than normal and colder than normal weather. (Id.) It provides the necessary flexibility to accommodate changes in weather, changes in demand, and changes in market price throughout the winter. (Id.)

Staff's First Plan Was Fatally Flawed

Ms. Jenkins of the Staff set out in this case to create her own gas supply management plan for the winter to use as a standard against which MGE's conduct would be measured. She has neither formal training nor practical experience in managing a gas supply. (Tr. 430-431) Ms. Jenkins initially claimed that a plan for November, December and January FOM flowing supplies should be based on "warmest month" requirements. (Ex. 12, pp. 19-24; Ex. 4, p. 13) Specifically, with regard to November 2000, she criticized MGE by saying that it did not plan on and nominate enough FOM flowing supplies "to cover even warm month requirements (natural gas requirements for warmest November weather.)" (Ex. 12, pp. 21-22) She said if MGE *instead* had planned on using more flowing supplies, "then less storage withdrawals would have been necessary in November 2000, leaving storage gas for the normally colder months to come." (Ex. 12, p. 22) Ms. Jenkins made a similar analysis and recommendation for December and January as well, alleging that MGE should have ordered FOM flowing supplies to cover warm month requirements. (Ex. 4, p. 14) These statements clearly demonstrate Ms. Jenkins' underlying motive was to serve anticipated customer load with FOM supplies each month and conserve (or hoard) storage gas for use later in the winter, i.e., February and March.

There are several significant problems with Ms. Jenkins' approach on ordering FOM flowing supplies. Mr. Langston pointed out that it was too simplistic in that it disregarded the daily demand variability that is experienced within a month. (Ex. 4, p. 14) He revealed that her approach incorrectly based the level of FOM flowing supplies on average monthly demand which significantly overstated the level of FMO supplies that should be scheduled. (Ex. 3, p. 49; Ex. 4, p. 14) In addition, the numbers she used to represent average demand were not appropriate. The numbers she used the first time came from the 2000 MGE Reliability Report. (Ex. 3, p. 49) He explained there were significant problems with her average demand approach and the use of the Reliability Report numbers for the particular purpose she chose.

The Problems With Ms. Jenkins' FOM Flowing Supplies Approach

To highlight the problem with Ms. Jenkins' average demand approach, Mr. Langston pointed out that she was continually advocating that MGE contract for a much higher and potentially harmful level of FOM flowing supplies than needed. On Schedule 13-2 of her direct testimony, she utilized a "warm month" demand figure for November of 181,265 MMBtu per day. (Ex. 12, Schedule 13-2, line 86, Column D) This means Ms. Jenkins was claiming that to be "prudent," MGE should order, at a minimum, FOM flowing supplies of 181,265 MMBtu/day for the month of November. In her supplemental direct testimony, under her revised approach, the number changed to 165,468 MMBtu. The problem with either of those two levels of supplies coming into the MGE system every day, Mr. Langston explained, is that it is more gas than would normally be used on most days in November. (Ex. 4, p. 15)

In very simple terms, MGE's system of distribution pipes is not a "balloon" that is capable of expanding to absorb all the gas that can be shoved into it under Ms. Jenkins' approach. MGE has to balance the flow of gas physically going into the system with the volumes of gas being consumed by the customers.

On two separate occasions, Mr. Langston graphically depicted what would have happened if MGE had used Ms. Jenkins' approach to scheduling FOM flowing supplies for the years 1999, 2000 and 2001. First, Ex. 3, Schedule MTL-15 showed the results of just her original approach, i.e., what she was advocating through the May 2003 hearings. Second, Ex. 29, Schedule MTL-43, showed the original approach in addition to her latest revision unveiled in October 2003. As shown, the erratic lines on both those charts track the actually-experienced daily demands in November for those three years. The parallel lines show the planned FOM flowing supplies of both MGE and Staff. As is apparent from Schedule MTL-43, MGE's level of planned FOM supplies for November at 108,340 MMBtu/day is much lower than Ms. Jenkins' revised level of 165,468 or her original level of 181,265.

What does this mean in the real world? The table at the bottom of Schedule MTL-43 shows the number of days in November for each of the three years that the actual demand on MGE's system was below the level of MGE's planned and Staff's proposed FOM flowing supply levels. In other words, it totals the days that more gas was flowing into MGE's system than was consumed by its customers. As shown on Schedule MTL-43, Mr. Langston demonstrated that MGE's actual demand in November 1999 would have been below the level of Ms. Jenkins' proposed level of FOM flowing supplies for 21 out of 30 days (19 out of 30 in her revised approach). In addition, in

November 2001, Ms. Jenkins' FOM flowing supply proposal would have resulted in MGE having more gas than it needed for its customers in 24 out of the 30 days (22 out of 30 in her revised approach). Only in November 2000, the coldest November ever experienced, would Ms. Jenkins' proposed level of FOM flowing supplies *not* have resulted in having gas in excess of MGE's customers' needs a majority of the days in the month. In contrast, there are substantially fewer days in which there would be excess gas if MGE's planned FOM supply level for November were utilized.

In other words, Ms. Jenkins' proposals definitely result in more gas being planned to flow into MGE's system on a daily basis in November than the facts show will likely be consumed. (Ex. 3, p. 50) Thus, MGE showed that her basic approach is flawed by "back-casting" it on to actual experience. Clearly, her approach would not work as a prudent "plan" for MGE to follow.

The real-world impact of her scheduling of excessive flowing supplies goes back to the fact that MGE's system is not a balloon. All of that excess FOM gas inherent in Ms. Jenkins' approach being pumped into MGE's system every day has to go somewhere. Mr. Langston testified that it would be both costly and potentially operationally harmful by negatively impacting reliability. (Ex. 3, p. 53) MGE could not count on being able to inject it into storage in November, because the idea is to have storage essentially full in November in case the weather turns out to be colder than normal. (Ex. 3, p. 53; Tr. 87) So MGE would have to try to sell this excess gas in the spot market. Unfortunately, this would effectively be "dumping" gas into a market that does not want it. MGE would likely lose money on such sales because logically, if the weather is warm enough to produce the excess gas, the spot market prices for the gas

are going to be lower than the price at the first of the month, when it was purchased. Lower demand means lower prices. (Ex. 3, p. 53; Tr. 97) If MGE couldn't find buyers and couldn't arrange for emergency storage through the pipeline, it would be liable for pipeline imbalance penalties. (Ex. 3, p. 54)

Mr. Reed shared these concerns expressed by Mr. Langston when he testified that in November, it is important to not over-nominate the FOM flowing supplies because "you may simply not have any place to put the gas. You may either be dumping it into a bad market or running up imbalances on the pipeline." (Tr. 57) Imbalance penalties are assessed by the interstate pipelines for violation of tariff provisions. (Tr. 115) They can occur whenever you've put more gas into the system than you've taken out, or taken more gas out of the system than you've put in. (Id.) There can be substantial penalties associated with both an "overrun" and an "underrun." (Tr. 116) One of the reasons that distribution companies like MGE need to have the "shock absorber" effect of storage gas available in November is to allow them to avoid incurring these imbalance penalties. (Tr. 116) As noted previously, FOM flowing supplies are at a constant, fixed volume by contract. Storage withdrawals are not, so they present greater flexibility.

Ms. Jenkins never claimed that there was any recognized industry standard in place that MGE should be measured against in setting FOM flowing supplies for any month. She created her own standard – after the fact -- which MGE has clearly demonstrated assumes obviously excessive and inappropriate daily flows. It is this flawed concept that the Staff used to quantify the alleged harm to the ratepayers the first time around when Staff claimed the harm was more than $8 million. Even after the

significant modifications to its approach in the supplemental phase of this proceeding, Staff's revised proposal and resulting disallowance recommendation still suffer from the same problem. The evidence, at least at this point in the discussion, clearly shows that Ms. Jenkins' concept of nominating very high levels of FOM flowing supplies is not a standard that makes any sense and therefore should not be used to judge MGE or anyone else.

The Problems With Staff's Numbers Used for Demand Estimates

The evidence shows that Ms. Jenkins has not been forthcoming or consistent in the constantly shifting approach she took to this issue. Mr. Langston demonstrated this by highlighting and comparing what she has said at various stages of the proceeding. He points out in his supplemental rebuttal testimony (Ex. 29) that in her direct testimony, Ms. Jenkins clearly said that her approach was to use storage to meet demand greater than "warmest month" demand. (Ex. 29, pp. 9-10) She told Commissioner Murray on the witness stand that she used "warmest month" and she said that she was saying MGE should "nominate at warmest month." (Tr. 505; Ex. 29, pp. 10-11) In a later deposition, she admitted that her testimony at the May 2003 hearing was inconsistent with what she actually did. (Ex. 29, pp. 11-12)

Ms. Jenkins started out in this case using customer demand or usage numbers that she obtained from a "Low Case" scenario she found in a Reliability Report submitted to the Staff by MGE on July 1, 2000. (Ex. 3, p. 49) In simple terms, she contended that MGE's storage utilization plan was imprudent because she would have used about twice as much FOM flowing supplies and about half as much from storage as MGE planned. (Ex. 3, p. 49-50) MGE pointed out that the 2000 Reliability Report

and other sources she was using for usage or demand data or for MGE's plans were not an appropriate source of data for her purposes. (Ex. 5 NP, pp. 2-5) That turned out to be quite prophetic as the case progressed.

Her insistence during cross examination in May 2003 that she was relying upon "warmest month" numbers caused MGE to come to the realization that she was not actually doing that. That led to the cross examination on May 14, 2003, which established that, while she was relying on "Low Case" numbers from the Reliability Report that she thought meant "warmest month," she had really had access to numbers all along which showed what the actual usage was on MGE's system for the warmest November in the past 40 years. (Tr. 550-551) She also had access to actual usage numbers for December 1999 which was an extremely warm December, and the warmest in recent history. (Tr. 559)

In light of this discrepancy between what she said she was doing and what she actually did, she was asked whether she would get a different result than her proposed $8 million disallowance if the actual numbers from the warmest November and a warm December were substituted for the numbers she got from the Reliability Report. (Tr. 561) She acknowledged that she had given MGE an electronic copy of her spreadsheet and that would enable MGE to plug in different numbers or assumptions, and it would then produce a different result. (Tr. 561) She was handed a copy of a printout in which she acknowledged that MGE had just substituted the November and December 1999 actual usage numbers. (Tr. 563) She admitted that to properly apply her storage approach, it would be necessary to use accurate information regarding warmest month requirements for November and December. (Tr. 563) At that point, MGE suggested she

be given the opportunity to verify the numbers. (Tr. 565) The Commission recessed the hearing to allow her to do that.

Ms. Jenkins then filed supplemental direct testimony in October 2003. In it, she admitted that November 1999 was the warmest November in the last 30 years. (Ex. 36, p. 8) She also admitted that December 1999 was warm, but that it was not the warmest in the last 30 years. Warmer Decembers were encountered, she said, in 1991 and 1994. (Id.) Of course, what she didn't say about that was that a more recent usage number might be more representative than numbers that were several years old. The point, however, is that she took the recess which was designed to give her the opportunity to check the validity of the November and December 1999 numbers as an opportunity instead to revamp her approach entirely and come up with totally new demand estimates for all five winter months. (Ex. 29, p. 14)

Mr. Langston pointed out that she did not have to do that in order to stay within the confines of her previously announced "warmest month" approach contained in her direct testimony. He demonstrated how in her original approach, she used the allegedly "warmest month" numbers in her calculations for only the months of November and December. (Ex. 29, p. 15) Her recommended storage withdrawals then "fell out" of her equation as the difference between her flawed calculation of "normal" monthly demand and the level of FOM flowing supplies. (Id.) For the months of January through March in her original calculations, though, she did the opposite. First, she calculated the level of storage withdrawals based on her "distribution of normal heating degree days" approach. The level of FOM flowing supplies then "fell out" of the equation as the difference between her "normal" monthly demand and projected monthly storage

withdrawals. (Ex. 29, p. 15) Therefore, since Ms. Jenkins did not rely on any "warmest month" demand estimate in her original calculations for the months of January through March, there was no need for her to "recalculate" them as she claimed in her October 2003 supplemental direct testimony. (Ex. 29, pp. 15-16)

When she revealed her revamped approach in October 2003, it became apparent that she had made several major changes. One was to revise her overall approach for January, February and March, so that FOM flowing supplies are based on a calculation of "warmest month" demand and not based on the amount that is left over after determining storage withdrawals based on the distribution of normal heating degree days. (Ex. 29, p. 17) Another was her attempt to come up with all-new estimates of "warmest month" demands for all five winter months using a regression analysis that looked at only two years worth of heating degree days and volume data. (Ex. 29, p. 17) Ultimately, these form the foundation upon which her current level of a $2.9 million disallowance is premised.

The main problem with her new monthly demand estimates is that they are inaccurate. (Ex. 29, p. 26) Obviously, if they are going to be used to measure alleged ratepayer "harm" in this instance, there should be some evidence that the measuring stick being used is accurate. It is not her use of a regression analysis, *per se*, that causes the problem. It is the fact that she has misapplied the analysis and has not used appropriate data. For example, she used only two years worth of data (1998-2000) in the analysis. (Ex. 29, p. 27) Her approach was also too simplistic in that it calculated a single baseload and heatload factor for all twelve months when it would have been

more accurate to calculate a separate heatload factor for each month or at least each season. (Id.)

These problems with Ms. Jenkins' demand estimates are brought into focus when her approach is backcast against an historical period to see how well it would have performed in an actual situation. Ms. Jenkins admitted that she did no checking to determine the reasonableness of her approach. (Ex. 29, pp. 30-31) Mr. Langston provided Schedule MTL-41 to Exhibit 29 to illustrate the problems. It compares MGE's actual demand over the past five years to the estimated demand that would be produced by her new approach. It shows there are five months in which her regression equation would have estimated a level of demand that varied from MGE's actual demand by at least ten percent. (Ex. 29, p. 28) Mr. Langston said this demonstrates that, not only is there a problem with the magnitude of the inaccuracy of her estimates, but also the frequency with which these inaccuracies occur. The facts show that twenty percent of the time, Ms. Jenkins' regression analysis produces significantly inaccurate results. (Ex. 29, p. 28) Three of the five months in which her estimates are off by more than 10% are in November. (Id) Further, her approach is the *most inaccurate* when the weather is *most extreme*. (Ex. 29, p. 28)

Another relatively simple way to highlight the inaccuracy of her approach to estimating demand is to compare her demand estimate for the "warmest" November with what we know was actually experienced in the warmest November of the past 40 years -- November 1999. Mr. Langston showed that her estimate of 5,114,047 MMBtu of demand is nearly 16% greater than the warmest month demand that was actually experienced. (Ex. 29, pp. 31-32) The same type of error occurs for her estimated

demand for March as well, since her projected demand is significantly greater than actually experienced in a recent warm March. (Id.) If nothing else, Ms. Jenkins should not have estimated warmest month demand when she had actual numbers available. (Id.)

Cold Weather in Nov. and Dec. 2000 Was Unprecedented

MGE followed its storage utilization plan to the extent possible in the winter of 2000-2001, but there were significant factors beyond its control which had an impact on that. November 2000 was the second coldest November in the past 40 years in MGE's service territory. (Tr. 445) December 2000 was the second coldest December in the past 40 years. (Tr. 445) November and December 2000 together were the coldest consecutive November and December on record. (Tr. 445) Exhibit 24 shows that the temperatures experienced in November and December 2000 were a 1-in-355 year occurrence. Due to that unprecedented cold weather, it should not be surprising that MGE withdrew more storage gas than it planned in both months. For that, MGE has been criticized by the Staff in this case. That criticism is based solely on storage utilization approaches the Staff developed after the winter of 2000-2001, rather than on conduct and decisions made by MGE at the time the storage plan was prepared. (Ex. 1, pp. 17-18) Staff's criticism obviously arises from the *results* of the winter when high gas costs were experienced. (Ex. 1, pp. 17-18)

On an objective basis, MGE's reliance on storage in November and December 2000 was consistent with the way storage was utilized by other gas companies across the country. Mr. Reed pointed out that many other LDC's withdrew greater levels of

storage as a result of the extreme weather and the record high and volatile gas prices being experienced at that time. (Ex.1, pp.19-20 and Schedule JJR-1)

The facts show that MGE's levels of storage withdrawals in November and December 200 were consistent with, or below, the broader experience in the United States. (Ex. 1, pp. 20-21) National statistics show that withdrawals were 70% greater than the historical average for that period. (Ex. 1, p. 20) Withdrawals in December were greater than ever previously recorded, and 25% greater than the previous record. (Ex. 1, p. 20)

In its storage plan, MGE estimated that it would withdraw 7.6 Bcf of natural gas from storage for November and December 2000. (Ex. 1, p. 21) The actual amount was 12.4. So for those two months, actual withdrawals were 63% greater than planned, compared to the 70% experienced nationally. (Id.) Therefore, while its withdrawals were actually greater than anticipated during an unprecedented record cold spell, they were generally consistent with, and slightly lower than, what everyone else was doing in the United States. (Ex. 1, p. 21) That hardly sounds like imprudence.

Mr. Langston explained that there was also an unusual situation in which Williams, the major interstate pipeline on the MGE system and the operator of the storage facilities, made a significant revision to MGE's storage withdrawal numbers in mid-December. (Tr. 269-273) As he explained it, when MGE got to the end of November 2000, the numbers it had from its sources and projections showed that it had withdrawn about 4.5 million Bcf from storage, compared to a planned volume of 4.15 Bcf. (Tr. 633) "So we felt that we were roughly 350,000 Ms [i.e. MMBtus] above plan, which across an entire winter we did not consider to be a substantial number out of 17.8

Bcf storage capacity." (Tr. 633) That storage withdrawal number was subsequently adjusted in the middle of December 2000 "after we received Williams' numbers and found out they had a bust in the measurement numbers they were reporting to us." (Tr. 633) That report showed that MGE's customers had used a lot more gas from storage than previously anticipated. (Tr. 270)

But before MGE received this new information from Williams in mid-December, it had to make decisions at the end of November about what it would do in December. Given that the numbers available to them showed that MGE was within 350,000 MMBtus of its storage plan, and that "we'd had a pretty cold November ... based on that ... we made a decision not to make any adjustments on the basis of our storage inventories." (Tr. 650)

Mr. Reed reviewed the factual circumstances that existed at the time and concluded that MGE's actions were prudent. (Ex. 1, p. 28) In reaching that conclusion, he cited the following facts: MGE utilized the same plan it had used in the previous two winters. That plan, while reviewed by Staff, was never previously criticized. (Ex. 1, p. 29) MGE's service territory experiences significant swings in demand that must be accounted for in a storage plan. (Id.) No one could have projected the level and duration of the extreme weather and price volatility that was experienced. (Id.) Other regulatory commissions have noted the unprecedented nature of the winter of 2000-2001; and MGE's actions were consistent with other LDC's in the United States at the time. (Id.)

MGE's Decision to "Short" December FOM Flowing Supplies

As indicated earlier, Staff has criticized MGE for making a particular supply decision in late November 2000. (Ex. 3, p. 57) The basis, Staff claimed, was that MGE had offered no support for its belief that prices would decline in December. (Ex. 1, p. 13)

MGE made a conscious decision in late November 2000 to buy 20,000 MMBtus less of FOM flowing supply gas in December solely in an attempt to get lower gas prices for its customers. (Tr. 650, 662) That decision was based on the fact that high prices of natural gas were then being experienced in the market and the reasonable expectation, based on weather and price forecasts then available, that prices would likely decline in December. The idea was to avoid purchasing higher-priced FOM gas, utilize lower-priced storage gas in the interim, and then at a later date either repurchase that gas at a lower cost to save the net difference or, depending on the weather, rely on storage volumes. (Tr. 661) MGE believed at the end of November, based on the information available at that time, that it was within 350,000 MMBtu's of its original storage plan, and therefore "we felt we had adequate storage at the end of November." (Tr. 651)

When MGE discovered as a result of Williams' mid-December measurement revision that the storage levels were not where MGE thought they were, and the fact that market prices for gas continued to climb, MGE purchased 20,000 MMBtus of gas per day for the rest of the month. (Tr. 651)

Now MGE made *exactly the same* type of decision in February 2001. In that instance, though, MGE's prediction that prices would fall after the first of the month – based on information it had at the time -- turned out to be correct, and as a result MGE saved money for the ratepayers by avoiding purchases of higher cost FOM gas. (Tr.

662) But the Staff has never acknowledged this offsetting "savings" from exactly the same type of decision made just a couple months later. (Tr. 273) Neither has Staff criticized this later attempt to save customers money since it obviously turned out to benefit customers.

Mr. Reed examined the facts at the time MGE made its decision and concluded that MGE's decision to order less FOM flowing supplies than planned for December 2000 was prudent based on the circumstances that existed at the time. (Ex, 1, p. 32) The facts known at the time show that natural gas prices were at record high levels at the end of November 2000. (Ex. 3, p. 58) Price forecasts from industry experts just a short time before were already incorrect and needed to be readjusted. Weather forecasts for the central United States for the first portion of December 2000 indicated above normal temperatures. (Ex. 3, p. 59) Weather forecasts for the United States as a whole for the first half of December indicated normal temperatures. (Id.) Most of the current projections available at the time would have contributed to a buyer expecting a decline from the prices available during bidweek for FOM volumes for December. (Ex. 1, p. 30) Mr. Reed included several examples from publications that indicated that the market in general expected the November and December prices to fall. (Ex. 1, pp. 30-31 and Schedule JJR-3)

Mr. Reed also looked at the actions of other LDC's and concluded that it was apparent that many others were doing the same thing as MGE. "Many LDC's tried to avoid paying the seemingly too high price available during bidweek, which was both volatile, and in many cases, substantially above then available projections." (Ex. 1, p. 31) Thus, "it was clearly within the realm of reasonable behavior for MGE to assume

that prices would likely fall during December and schedule less first-of-month supplies." (Ex. 1, pp. 32-33)

Argument

The evidence clearly demonstrates that MGE followed the same storage utilization plan for at least three years. (Ex. 1, p. 17) Although the Staff reviewed MGE's plans for several years prior to the winter of 2000-2001, it never raised any criticism of the plan in those ACA audits. (Id.) Staff waited until after a winter of record cold temperatures and record high gas prices to invent its own new approaches on how storage gas and FOM flowing supplies should be scheduled. (Id.) Therefore, Staff's criticism of MGE's storage withdrawal plan for the winter of 2000-2001 is not based on MGE's conduct and decisions at the time the storage plan was prepared, but rather is clearly based on the results of the winter.

The evidence shows that no one could have projected the level and duration of the extreme weather and natural gas price volatility that was experienced. (Ex. 1, p. 29) Similarly, it shows that MGE's actions were in the mainstream of other gas companies at the time. (Id.) There was simply no evidence presented which showed, when faced with a decision, MGE made a decision that no reasonable person in the same circumstance would have made.

The Staff's after-the-fact standards have serious flaws both in concept and application. When they are tested for their predictive ability against known events, they are lacking. There is simply not enough evidence in this record to justify penalizing any MGE decision under the Commission's prudence standard.

VI. RELIABILITY REPORT INFORMATION

The last issue in the Issue List involves Staff's request that the Commission require MGE to provide additional data for the 2001-2002 ACA period, as well as three years beyond that. As such, there is a fundamental question as to how this request relates to this particular ACA period now under review.

It is clear that the Staff wants to see this type of information from all of the gas companies in Missouri, not just MGE. (Tr. 496) On that basis alone, it should be the subject of a rulemaking proceeding. It is similar to the list the Staff has circulated in an informal rulemaking discussion with the gas companies. (Tr. 497)

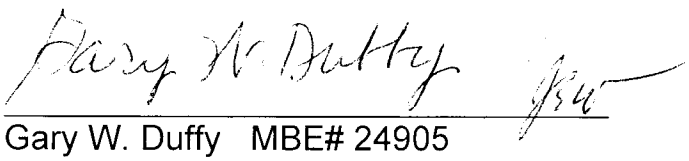
MGE filed an annual reliability report on July 1, 2002, in compliance with the Stipulation and Agreement approved by the Commission in Case No. GO-2000-705. This Stipulation and Agreement is no longer in effect by its own terms.

MGE believes that a state-wide forum is a more appropriate place to address how gas supply information is to be provided by LDCs in Missouri. (Ex. 3, pp. 60-61)

VII. CONCLUSION

For the sake of brevity, MGE has not attempted to deal here with every single fact allegation raised in the course of this proceeding. It has attempted to demonstrate in an understandable manner that when the evidence is examined in light of what MGE knew at the time it made the questioned decisions, it acted in a reasonable fashion. That evidence shows clearly that the Staff recommendations on each of the issues discussed herein should be rejected by the Commission.

Respectfully submitted,



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CERTIFICATE OF SERVICE

The undersigned certifies that a true and correct copy of the foregoing document was served this 15th day of January, 2004, upon counsel for all parties of record in this proceeding by either hand delivery or by placing a copy of same with the United States Postal Service, postage prepaid.

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