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Witness: Kenneth J. Neises
Issue: Price Stabilization Fund; Overview
Type of Exhibit: Surrebuttal Testimony
Sponsoring Party: Laclede Gas Company
Case No.: GO-98-484

SURREBUTTAL TESTIMONY

OF

KENNETH J. NEISES

FILED
AUG 5 1998
Missouri Public Service Commission

LACLEDE GAS COMPANY

Case No. GO-98-484

St. Louis, Missouri

August, 1998

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Case No(s). GR-2001-387
Date 2-14-03 Rptr TL

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of Laclede Gas Company's Tariff Sheets designed to extend for an additional year the experimental price stabilization fund.	))))	Case No. GO-98-484

A F F I D A V I T

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

Kenneth J. Neises, of lawful age, being first duly sworn, deposes and states:

1. My name is Kenneth J. Neises. My business address is 720 Olive Street, St. Louis, Missouri 63101; and I am Senior Vice President-Energy & Administrative Services of Laclede Gas Company.

2. Attached hereto and made a part hereof for all purposes is my surrebuttal testimony, consisting of pages 1 to 19, 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.

K J Neises

Kenneth J. Neises

Subscribed and sworn to before me this 5th day of August, 1998.

Joyce L Jansen

JOYCE L. JANSEN
Notary Public — Notary Seal
STATE OF MISSOURI
St. Louis County
My Commission Expires: July 2, 2001

SURREBUTTAL TESTIMONY OF KENNETH J. NEISES

Q. What is your name and address?

A. My name is Kenneth J. Neises, and my business address is 720 Olive Street, St. Louis, Missouri 63101.

Q. Are you the same Kenneth J. Neises who previously submitted direct testimony in this proceeding?

A. Yes, I am.

PURPOSE OF TESTIMONY

Q. What is the purpose of your surrebuttal testimony?

A. The purpose of my testimony is to respond to the concerns raised in the rebuttal testimony of Staff witnesses David Sommerer and James A. Busch regarding the structure, effect and overall merits of the Incentive Price Stabilization Program (Incentive PSP) proposed by the Company in this proceeding. More specifically, I will explain why I believe the Staff has greatly exaggerated the measured risks associated with this program, while substantially understating its potential benefits for Laclede Gas Company's (Laclede or Company) customers. I will also attempt to identify those concerns expressed by the Staff which I believe are simply irrelevant to a fair evaluation of the appropriateness of the Company's proposal. Finally, in an effort to provide an effective alternative to our original proposal should the Commission share Staff's concerns, I will present several modifications to the Company's proposed program designed to address those concerns. These modifications were previously developed and presented to Staff prior to the filing of this testimony during discussions with the Staff which were held in an effort to reach an agreement on a hedging mechanism that would be acceptable to all parties. While Laclede does not believe that these modifications are truly necessary, they nevertheless provide a simple, straightforward solution to Staff's stated concerns.

Q. Are the concerns raised in Staff's rebuttal testimony being addressed by any other Company witnesses?

A. Yes. John Snell of Risk Management Incorporated (RMI) has submitted testimony explaining why Staff's notions of a proper hedging program, and its criticisms of the Company's proposal, are fundamentally at odds with the financial techniques actually used by most firms to measure and manage price risk. Given Mr. Snell's extensive, hands-on experience in the procurement and use of financial instruments, particularly natural gas financial instruments, I urge the Commission to give serious consideration to his views regarding the appropriateness of the Company's proposed program. Some of the more significant flaws in Staff's analysis are also addressed in the surrebuttal testimony of Laclede witness Scott Jaskowiak. Mr. Jaskowiak also provides additional details on the program modifications which the Company is willing to make in the event the Commission shares any of Staff's concerns.

RESPONSE TO STAFF'S CONCERNS

Q. Do you have any general observations regarding the criticisms which Staff has leveled against the Company's proposed Incentive PSP?

A. What struck me the most about Staff's testimony was its failure to provide a balanced assessment of the Company's proposal and its potential impact on customers. In over thirty years of practice before various regulatory bodies, I have seen many proposals aimed at improving the way utilities perform their public service obligations. I have yet to see a perfect one, and I would be the last to suggest that the Company's proposal in this proceeding could not benefit from a constructive critique. Unfortunately, Staff has failed to provide any guidance on what it believes would be a mutually beneficial, incentive-based hedging program. Staff apparently wants the Commission to believe that Staff's **"buy and hold"** approach to hedging is the only approach worth considering.

Q. You previously indicated that Staff has interjected issues that are irrelevant to a consideration of the Company's proposal. Please explain.

A. Staff witness Sommerer devotes much of his testimony to explaining why he believes the Company needs to "diversify" the pricing of its physical gas supply portfolio, and apparently rely less on indexed-based contracts. In support of this proposition, Mr. Sommerer even attaches an Statement of Policy from the New York Public Service Commission which addresses this subject. If the Company were to respond to this extraneous issue, it would point out in some detail how anachronistic and redundant the New York PSC's limited diversification suggestions are in light of the strides already made by this Commission and Laclede to use financial instruments and other mechanisms to reduce price risk. The clear purpose of this proceeding, however, is to discuss the merits of the Company's hedging proposal -- a purpose that is ill-served by Staff's obvious effort to change the subject.

Q. Aside from introducing extraneous issues, has Staff presented a balanced assessment of the Company's proposal?

A. No. I think it is fair to say that Staff has gone to considerable lengths to paint the bleakest possible picture of the intent and potential impact of each feature of the proposed Incentive PSP. No matter how inconsequential or unlikely a potential concern may be, Staff takes great pains to convert it into an obstacle of seemingly daunting proportions. At the same time, Staff makes absolutely no effort to suggest what steps could be taken, or what modifications could be made in the program, to resolve its concerns. The end result is simply a non-productive hodgepodge of obvious exaggerations regarding supposed flaws in the program that are neither internally consistent nor reflective of the actual operation and intent of the program.

Q. One of the Staff's major criticisms is that the Company's proposal may give Laclede an incentive to **purchase cheaper call options with higher strike prices, rather than more expensive call options with lower strike prices**. Why is this criticism invalid?

A. If it does anything, I think this criticism simply demonstrates Staff's fundamental inability to make up its collective mind on what kind of hedging program it really wants.

Q. Please explain.

A. On the one hand, Staff witness Busch indicates, with apparent favor, that the objective of the current PSP "is to provide price protection to Laclede's ratepayers against severe upward price spikes in natural gas during the winter heating season..." (Busch Rebuttal, p.3; emphasis supplied). If that is the case, then one of the most economical and conservative ways to achieve this objective is to **buy cheaper call options with higher strike prices, since such a strategy will both guarantee savings upfront for the ratepayer while still ensuring price protection in the event severe price spikes actually occur**. Despite this rather obvious fact, however, both Staff witness Busch and Staff witness Sommerer repeatedly criticize Laclede's proposal on the grounds that it gives the Company too great of an incentive to pursue this very type of purchasing strategy, and too little of an incentive to spend more ratepayer money on purchasing **costlier call options that have strike prices substantially below these severe price spike levels**. (Busch Rebuttal, pp. 21-25; Sommerer Rebuttal, pp. 5-6) Under this alternative view, the Staff appears to be suggesting that the primary purpose of the hedging program isn't to **protect against the financial consequences of severe price spikes after all. Instead, Staff appears to be suggesting that the hedging program should be geared towards spending more money on call options that have a better chance of "closing in the money" -- an approach that Staff would undoubtedly characterize as overly speculative if it had been proposed by someone else**.

Q. What is the Company's position on which strategy is appropriate?

A. Generally, the Company agrees with the overall objective of the existing program to provide for **catastrophic price protection. It is the severe upward price spikes that we must guard against. At the same time, if market conditions warrant, it is entirely appropriate to buy some options at a higher cost with a strike price lower than what is deemed to be catastropic price protection. The

Company has attempted to balance both of these objectives by providing incentives for both reductions in the cost of acquiring call options as well as success in achieving lower strike prices which settle in the money**. Given its failure to even clarify which of these objectives it believes is most important, the Staff is hardly in a position to question the manner in which that balance has been struck by the Company. This is particularly true given Staff's corresponding failure to offer any alternative to the Company's proposal.

Q. Do you agree with Staff that there is, in fact, an inappropriate incentive under the Company's program that would bias it towards **purchasing cheaper call options with higher strike prices rather than towards purchasing more expensive call options with lower strike prices**?

A. **No. What the Commission has to recognize is that regardless of whether the Company is achieving savings by reducing the cost of its options purchases or by realizing gains on options with lower strike prices, it will only make money if its customers are also being benefited. In other words, our interests and the interests of our customers are synonymous under the proposed program. Accordingly, if the Company believes, based on its review of current market conditions, that the purchase of a call option with a lower strike price is actually likely to produce a gain, that is "close in the money," it will buy the higher cost option. If, on the other hand, the

Company believes it is unlikely that a more expensive option with a lower strike price will close in the money, it will save both it and the customer money by buying a cheaper option with a higher strike price. That is not to say, of course, that the program cannot be adjusted to provide the Company with an even greater incentive to purchase options with lower strike prices. One such alternative is addressed later in my testimony**.

Q. What about Staff's claim that the Company's proposed program would expose ratepayers to additional risk from rising gas prices?

A. Here again, Staff relies on exaggeration and inconsistent reasoning, rather than solid analysis. For example, both Mr. Sommerer and Mr. Busch claim that the program would result in additional risk for the ratepayer because any **trading out of the options would leave a portion of the volumes which are supposed to be protected under the program unhedged for some period of time. (Sommerer Rebuttal, p. 5; Busch Rebuttal, p. 9-10). In the event prices rose in the interim, so the argument goes, additional risk would be created for the ratepayer. If carried to its logical extreme, however, Staff's position would suggest that the Company should simply purchase all of its call options on the first day of the program in order to ensure that none of the mandated volumes remained uncovered and thus subject to the risk of rising prices. Even Mr. Busch, however, does not endorse such an extreme approach. To the contrary, he states at page 26 of his rebuttal testimony that Laclede should enter the options market in a "piecemeal" manner, taking advantage of dips in the market to buy options at lower strike prices when they are available. Obviously, the risk of rising prices is just as great if one simply waits three or four months to buy an option than if one buys, sells and then repurchases the option over the same period of time. The only difference between the two approaches is that under the second one, the buyer has more flexibility to actually manage the price risk by virtue of the fact that he or she can both buy and sell the option to take advantage of changing market conditions. In other words, the buyer isn't mandated to blindly hold the option, while remaining oblivious to potentially favorable developments in the marketplace**.

Q. Are there other reasons why you believe Staff's concerns regarding the program's risk are misplaced or exaggerated?

A. Yes. Although Staff repeatedly warns of the risk of unlimited increases in gas costs, even its own proposal for hedging, as reflected in the existing program, does not require that more **than 70% of the Company's normal winter volumes be hedged. If the need to avoid potential exposure to price risk was as all-consuming as Staff implies, presumably Staff would demand that utilities protect all volumes that they would expect to purchase during a design winter. The fact that Staff has not

<u>pursued such a requirement suggests that it too is willing to recognize some trade-off between the cost of protection and price risk</u>**. I think Staff's concerns over unlimited increases in the cost of gas also have to be taken with a grain of salt in light of Mr. Busch's comments, in criticizing another aspect of the Company's proposal, that since 1990, the closing contract price for natural gas on the NYMEX market has never been above $4.00 per MMBtu at expiration (Busch rebuttal, p. 25).

Q. But isn't it possible, as Staff suggests, that the Company might leave a substantial portion of its gas supply volumes unprotected because of **trading activities** that, in hindsight, turn out to have been ill-advised?

A. The Company has no intention of **<u>leaving a substantial portion of its gas supply volumes unhedged. Under the program, the Company is required to hedge 70% of its aggregate normal requirements for November through March</u>**. If it does not do so, the Company must assume financial responsibility for the difference between the CPL and the contract settlement price. By undertaking this risk, I believe the Company has provided the Commission with the most powerful type of assurance possible that the mandated volumes will be protected. Laclede management simply has no intention of exposing either its shareholders or its customers to the potentially significant financial consequences which could arise in the event there was a material failure by the

Company to obtain the mandated level of price protection. While it is true that the Company would not be required to compensate the customer for any "losses" that might occur because it did not buy **options with strike prices below the CPL, that is the case today. Under the current program, so long as the Company purchases options with at least a $4.00 strike price (the approved catastrophic price level) it cannot be subject to an imprudence challenge**.

Q. **Does the current PSP require the Company to purchase price protection for 70% of its flowing gas and to provide immediate compensation for any losses which result from a failure to do so**?

A. No. The current program merely authorizes Laclede to procure financial instruments. Of course, if the Company decided not to purchase any price protection, it would be subject to a prudence review. But prudence reviews do not necessarily result in an adjustment and do not provide immediate compensation. Laclede's customers would have to wait for some future prudence disallowance which, as Staff witness Sommerer states at page 4 of his rebuttal testimony, "are typically delayed many months after the case harm has already been done and are always difficult to prove."

Q. Do you think that the Staff seriously believes that Laclede would undertake unreasonable risks?

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Q. Do you think that the Staff seriously believes that Laclede would undertake unreasonable risks?

A. No. Staff repeatedly asserts in its testimony that Laclede is far more likely under the proposed program to take the "safe" route of **locking up savings from the outset through the purchase of cheaper call options with higher strike prices, than it is to follow the more aggressive path of spending more money to acquire call options with lower strike prices on the theory that such options stand a better chance of closing "in the money"** (Busch Rebuttal, pp. 21-25; Sommerer Rebuttal pp. 5-6) While I do not necessarily agree with much of Staff's analysis on this point, the fact remains that Staff can't have it both ways. If Staff truly believes the Company is risk averse enough to always opt for the "bird in the hand", as asserted by Mr. Sommerer at page 6 of his rebuttal testimony, Staff can't simultaneously believe that Laclede is reckless enough to risk huge losses because of a material failure to obtain the mandated levels of price protection.

Q. The Staff appears to object to the ratepayers sharing 50% of the "losses" resulting from the Company acquiring **protection above the CPL after the first 90 days of the program. Please comment**.

A. **I am sympathetic with the Staff's concerns on this point. The reason the Company proposed a 50/50 sharing of any financial consequences resulting from the Company acquiring options with strike prices above the CPL was to make the program symmetrical with the provision that the

Company and its ratepayers share equally (50/50) the financial gains associated with the Company acquiring protection better than the TSP. If the Commission shares Staff's concern and does not believe that ratepayers should shoulder any "losses" resulting from the Company acquiring protection above the CPL, the solution is for the Commission to adopt the modifications to the program which the Company is proposing**.

Q. **Both Mr. Sommerer and Mr. Busch criticize the Company's proposal that it not be required to absorb the financial consequences of acquiring protection above the CPL if, during the *first* 90 days of the program, radical changes in the market place substantially increase the cost of obtaining call options. (Sommerer Rebuttal, p. 6; Busch Rebuttal pp. 20-21) Please comment**.

A. **Although Staff characterizes this aspect of the Company's proposal as a device for reducing the Company's risk, it is, in reality, an essential feature for ensuring that the Company can act rationally, and in the best interests of its customers, in the event market conditions during the first 90 days of the program deviate radically from those assumed when the TSP and CPL are set. As the Commission may recall, at the very time the hedging program was approved last year, there was an immediate and substantial increase in the cost of options. Rather than lock in at these substantially higher prices, *however*, the Company correctly anticipated that the cost of call

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options would eventually fall and, by waiting, was ultimately able to make its purchases at a vastly reduced cost. It is also possible, of course, that prices may immediately escalate again next year and that this time around market conditions will suggest a continuing run-up in prices for the foreseeable future. Under either of these unusual scenario, the Company should have the ability during this limited period of time to either purchase options at strike prices above the CPL or defer such purchases in the event the Company believes option prices are likely to fall, without regard to absorption considerations**. Of course, if the Company believes market conditions have changed radically enough to warrant such actions, it does not believe it should continue to have an opportunity to profit under the program. Accordingly, if Laclede invokes this provision during the first 90 days, it agrees that the incentive aspects of the program should terminate for that year.

Q. What is your reaction to Mr. Busch's suggestion at pages 8-9 of his rebuttal testimony that the Company implement a **paper trading system before conducting an actual trading program**?

A. **It is unrealistic to expect that a paper trading program would be an effective way to either prepare for or predict the success of an actual, incentive-based trading program**. First, it is unreasonable to expect that management would devote the same level of resources and attention to an exercise which has no financial consequences for either the Company or its shareholders. The Company's resources are not unlimited and they must be focused on activities that actually make a difference in terms of the cost and reliability of the services we provide. Accordingly, the results of such an effort would not be reflective of those likely to be experienced under a real program. Second, it has to be recognized that market conditions in the natural gas industry, including trends in the cost of financial instruments, can vary significantly from year to year, based on changes in weather and other factors. Under such circumstances, there is no reason to believe that the results obtained in one year would be reflective of the results that are likely to be experienced in the next year. Indeed, it is for this reason, among others, that the Company believe it is imperative to have a three year program, notwithstanding Staff's concerns.

<u>POSSIBLE MODIFICATIONS TO INCENTIVE PSP</u>

Q. Please explain why the Company has developed several additional modifications to its proposed Incentive PSP.

A. In an effort to develop an effective Incentive PSP that would be acceptable to all parties, the Company prepared and presented to Staff several modifications to its proposal that were designed to address Staff's stated concerns. Although Laclede is not convinced that such modifications are truly necessary, it nevertheless remains willing to make them in the event the Commission shares any of the concerns expressed in Staff's rebuttal testimony.

Q. Please describe these modifications.

A. The modifications which the Company is willing to make to its proposed Incentive PSP are discussed in somewhat greater detail in the surrebuttal testimony of Scott Jaskowiak, where they are presented as Alternative B. The modifications are relatively simple, however, and can be summarized as follows. First, the Company is willing to modify its proposed 50% sharing of financial consequences associated with failing to obtain the required level of price protection. In its place, the Company would agree to absorb 100% of the financial consequences arising from such a failure, subject to the 90 day window period which I previously discussed. In exchange for undertaking this additional risk, and in an effort to address Staff's concerns regarding the program's supposed bias against **purchasing options with lower strike prices, Laclede would also propose that it be permitted to share in 25% of any gains realized from the sale of options with strike prices between the TSP and the CPL, and 60% of the gains realized from the sale of options with strike prices below the TSP. Finally, in the interests of further simplifying its proposal and addressing two other concerns identified by the Staff, the Company is willing to eliminate from its proposal the proposed use of put options and the ability to purchase call options in non-winter months**.

Q. How do these additional modifications address Staff's concerns?

A. To the extent there is any lingering concern over the Company's commitment to actually obtain the required level of price protection on **70% of its aggregate normal winter volumes**, it should be completely eliminated by the Company's agreement to absorb 100% of the financial consequences associated with its failure to do so. While I believe this additional incentive is unnecessary, it is certainly responsive to Staff's stated desire to have a **firm cap** on the customer's exposure to price risk. Indeed, by agreeing to absorb amounts in excess of the CPL, the Company's proposal provides far more protection from such risk than does the existing program.

Q. **How does affording the Company the opportunity to retain 25% of the gains realized on call options purchased between the TSP and the CPL address Staff's concerns**?

A. **By permitting the Company to retain a share of the gains resulting from the sale of call options with strike prices between the TSP and CPL, as well as a slightly larger share of any gains realized below the TSP, such a modification should serve to ameliorate Staff's concerns over whether the proposed program gives the Company an incentive to purchase cheaper call options at higher

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strike prices, rather than more expensive call options at lower strike prices. Although the Company already believes it has an incentive to pursue lower strike prices when market conditions are favorable, such a change will obviously make that strategy even more attractive relative to the cost reduction aspect of the program**. Of course, as I stated previously, such a change is also warranted by the Company's assumption of greater risk under the program, as described above.

Q. Please summarize your testimony.

A. The Incentive PSP has been designed by the Company to impose only very limited risk on Laclede's ratepayers. Because Laclede will only **trade in call options, the maximum cost of the program will be strictly limited to the actual purchase price of these options, plus transaction costs. Moreover, because Laclede will guarantee the purchase of call options covering 70% of its normal winter requirements, the ratepayers' risk of gas price escalation will be limited and even reduced from the risk contained in the current program. On the other hand, the Company believes that the potential benefits of the program are substantial. If Laclede has the opportunity and incentive to optimize the value or minimize the cost, of its option purchases, then both the Company and its customers will clearly benefit**.

Given the proposed program's limited risks to ratepayers and substantial potential benefits, it is difficult to understand why Staff has failed to suggest modifications to accommodate its concerns. The Commission should not permit such a failure to prevent the implementation of an innovative program that offers substantially more benefits to Laclede and its customers than those afforded by continuing the inflexible, **blind "buy-and-hold" approach** to hedging that Staff advocates. For all of these reasons, I would urge the Commission to approve the Company's initial proposal or, if it is so inclined, the revised proposal which has been developed by the Company to address Staff's stated concerns.

Q. Does this conclude your surrebuttal testimony?

A. Yes, it does.