

**THE GENERAL REPORT ON
ANALYSIS OF GAS SUPPLY AND HEDGING PRACTICE
BY REGULATED NATURAL GAS UTILITIES IN MISSOURI**

BY

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UNDER CONTRACT NUMBER

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3.4 Some Price Risk Management Programs Yielded Profits To Companies

Surprisingly enough some approaches to price risk management had evolved into a profit-making program for the utility where it wasn't clear that reducing systems customers exposure to price risk was the primary purpose of the program.

Expected returns were built into the program. A target strike price was established for the program. The company was authorized to spend a certain amount of money on the program which amount was used in calculating the actual strike price. The company then had 90 days to put on positions for the upcoming heating season. Of course, the cost or value of the insurance depended on the term – the shorter the term the less the cost. Each day the company held off purchasing the insurance the less the expected cost. The less the expected cost the greater the potential profit.

Three things could occur.

One, the market could remain stable, in which case the company could receive a return equal to the difference between the amount of moneys allocated to the program less the actual cost when they opened the position.

Second, the market could improve for the company relative to the cost of establishing a position. For example the expected cost of gas or expected volatility could decline. In this case the return is even greater than in the previous example. There is the return from the term of the insurance policy being less. There is also the return from the fact that the risk has declined over time.

The importance of the term is not to be underestimated. The term of the contract is at most one year. Thus, if they hold off putting any option contract in place for 3 months,

the term of the contract is reduced by at least 25%. If they hold off putting a November option contract in place for 3 months from a start date in April the term of the contract is reduced by 3/7th or 43% since the November contract terminates in late October.

Third, if the market gets worse relative to the cost of establishing a position by the company, the company could exit the market. For example, if the expected price of gas increases or the expected volatility increases the company had the option of not signing up for price risk insurance for customers.

Most probably the company would not sign up for the insurance because this would represent a cost to the company. The amount of money required to purchase the insurance at the agreed strike price would exceed the agreed program funds. This results in an unappealing situation for the customer. The customer would be fully exposed to price risk when price risk was known to have increased. The customer would only receive insurance if the company received a return which return could be a byproduct of a decline in risk over time.

If the company purchased the insurance it had an opportunity for an additional return. If it closed out the position prior to the last three days of the contract it received a portion of any gains associated with the contract.

If price volatility increased in the last month of the contracts' life the value of the insurance would increase and the company would gain from selling the insurance. When the company received a gain by selling the insurance prior to its maturity, however, the consumers would necessarily be exposed to price risk unless a physical deal was coupled with the financial deal at the time the financial deal was completed.