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Sponsoring Party: Missouri Propane Gas Ass'n

Case No.: GA-2007-0212, *et al.*

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Date 7-27-07 Case No. GA-2007-0212
Reporter SMB GA-2007-0310,
GF-2007-0215

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Southern Missouri Gas Company, L.P.'s Purchased Gas Adjustment Factors to be Reviewed In Its 2005-2006 Actual Cost Adjustment.	)))	Case No. GR-2006-0352

RESPONSE TO STAFF RECOMMENDATION OF SOUTHERN MISSOURI GAS COMPANY, L.P. D/B/A SOUTHERN MISSOURI NATURAL GAS

Comes now Southern Missouri Gas Company, L.P. d/b/a Southern Missouri Natural Gas ("SMNG") and pursuant to 4 CSR 240-2.080 and the Order Directing Filing issued on June 19, 2007, provides its Response To Staff Recommendation as follows:

1. On June 19, 2007, the Commission issued its Order Directing Response directing SMNG to respond to the recommendations of the Commission Staff no later than July 19, 2007. The purpose of this pleading is to comply with this order.

2. On June 8, 2007, the Commission Staff filed its recommendations following the completion of the audit of the Actual Cost Adjustment ("ACA") rates for the 2005/2006 ACA period. The Commission Staff reviewed SMNG's calculations and made the following recommendations:

"The Staff recommends that Southern Missouri Natural Gas :

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

Using High End of Staff's Recommended Adjustment for Hedging			
Description	**Company's Ending Balances Per Filing**	**Staff Adjustments**	**Staff Recommended Ending Balances**
Prior ACA Balance 8/31/05	232,412		232,412
Cost of Gas	6,709,644	(378,470)	6,331,174

Cost of Transportation	1,134,650		1,134,650
Revenues	(8,078,415)		(8,078,415)
Pipeline Refunds Received	0	(209)	(209)
Interest on Under-recovered ACA Balance	15,835		15,835
Total ACA Balance 8/31/06	14,126	(378,679)	(364,553)

Using Low End of Staff's Recommended Adjustment for Hedging			
Description	**Company's Ending Balances Per Filing**	**Staff Adjustments**	**Staff Recommended Ending Balances**
Prior ACA Balance 8/31/05	232,412		232,412
Cost of Gas	6,709,644	(220,453)	6,489,191
Cost of Transportation	1,134,650		1,134,650
Revenues	(8,078,415)		(8,078,415)
Pipeline Refunds Received	0	(209)	(209)
Interest on Under-recovered ACA Balance	15,835		15,835
Total ACA Balance 8/31/06	14,126	(220,662)	(206,536)

2. Maintain a current hedging plan, evaluate the placement of hedges earlier and over a longer time framer, continue to evaluate the possibility of further diversifying its gas supply portfolios including a gas supply planning horizon of multiple years and evaluation of firm storage opportunities, and keep abreast of the market developments to help its gas procurement decision-making. The current hedging plan must include detailed plans to provide proper documentation of gas purchasing decisions at the time that such decisions are made.

3. Respond to the concerns expressed by Staff in the Reliability Analysis and Gas Supply Planning section within 30 days with a detailed plan of action to address these issues.

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

SMNG Response to Staff Recommendation

3. After reviewing the Staff's Recommendation and Memorandum in this matter, the Company has determined that the above-referenced recommendations are acceptable to the Company, with the exception of Staff's proposed adjustment for hedging practices. SMNG adamantly disagrees with Staff's recommended "...adjustment to reduce gas costs by $220,453 to $378,470 for this ACA period." (Staff Memorandum, p. 6 of 11).

4. A disallowance of this magnitude would be financially detrimental to the Company's ability to continue to provide safe and reliable service throughout its Missouri service areas. In addition, the Staff's proposed adjustment appears to be based solely on the use of hindsight, and is therefore an unlawful and unreasonable adjustment.

Legal Standard For Prudence Adjustments

In *Re Missouri Gas Energy*, 11 Mo.P.S.C.3d 206, 222-224 (March 12, 2002), the Commission established the legal standard for reviewing the prudence of a natural gas corporation's purchases of natural gas. In this case, Staff had proposed to disallow approximately $3.5 million in natural gas costs incurred by Missouri Gas Energy in its 1996-1997 ACA period. In rejecting the Staff's proposed prudence adjustment, the Commission explained the application of the prudence standard in ACA cases as follows:

> The Commission established its prudence standard in a 1985 case involving the costs incurred by Union Electric Company in constructing its Callaway nuclear plant. In determining how much of those costs were to be included in Union Electric's rate base, the Commission adopted a standard for determining the prudence of costs that had been established by the United States Court of Appeals, District of Columbia, in a 1981 case. The standard adopted by the Commission recognizes that

a utility's costs are presumed to be prudently incurred, and that a utility need not demonstrate in its case-in-chief that all expenditures are prudent. "However, where some other participant in the proceeding creates a serious doubt as to the prudence of an expenditure, then the applicant has the burden of dispelling those doubts and proving the questioned expenditures to have been prudent."

The Commission, in the Union Electric case, further established that the prudence standard was not based on hindsight, but upon a reasonableness standard. The Commission cited with approval a statement of the New York Public Service Commission that:

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

(footnotes omitted).

Based upon the legal standard adopted by the Commission in the Missouri Gas Energy case, SMNG should not be subjected to any disallowance of its natural gas costs. SMNG used its best judgment under all the circumstances to make its gas purchasing and hedging decisions, using the information that was available at the time of the decisions. It is not reasonable for the Staff to Monday-morning-quarterback those Company decisions nearly two years later when historic pricing information is now available.

With the benefit of complete hindsight, Staff has proposed three alternative adjustments based upon three alternative Scenarios. Scenarios I and II assume that SMNG would have locked in the record high natural gas prices that existed on 7/26/05 and 9/2/05 in addition to the basis hedges that were locked in on those dates. Scenario III assumes that SMNG would have locked in 54% of the normal winter volumes on 8/11/05 and 8/24/05 and also applied the actual basis differentials that SMNG had secured on 7/26/05 and 9/2/05. Staff's proposed adjustment(s) are based upon a comparison of what the cost of gas hypothetically would have been had SMNG utilized the purchasing strategies assumed in the Scenarios, rather than using the Company's actual hedging and purchasing plan. However, the "damages" calculated by Staff are based upon the use of 20/20 hindsight, and not upon the information that was available at the time the purchasing decisions were being made by SMNG.

As SMNG has previously explained to the Commission in hearings held on September 29, 2005 in this case, SMNG believed it was prudent to utilize basis hedges, and lock in all-time high basis differentials (i.e. discounts to the NYMEX)(Tr. 44, 46) as the natural gas prices soared to all-time high levels following the price increases that resulted from hurricanes and hedge fund activities in the summer of 2005. (Tr. 43-52) It is unreasonable and unlawful to make a prudence disallowance based upon information (i.e. future natural gas prices later in the winter) that was not available at the time decisions were being made, as Staff is proposing. In fact, the Company used its best judgment, based upon the information that was available at the time, to determine the prudent purchasing and hedging practices for the 2005-2006 winter heating season. In fact, during the hearings held on September 29, 2005, in this case, Staff witness Tom Imhoff testified that the PGA tariff in this matter was calculated in conformance with SMGC's tariffs. (Tr. 110)

During the hearings held in this case on September 29, 2005, Staff witness David Sommerer also was given the opportunity to recommend to SMNG whether to lock in its gas supply at that time (i.e. September 29, 2005), based upon the information that was then available to Staff. He declined to make any recommendations about whether the Company should lock in its winter supplies at that time, and testified that he did not know whether the prices would continue to go up for the rest of the winter. He also confirmed that had the Company locked-in the prices at that time that those prices would have been more than twice the prices of the previous winter (Tr. 158-159):

Q. Okay. Mr. Sommerer, would you recommend that the company lock in its gas supply at this time (i.e. September 29, 2005)?

A. I would not make a recommendation either way for the company's purchasing they haven't been made and it's inappropriate for me to make that recommendation.

* * *

Q. Is the Staff projecting that markets are going to continue to go up the rest of the winter?

A. No.

Q. Do you think they're going to come down?

A. I don't know.

Q. Had the company locked in at the 8, 9 dollar range, would you agree that that would have higher than the whole winter cost of last year?

A. Based upon my recollection, I think that would be the case, yes.

Q. And that would be – if we locked in today, it probably be more than twice what it was last year; is that correct?

A. Depending on whether you included transportation, but I think those percentages are within the ballpark. (Tr. 159-160)

Based upon Staff's unwillingness to suggest that the Company should lock in its natural gas supplies in the face of record high natural gas prices, and Staff's admitted inability to predict which direction prices were going to go at the time that the Company had to be make its purchasing decisions, it is now disingenuous for Staff to propose an adjustment after-the-fact and based on information that was not available to the Company that would suggest that SMNG was imprudent for not locking in prices on 7/26/05 and 9/2/05. Of course, with only contemporaneous information available, Staff was unwilling to recommend that the Company lock in prices at this time. Staff, like SMNG personnel, did not know the direction of the market prices, based only upon contemporaneous information. As explained herein, it is not lawful or reasonable for the Commission to adopt Staff's approach and use 20/20 hindsight to make such a prudence adjustment now that more complete price information is available.

Staff also observed that SMNG's hedging practices for the winter months, November 2005 through March 2006, did not follow its past practice of purchasing fixed price contracts in the summer of 2005. As previously explained in hearings held on September 29, 2005 in this case, SMNG was facing substantially different market conditions during the summer and fall of 2005 than had existed in previous years. As Staff noted in its Staff Memorandum, "Unfortunately, the NYMEX future prices, continued to rise throughout the summer and fall of 2005 amid one of the most devastating U.S. Gulf hurricane seasons and for much of the rest of the year." (Staff

Memorandum, page 4 of 11). This highly unusual occurrence required that SMNG modify its past practices in order to secure the most reasonably priced natural gas for its customers. While it may be possible with 20/20 hindsight to point to the time it would have been the least expensive to utilize the basis differentials and lock-in fixed price contracts, this is not the legal standard that is required to be utilized in this case.

It is also important to point out that SMNG faces very real and unregulated competition from the propane industry. As a result, in addition to mitigating price volatility, SMNG must also be conscientious about keeping its gas supply costs as low as possible which was a factor in its decision to lock in record high "discounts" (i.e., basis differentials) with the full intent of locking in fixed prices for the winter.

Staff also criticizes SMNG for deviating from its Gas Supply Plan dated August 26, 2005. (Staff Memorandum, page 5 of 11). Given the highly unusual circumstances that existed at the time the Company's purchasing and hedging decisions were being made, it was necessary to deviate from its previous plan to purchase 60-75% of the winter heating-season gas supplies at fixed prices. Had the Company mindlessly followed its Gas Supply Plan dated August 26, 2005, it would have been locking-in some of the highest natural gas priced supplies in its history. Based upon the fundamentals in the gas market that existed at that time, SMNG management felt that the most prudent course of action was to lock-in record high basis differentials, and then exercise those basis differential hedges when the natural gas prices moderated. SMNG followed this plan, and as result, SMNG's customers benefited from the use of these basis hedges.

SMNG has committed, as a part of the settlement in Case No. GC-2006-0180 which was approved by the Commission on April 11, 2006, to follow a practice of purchasing fixed price contracts as follows:

> The Signatory Parties agree that SMNG's initial gas supply purchasing and hedging strategies plan to be filed on April 1, 2006, for the 06-07 winter heating season shall adhere to the following requirements: (1) SMNG will secure a minimum of 20% of normal winter heating-season gas supply at fixed prices or otherwise hedged against market exposure, no later than April 30, 2006, unless good cause is shown for deviating from this benchmark; (2) SMNG will secure a minimum of 40% normal winter heating-season gas supply at fixed prices or otherwise hedged against market exposure, no later than July 15 of 2006, unless good cause is shown for deviating from this benchmark; (3) SMNG will secure a minimum of 55% of normal winter heating-season gas supply at fixed prices or otherwise hedged against market exposure, no later than October 1, 2006, unless good cause is shown for deviating from this benchmark.

(Unanimous Stipulation And Agreement, p.3, Case No. GC-2006-0180). SMNG successfully completed this plan in the 06-07 winter, and has developed similar hedging plans for the upcoming winter of 2007-2008.

For these reasons, the Staff should reconsider its $220,453 to $378,470 disallowance related to SMNG's purchasing practices.

<u>SMNG Comments Regarding Reliability and Gas Supply Planning</u>

5. As a general matter, Staff also requests that SMNG provide better documentation in the future to support its gas supply purchasing decisions. SMNG agrees to provide better documentation of its various assumptions as discussed more specifically below:

a. Estimates of Peak Day Requirements and Monthly Requirements

SMNG agrees with Staff's observation that on a moving forward basis, SMNG is improving its documentation supporting its estimates of peak day requirements and monthly requirements. SMNG hopes to continue to provide the improved documentation requested by the Staff to support these estimates. SMNG will continue to make attempts to provide more data for large general and large volume customers for estimating peak day requirements.

2. Planning for Capacity Levels for Future ACA periods

a. Market Area Capacity

Staff indicated that it intends to review SMNG's decisions to obtain increased pipeline capacity in the next ACA audit. SMNG will be responsive to Staff's questions regarding this topic in the future investigation. SMNG would respectfully point out at this time that interstate pipeline capacity has proven to be a difficult resource to expand in small increments, and SMNG expects to need this capacity as it expands its service areas in the future.

b. Upstream Capacity

As Staff recommends, SMNG's assumptions and decisions for its peak day planning will continue to be documented in the future, including supporting workpapers.

3. Company Gas Supply Plans for Cold Weather

As Staff recommends, SMNG's reliability analysis and gas supply plans will continue to examine the issue of supply availability for extremely cold days. At this point, SMNG believes that its peaking contracts will provide the assurances for cold weather supply for SMNG.

4. Company Documentation of Gas Supply Decisions

As discussed above, SMNG intends to continue to improve its documentation for gas purchasing decisions and the actual transaction selected.

WHEREFORE, having responded to the Staff Recommendation, Southern Missouri Gas Company, L.P. d/b/a Southern Missouri Natural Gas requests that the Commission to issue an Order scheduling a prehearing conference to discuss a procedural schedule in this matter.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the above and foregoing document was emailed, mailed or hand-delivered, this 19th day of July, 2007, to:

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