Exhibit No.:	
Issue:	Overview
Witness:	Douglas H. Yaeger
Type of Exhibit:	Direct Testimony
Sponsoring Party:	Laclede Gas Company
Case No.:	GR-2005-_______
Date Testimony Prepared:	February 18, 2005

LACLEDE GAS COMPANY

GR-2005-______

DIRECT TESTIMONY

OF

DOUGLAS H. YAEGER

FEBRRUARY 2005

DIRECT TESTIMONY OF DOUGLAS H. YAEGER

Q. Please state your name and business address.

A. My name is Douglas H. Yaeger, and my business address is 720 Olive Street, St. Louis, Missouri 63101.

Q. By whom are you employed and in what capacity?

A. I am employed by Laclede Gas Company as Chairman of the Board, President and Chief Executive Officer.

Q. Have you prepared a schedule that describes your qualifications and experience?

A. Yes, Schedule 1 to my direct testimony describes my qualifications and experience in the natural gas industry.

Q. What is the purpose of your testimony in this case?

A. The purpose of my testimony is to discuss why Laclede is seeking rate relief at this time as well as some of the more important policy issues that will come before the Commission in this case.

Q. How long has it been since Laclede last filed for a general rate increase?

A. Our last request for a general increase in rates was filed over three years ago. The three plus years between that filing and the one we are making today represent a significant and, I believe, promising departure from Laclede's historical practice of filing general rate case proceedings at one- or two-year intervals.

Q. Why has Laclede traditionally found it necessary to file rate cases on a periodic basis?

A. The need to seek periodic rate relief has resulted from a number of factors, some relating to the unique demographic circumstances Laclede faces, and others relating to the impact of various regulatory policies and practices. With regard to demographics, Laclede serves a mature market and has, for some time now, experienced extremely limited net growth in its service territory. In fact, our overall growth in customers has averaged less than 1 percent per year. At the same time, the Company's service territory continues to be affected by a significant amount of urban sprawl, as customers continue to move from the inner core of our service territory to the outlying suburbs and beyond.

Q. How have these demographic factors affected the Company?

A. It has placed a significant burden on the financial resources required by the Company to provide natural gas service. In effect, it has forced the Company to incur both the fixed investment costs and maintenance expenses necessary to continue service to a declining customer base within the traditional core areas of its service territory, while also incurring the costs of extending and maintaining its distribution facilities in order to provide service in new areas to which many of those former core area customers have moved. The end result is a significant net increase in costs with little net customer growth to pay for these increased costs. At the same time, Laclede has had persistent increases in other costs, which include, among others, substantial increases in bad debt expense arising in large measure from increased gas costs. Additionally, the Company incurs financing costs associated with having to make gas purchases at historically high prices months in advance of when we sell and receive payment for those supplies from our customers. Moreover, the Company has incurred, and will continue to incur, costs associated with complying with Section 404 of the Sarbanes-Oxley Act of 2002. Add to these items the ongoing cost increases in other areas of our operations, including the need to make annual capital and safety-related expenditures of nearly $55 million per year, many of which are governmentally-mandated, and it becomes apparent why the Company has had to seek rate relief on a periodic basis.

Q. How has the Company financed its annual capital requirements and safety-related expenditures?

A. As discussed more fully in the testimony of Company witness G. W. Buck, the Company has traditionally used short-term debt as a “bridge” to permanent financing. However, in the post-Enron era, the rating agencies are ever more vigilant in monitoring companies’ financing practices, cash flows, and liquidity. In April of 2004, while interest rates were at 40-year lows, the Company issued $150 million of debt securities to pay down short-term debt, refinance a $50 million issue at lower rates, and refund a $25 million debt maturity. To further strengthen and stabilize our balance sheet, Laclede Gas’ parent, The Laclede Group, completed one of the largest equity offerings in the Company’s history in May 2004. The Company issued 1.725 million shares and raised an additional $44.7 million that was “equity-infused” down to Laclede Gas. These unprecedented financings, while adversely impacting the Company’s near-term earnings, served to stabilize Gas’ balance sheet and provide vital liquidity capacity during a period of volatile and increasing natural gas prices.

Q. You also mentioned the impact of regulatory policies and practices on the Company’s need to file for periodic rate relief. What policies and practices are you referring to?

A. While I believe the situation has improved significantly in the recent past, there have been a number of regulatory policies and practices that, at least on an historical basis, have contributed to this need to seek periodic rate relief. In terms of capital recovery, these have included approaches for establishing returns on equity that have resulted in allowed returns that are simply not competitive with companies comparable to Laclede, as well as depreciation policies that have substantially reduced the cash flows available to support our infrastructure requirements. They have also included policies and practices that have not adequately compensated or reimbursed the Company for the additional costs and risks for which Laclede assumed sole responsibility as a result of FERC Order 636.

Q. What impact have all of these factors had on the Company?

A. In addition to requiring that we seek rate relief on a periodic basis, all of these factors have also contributed to significant downgrades in the Company's credit ratings in recent years. In fact, at least one of the major rating agencies has indicated that, unless these factors for Laclede show continued improvement, there likely will be additional downgrades.

Q. How then has the Company managed to defer seeking rate relief for a longer period of time than has customarily been the case?

A. Well, first and foremost, we recognize that we have an obligation to control or minimize costs where we can so that we only seek rate relief when it is absolutely necessary. To that end, we are now in the fourth year of a more formalized business planning process where we have made key company management more accountable for controlling costs, improving customer service and creating shareholder value. We have made good progress – a result that has contributed to our ability to defer seeking rate relief. In addition, we have also been helped by a number of positive regulatory developments.

Q. Please describe what regulatory changes you are referring to.

A. Some of these positive regulatory developments took place in our last general rate case proceeding. Perhaps the most significant change was the Commission's approval of our weather mitigation rate design. Among other things, this rate design has helped to ensure that the Company will not significantly under- or over-recover its fixed distribution costs simply because the weather happens to be warmer or colder than normal. By appropriately de-coupling fixed cost recovery from the amount of natural gas the customer uses, the rate design also serves to greatly lessen, if not entirely eliminate, the financial penalty that is incurred when an LDC pursues the kind of long-term energy conservation and efficiency programs that can significantly reduce energy bills for customers.

Q. Please continue.

A. Our last rate case also continued to provide Laclede with the opportunity to retain a share of the savings achieved under a gas supply incentive plan, as well as the revenues realized from our sale of gas and pipeline capacity to customers located off our system. As discussed in the direct testimony of Laclede witness K. J. Neises, the Company has, with the exception of one brief period, operated under one form of gas supply incentive plan or another since 1996. We believe that properly designed programs such as these maximize the benefits for all utility stakeholders, including customers, as the Company carries out its gas supply management responsibilities.

Q. Please describe how the Infrastructure System Replacement Surcharge has impacted Laclede.

A. The positive impact of the Infrastructure System Replacement Surcharge, or "ISRS" mechanism, approved by the Missouri General Assembly in 2003, has been critical in improving our ability to begin recovering on a more timely basis those safety-related and public improvement expenditures that we are required by law to make.

Q. Have there been other positive regulatory developments recently?

A. Yes. While it did not help us to meet our financial requirements over the past three years, Laclede appreciates the Commission's recent decision to return to a more traditional approach on depreciation and views it as a very positive development for the future.

Q. Have these developments helped to improve how Laclede is perceived by credit agencies and the investment community in general?

A. At a minimum, they have been instrumental in stopping the credit ratings free fall that the Company found itself in only a few years ago. That, in itself, is a welcome result. It is essential, however, that additional progress be made. Indeed, such progress is particularly critical given the increased scrutiny that all energy companies face in a post-Enron environment and the increased emphasis that both the investment community and gas sellers place on the financial capabilities of LDCs to meet their obligations and commitments.

Q. What then does Laclede hope to accomplish in this case?

A. I am hopeful that this proceeding will provide an opportunity to solidify and build upon the foundational measures that have allowed us to reduce the frequency of our base rate filings and provide a vehicle for implementing programs that will better enable the Company and its customers to cope with the challenges we face as a result of the higher price environment that prevails today in the wholesale natural gas market. I want to emphasize that the Company intends to work with the Staff, Public Counsel and other parties, as it has in previous cases, to formulate constructive ways to accomplish these goals, and I am optimistic that appropriate solutions acceptable to everyone can be reached and recommended to the Commission. To that end, I want to discuss three issues that are of particular importance in this case.

Q. What is the first issue?

A. The first issue involves the weather mitigation rate design that was approved by the Commission in our last case. We believe it is absolutely essential that the basic structure of this rate design be preserved. Its continuation is simply too important to both the Company and its customers, and it has worked too well, for it to be significantly altered or eliminated.

Q. Please explain why.

A. Although Mr. Cline will address this subject in greater detail, I would like to briefly highlight three considerations that I believe strongly support the continuation of this innovative rate design. First, I think it is particularly significant that in the three plus years that this rate design has been in effect, it has received virtually no criticism from our customers. It is unusual <u>not</u> to receive some negative feedback from customers whenever a utility changes anything in the way it provides or charges for its services, no matter how minor that change may be.

Q. Are you surprised by the absence of customer complaints regarding the weather mitigation rate design?

A. No. The weather mitigation rate design was specifically designed to avoid any adverse customer impacts. It has obviously accomplished that goal, and I see no reason why it would not continue to be viewed favorably by our customers in the future.

Q. Please discuss the second consideration that you believe supports continuation of the weather mitigation rate design.

A. Continuation of this rate design is also vitally important because it represents one of the most significant initiatives the Commission can undertake to promote long-term conservation and energy-efficiency measures for our customers, such as those that are currently under consideration by the Commission's task force on long-term energy affordability.

Q. Why is that the case?

A. The weather mitigation rate design makes the recovery of our fixed distribution costs less dependent on the amount of gas the customer uses. Therefore, it serves to eliminate a primary disincentive faced by LDCs in the pursuit of permanent programs aimed at getting customers to significantly reduce their usage. In effect, it avoids the perverse situation where the more successful a utility is at getting customers to conserve, the more it under-recovers its costs.

Q. Why is it so important to encourage such conservation efforts?

A. The primary purpose of conservation is to promote the efficient use of natural gas. Not only does conservation extend the utilization of critical gas supplies, but it also allows those customers who reduce their usage as a result of such efforts to save on the single largest item that makes up their bill – the commodity cost of gas - which has been primarily responsible for driving up customer bills in recent years. This represents an area where real conservation gains can be made, thus providing the dual benefit of saving customers money and fostering an environment that actively supports conservation of a precious natural resource. In other words, by protecting the LDC from usage-related under-recoveries on the much smaller part of the bill that recovers its fixed distribution costs, the weather mitigation rate design allows the utility and its customers to become true partners in accomplishing this important goal. By encouraging conservation, such rate designs should also help to relieve some of the demand-related price pressure on natural gas supplies – an element that I strongly believe should also be a focus of any federal energy policy.

Q. Has there been any recognition nationally that such rate designs can play a significant role in promoting conservation?

A Yes. In evaluating whether these kinds of rate designs really are an important and useful tool for promoting energy conservation, I would urge the Commission to consider the Joint Statement issued last year by the Natural Resources Defense Council and the American Gas Association, a copy of which is attached to my direct testimony as Schedule 2. As shown there, the NRDC firmly supports the implementation of utility rate designs, like Laclede's, that promote conservation by eliminating the financial penalty that utilities face when customers reduce their usage. Endorsement of these sorts of rate designs as a way to encourage energy efficiency by conservation-oriented environmental groups like the NRDC should give the Commission even greater confidence that these rate designs actually do serve that role.

Q. What is the third major reason you believe the weather mitigation rate design should be preserved?

A. As I have indicated previously, the rate design is also critical to how we are perceived by the investment community from which we have to attract the dollars required to fulfill our basic public utility obligations. That is due, in large measure, to the fact that the investment community views the rate design as a tool that gives the Company a realistic opportunity to recover the fixed costs that it must incur each day to fulfill its obligations to its customers.

Q. Why is this so important?

A. I think that it is important to keep in mind that the vast majority of the costs Laclede incurs are non-discretionary expenditures that are essential to providing service to its customers. These include expenditures such as the personnel, equipment and investment costs that must be incurred to maintain our 15,000 miles of distribution facilities on a 24-hour basis in accordance with the Commission's safety rules. They also include the expenditures required to connect new businesses and homes to Laclede's distribution system, construct our portion of the state's critical economic infrastructure, and provide service to customers, including those who cannot afford to pay for it, under extremely favorable terms that are virtually unheard of in any other business endeavor. Prior to implementation of the weather mitigation rate design, Laclede experienced huge under-recoveries of these costs simply because temperatures happened to be warmer than normal or customers used less-than-anticipated volumes, and it also had the opportunity for significant over-recoveries during colder than normal periods – factors that were completely beyond the control of the Company. No business enterprise, including a regulated utility, can afford to incur mandated or required fixed costs year after year that are never paid for by the customers on whose behalf they have been incurred. Nor is it in any sense fair or reasonable to require a firm to do so.

Q. Are the same considerations equally applicable to the Company's customers?

A. Absolutely. Just as a regulated utility should not be expected to chronically under-recover its costs, the customers of that utility should not be expected to pay substantially more than the actual costs of serving them simply because the weather happens to be colder than normal. In short, there should not be winners and losers as a result of the vagaries of weather. The weather mitigation rate design is absolutely essential to ensuring this does not happen to any extreme extent. Indeed, it simply permits costs that are truly fixed in nature to be recovered on a more fixed basis, while allowing costs that are truly variable to be recovered on a variable or volumetric basis – a result that is also fully consistent with fundamental principles of cost causation. I would therefore strongly recommend that the Commission continue this rate design.

Q. Please discuss the second area where you believe positive Commission action is required.

A. With the significant tightening in the supply/demand balance in the market for natural gas supplies, LDCs and other gas buyers across the country have seen natural gas prices escalate dramatically to levels that have little historical precedent. Laclede has been active in suggesting legislative initiatives at the federal level that it believes are necessary to address this national energy problem, including measures that would address both the supply and demand side of the imbalance. Although the problem is national in scope, we believe there are also a number of proactive steps that can be taken at the state level to respond to this situation in a constructive manner.

Q. Please describe what steps Laclede believes the Commission should take in this regard.

A. As discussed in the direct testimonies of Company witnesses K. J. Neises and M. T. Cline, the first step is our proposal to broaden the gas supply incentive plan that is currently in effect for Laclede. As I mentioned previously, such plans offer the opportunity to maximize the benefits for all utility stakeholders, including customers, as Company witness K. J. Neises describes in his direct testimony. It is also critical that reasonable ratemaking treatment be afforded the Company's efforts to sell gas and pipeline capacity to customers located off its distribution system, when those items are temporarily unneeded to serve its own customers. This is particularly true given how important such treatment is to the Company's ability to fund its proposals for implementing new energy assistance and efficiency programs for lower income customers. We strongly believe that such an approach works to the benefit of all of our customers.

Q. Please explain why you think the Company's proposals benefit all customers.

A. To begin with, it gives our most vulnerable customers a real opportunity to cope with energy bills that, for many of them, are simply beyond their ability to pay at a point in time. In exchange for doing so, however, our proposal requires that these customers commit to making timely payments, implement simple conservation measures and take other steps that will hopefully reduce costs not only for them but also for other customers in the future. Moreover, our proposals allow this assistance to be provided through benefits that are achieved by the Company on behalf of all of its customers as a result of its successful efforts to obtain favorable results in its dealings with out-of-state marketers, producers and buyers. While such an initiative would make sense in any price environment, its merits are even clearer given the kind of price challenges we and our customers must deal with today.

Q. What other steps should the Commission take to address this situation?

A. We also believe it makes more sense than ever to revise our Purchased Gas Adjustment ("PGA") mechanism so that it more accurately reflects the gas costs that are actually being incurred to serve our customers – a true <u>purchased</u> gas adjustment mechanism. To that end, Laclede witnesses G. W. Buck and M. T. Cline discuss a proposal in their direct testimonies to revise the PGA to account for the carrying costs associated with the natural gas and propane inventories that we purchase and maintain in storage to supplement flowing supplies during the winter heating season. Mr. Cline also proposes to revise the PGA to include the gas cost component of uncollectible accounts. Again, these are items for which I believe there should be no winners or losers – that the actual carrying costs incurred and gas costs written off would be collected from customers – no more, no less.

Q. Why have storage inventory costs become an issue?

A. Prior to implementation of FERC Order No. 636 in 1993, pipeline companies were responsible for acquiring the gas supplies and upstream pipeline transportation capacity, arranging for and financing storage inventories to supplement flowing supply during the winter months, and scheduling for the transportation of such supplies to the LDCs on an as-needed basis. All of these costs, including inventory financing costs, were passed on to the LDCs under FERC tariffed rates. Subsequent to passage of Order No. 636, pipeline companies essentially became "common carriers" and the responsibilities for procurement, storage and transportation shifted downstream to LDCs. The single biggest financial impact of Order 636 is that Laclede is now responsible for the financing of significant storage inventories along with the responsibility for acquiring it. Laclede purchases gas for storage and uses it to supplement flowing gas supplies during the winter months when demand and, usually the price, is highest. The requirement to finance these inventories has exposed Laclede to the interest rate and leverage risks associated with highly volatile natural gas prices.

Q. How are inventory costs currently recovered in rates?

A. Under current ratemaking, inventory costs are recovered through base rates at some estimated level which can vary significantly depending on the assumptions used in determining the price and volume of such supplies and the cost of financing them. As a result, the recovery of inventory investment through base rates can result in a significant over- or under-recovery of these costs by the Company if short-term interest rates change, the price of natural gas spikes or declines during periods of injection, or the utility deems it necessary to acquire more or fewer volumes of gas for storage due to changes in demand. In the one case, the utility will absorb significantly higher financing costs than are embedded in base rates, while in the other, it will enjoy a windfall to the detriment of its customers, all based on factors generally beyond the control of the Company. There is simply no equitable reason to "bet" on how these variables may turn out. Instead, our proposal to reflect such financing costs in the PGA would ensure that neither the Company nor its customers benefit or lose as a result of what happens with these unknowable and uncontrollable factors by taking the guesswork out of matching costs and revenues for these items.

Q. Do many of these same considerations also justify reflecting in the PGA changes in the gas cost portion of the bad debt expenses experienced by the Company?

A. Yes. Just like the financing costs for gas inventories, the gas cost portion of the Company's bad debts can rise or fall dramatically based on changes in the price of gas and other factors, and both gas inventories and bad debts are at historically high levels right now. Rather than simply attempt to guess at where those costs will be tomorrow or next year and build that guess into rates, we again believe it protects both the Company and our customers to reflect them in the PGA so that no one ends up over- or under-collecting or over- or under-paying for them. It is important to note that we are proposing to include in the PGA only the actual total gas costs that the Company incurs, but not the portion of bad debts applicable to the Company's distribution costs. There is nothing at all strange or inappropriate about including gas costs in a mechanism that is specifically designed to recover gas costs incurred by the Company in the first place.

Q. What is the third issue that you believe deserves special attention by the Commission in this proceeding?

A. The third major issue that I believe requires special attention in this case relates to the establishment of a fair and reasonable return on equity. We are also hopeful that the Commission, just as it did in the area of depreciation, will give due consideration to the need to establish a return on equity that is competitive with other companies comparable to Laclede. As the Commission itself has recently recognized, Laclede and other Missouri utilities must compete with other firms to attract the capital required to fulfill our public utility obligations. When doing so, it is essential that Missouri be perceived by those investors as a place where their discretionary investments are welcomed with a realistic opportunity to earn competitive returns. Reliable utility service, and the infrastructure necessary to provide it, is a key element of our state's ability to develop economically. By helping to attract the capital necessary to support and maintain those services, I truly believe that the establishment of a competitive return will benefit not only the Company and our customers, but also the state of Missouri as a whole.

Conversely, it is simply inappropriate and unreasonable to penalize Laclede, or any other utility for that matter, simply because they do business and make investments in Missouri. And based on my experience with those who advise or provide information to investors on where their dollars should flow, it is clear to me that such results are also counterproductive for both utilities and their customers over the long term.

Q. Has the method used by Staff and Public Counsel to derive their recommended returns on equity in recent proceedings resulted in these kinds of competitive returns?

A. No. Both Staff and Public Counsel have typically derived their return recommendations for Laclede based almost exclusively on a company-specific discounted cash flow analysis of Laclede's expected returns rather than an analysis of the returns required for companies with comparable risks. There are a number of inherent flaws in such an approach.

Q. Please explain.

A. First, the results are circular in that Laclede's authorized return going forward is determined by how well or how poorly the Company was treated by regulators in the past. In addition, such an approach has tended to result in lower – in some cases significantly lower – recommended returns than those being authorized in other jurisdictions. Finally, the company-specific analysis fails to comport with what counsel has advised me is a fundamental legal obligation of the Commission to base its return for Laclede on a comparable company analysis. Second, the discounted cash flow analysis as historically employed by Staff and Public Counsel applies a return on equity derived from an examination of <u>market</u>-based factors to the <u>book</u> value of the Company’s plant. Staff and Public Counsel have historically ignored this basic inconsistency in their discounted cash flow calculations despite market-to-book ratios typically in excess of 150%. In order to establish an accurate market-based return on equity calculation, it is essential to recognize and adjust for this difference. Third, while the discounted cash flow analysis is a commonly used method of estimating a fair return, it is not necessarily the optimum method in all situations. An analyst should consider several models and methodologies in order to arrive at a well-reasoned return recommendation. Company witness K. C. McShane has examined a fair return from several perspectives, including discounted cash flow, to arrive at the Company's recommendation in this case.

Q. How then would you recommend the Commission address this matter?

A. I recommend that the Commission adopt the return recommendations submitted on behalf of the Company by Laclede witness K. C. McShane. In my view, such recommendations reflect not only today's market realities but also a return that will make Laclede competitive with other investment options.

Q. Would adoption of the measures you have discussed in your testimony impose a significant financial burden on the Company's customers?

A. In relative terms, granting the Company's entire request for rate relief would increase the overall rates to our customers by just 4.1%. To put this into perspective, the rate decrease that the Company passed through to customers last January to reflect changes in wholesale gas costs was approximately three times the net additional revenue of $34 million that the Company is seeking in this proceeding. Moreover, I am confident that adoption of these proposals would permit the Company to make further progress toward breaking out of its pattern of revolving rate cases and allowing us to bring stability to our distribution rates for a number of years to come. Such measures will also provide the

Company with the appropriate amount of rate relief necessary to enable it to carry out its fundamental public utility obligations. Indeed, the establishment of compensatory rates, as well as the adoption or continuation of measures designed to make sure that such rates will be translated into actual revenues, are absolutely critical to ensuring -- both now and in the future -- the type and level of service that our customers expect and deserve, and that will ultimately attract new customers and investment to our service territory and the State of Missouri.

Q. Does this conclude your direct testimony?

A. Yes, it does.

QUALIFICATIONS AND EXPERIENCE
OF
DOUGLAS H. YAEGER

Educational Qualifications

Mr. Yaeger received a Bachelor of Science Degree in Business Administration in 1971 from Miami University, in Oxford, Ohio. In 1976, he graduated from St. Louis University, St. Louis, Missouri, where he received a Master of Business Administration Degree. In May 1992, he completed the Advanced Management Program in the Harvard Business School, in Boston, Massachusetts.

Employment Experience

During most of the period from July 1971 through November 1990, Mr. Yaeger was employed by Mississippi River Transmission Corporation (MRT), an interstate natural gas pipeline, which primarily serves the Greater St. Louis Metropolitan Area. While employed at MRT, he held various positions in that Company's rates, regulatory affairs, gas supply, sales, marketing and accounting departments. At the time he left MRT, he held the position of Executive Vice President, with management responsibility for the areas of marketing, planning, budgets and administration, transportation and exchange and information services.

Mr. Yaeger joined Laclede as Vice President-Planning in December 1990. From September 1992 to September 1995, he served as Vice President and then Senior Vice President-Operations, Gas Supply and Technical Services. In September 1995, he was elected to the position of Executive Vice President-Operations and Marketing, where he assumed management responsibility for both operations and the Company's marketing activities. With his election to the position of President and Chief Operating Officer, effective in December of 1997, Mr. Yaeger assumed overall management responsibility for all of the Company's day-to-day operations. He was elected to his current position effective January 1, 1999 and assumed the position of Chairman of the Board of Laclede on January 28, 1999.

Previous Testimony

Mr. Yaeger has submitted pre-filed testimony and participated in the proceedings in Case No. GA-98-126 regarding the initial application of Missouri Pipeline Company for certificate authority to transport natural gas in the State of Missouri. He also submitted testimony in Laclede's six most recent general rate case proceedings, Case Nos. GR-94-220, GR-96-193, GR-98-374, GR-99-315, GR-2001-629 and GR-2002-356.

American Gas Association

NRDC
THE EARTH'S BEST DEFENSE

Joint Statement of the American Gas Association and the Natural Resources Defense Council

Submitted to the National Association of Regulatory Utility Commissioners
July 2004

The American Gas Association (AGA) and the Natural Resources Defense Council (NRDC) recognize the many benefits of using clean-burning natural gas efficiently to provide high quality energy services in all sectors of the economy. This statement identifies ways to promote both economic and environmental progress by removing barriers to natural gas distribution companies' investments in urgently needed and cost-effective resources and infrastructure.

NRDC and AGA agree on the importance of state Public Utility Commissions' consideration of innovative programs that encourage increased total energy efficiency and conservation in ways that will align the interests of state regulators, natural gas utility company customers, utility shareholders, and other stakeholders. Cost-effective opportunities abound to improve the efficiency of buildings and equipment in ways that promote the interests of both individual customers and entire utility systems, while improving environmental quality. For example, when energy supply and delivery systems are under stress, even relatively modest reductions in use can yield significant additional cost savings for all customers by relieving strong upward pressures on short-term prices.

NRDC and AGA also encourage state Commissions to support gas distribution company efforts to manage volatility in energy prices and reduce volatility risks for customers.

The Energy Efficiency Problem: Regulated Natural Gas Utilities are Penalized for Aggressively Promoting Energy Efficiency

Local natural gas distribution companies (gas utilities) have very high fixed costs. These fixed costs include the costs of maintaining system safety and reliability throughout the year, staffing customer service telephone lines 24 hours a day and doing what it takes each day of the year to ensure the safe and reliable delivery of natural gas to homes, schools, hospitals, retailers, factories and other customers.

Natural gas utilities typically purchase natural gas on behalf of their customers, and pass through the cost without markup. This means that natural gas utilities do not profit from their acquisitions of natural gas to serve customer needs. The profit (authorized level of rate of return) comes from the rates utilities charge for transporting the natural gas to customers' homes and businesses.

The vast majority of the non-commodity costs of running a gas distribution utility are fixed and do not vary significantly from month to month. However, traditional utility rates do not reflect this reality. Traditional utility rates are designed to capture most of approved revenue requirements for fixed costs through volumetric retail sales of natural gas, so that a utility can recover these costs fully only if its customers consume a certain minimum amount of natural gas (these amounts are normally calculated in rate cases and generally are based on what customers consumed in the past). Thus, many states' rate structures offer – quite unintentionally – a significant financial disincentive for natural gas utilities to aggressively encourage their customers to use less natural gas, such as by providing financial incentives and education to promote energy-efficiency and conservation techniques.

When customers use less natural gas, utility profitability almost always suffers, because recovery of fixed costs is reduced in proportion to the reduction in sales. Thus, conservation may prevent the utility from recovering its authorized fixed costs and earning its state-allowed rate of return. In this important respect, traditional utility rate practices fail to align the interests of utility shareholders with those of utility customers and society as a whole. This need not be the case. Public utility commissions should consider utility rate proposals and other innovative programs that reward utilities for encouraging conservation and managing customer bills to avoid certain negative impacts associated with colder-than-normal weather. There are a number of ways to do this, and NRDC and AGA join in supporting mechanisms that use modest automatic rate true-ups to ensure that a utility's opportunity to recover authorized fixed costs is not held hostage to fluctuations in retail gas sales.[1] We also support performance-based incentives designed to allow utilities to share in independently verified savings associated with cost-effective energy efficiency programs.

Many states' rate structures also place utilities at risk for variations in customer usage based on variations in weather from a normal pattern. This variation can be both positive and negative. Utilities' allowed rate of return is premised on the

[1]For example, in 2003 the Oregon Public Utility Commission approved a "conservation tariff" for Northwest Natural Gas Company (NW Natural) "to break the link between an energy utility's sales and its profitability, so that the utility can assist its customers with energy efficiency without conflict." The conservation tariff seeks to do that by using modest periodic rate adjustments to "decouple" recovery of the utility's authorized fixed costs from unexpected fluctuations in retail sales. *See* Oregon PUC Order No. 02-634, *Stipulation Adopting Northwest Natural Gas Company Application for Public Purpose Funding and Distribution Margin Normalization* (Sept. 12, 2003). In California, PG&E and other gas utilities have a long tradition of investment in energy efficiency services, including those targeting low-income households, and the PUC is now considering further expansion of these investments along with the creation of performance-based incentives tied to verified net savings. California also pioneered the use of modest periodic true-ups in rates to break the linkage between utilities' financial health and their retail gas sales, and has now restored this policy in the aftermath of an ill-fated industry restructuring experiment. Thus, in March 2004, Southwest Gas Company received an order that authorizes it to establish a margin tracker that will balance actual margin revenues to authorized levels.

expectation that weather will be normal, on average, and that customer use of gas will maintain a predictable pattern going forward. Proposals by utilities to decouple revenues from both conservation-induced usage changes and variations in weather from normal have sometimes been characterized as attempts to reduce utilities' risk of earning their authorized return. The result of these rate reforms, in this regulatory view, should be a lowered authorized return. But reducing authorized returns would penalize utilities for socially beneficial advocacy and action, including efforts to create mechanisms that minimize the volatility of customer bills.

Our shared objective is to give utilities real incentives to encourage conservation and energy efficiency. With properly designed programs, the benefits could be significant and widespread:

- Customers could save money by using less natural gas;
- Reduced overall use will help push down short-term prices at times when markets are under stress, reducing costs for all customers (whether or not they participate in the utility programs);
- Utilities would recover their costs and have a fair opportunity to earn their allowed return;
- State policies to encourage economic development could be enhanced by increased energy efficiency and lower business energy costs;
- State PUCs would be able to support larger state policy objectives as well as programs that reflect the public's desire to use energy efficiently and wisely.

In today's climate of rapidly changing natural gas prices, such reforms make good sense for consumers, shareholders, state governments, and the environment.

Natural Gas Consumers, Price Volatility and Resource Portfolio Management. Another area of concern shared by NRDC and AGA is the impact of natural gas price volatility on natural gas consumers, which can be exacerbated by limited diversification of utilities' resource portfolios. Today many of the nation's natural gas utilities find themselves relying on short-term markets for most of their gas needs, with either the encouragement or the acquiescence of their regulators. During much of the 1990's this approach was typically advantageous to consumers, as the market price of natural gas was generally low and did not fluctuate dramatically. As wholesale natural gas prices have risen since 2000 and become more volatile, however, many utilities and commissions are reconsidering this emphasis on short-term market purchases.

While purchasing practices based on short-term supply contracts may offer consumers relatively low-cost natural gas, those consumers are also exposed to more volatile prices and natural gas bills that may rise and fall unpredictably. Public Utility Commissions should favorably consider gas distribution company proposals to manage volatility, such as through hedging, fixed-price contracts of various durations, energy-efficiency improvements in customers' buildings and equipment, and other measures designed to provide greater certainty about both supply adequacy and price stability. Achieving these goals will sometimes require paying a premium over prevailing spot market prices. Like diversified investment portfolios that are designed to mitigate risk, prudent hedging plans should be encouraged as a way to help stabilize gas prices and ensure long-term access to affordable natural gas services.

This Joint Statement also has been reviewed and endorsed by:

ALLIANCE TO
SAVE ENERGY
Creating an Energy-Efficient World

Alliance to Save Energy

ACE3

American Council for an Energy-Efficient Economy

L:NRDC-AGA Statement – 7-7-04 (FINAL with ACE3).doc

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Laclede Gas Company's Tariff to Revise Natural Gas Rate Schedules.	)))	Case No. GR-2005-____

AFFIDAVIT

STATE OF MISSOURI)
) SS.
CITY OF ST. LOUIS)

Douglas H. Yaeger, of lawful age, being first duly sworn, deposes and states:

1. My name is Douglas H. Yaeger. My business address is 720 Olive Street, St. Louis, Missouri 63101; and I am Chairman, President & Chief Executive Officer of Laclede Gas Company.

2. Attached hereto and made a part hereof for all purposes is my direct testimony, consisting of pages 1 to 18, and Schedule No. 1-2 inclusive.

3. I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded are true and correct to the best of my knowledge and belief.

Douglas H. Yaeger

Subscribed and sworn to before me this 7th day of February, 2005.

Joyce L. Jansen

JOYCE L. JANSEN
Notary Public — Notary Seal
STATE OF MISSOURI
ST. CHARLES COUNTY
My Commission Expires: July 2, 2005