MEMORANDUM

TO: Missouri Public Service Commission Official Case File, Case No. GR-2005-0104, Missouri Gas Energy, a Division of Southern Union Company

FROM: David M. Sommerer, Manager - Procurement Analysis Department
Annell G. Bailey, CPA, Regulatory Auditor - Procurement Analysis Department
Phil S. Lock, Regulatory Auditor - Procurement Analysis Department
Lesa A. Jenkins, PE, Regulatory Engineer - Procurement Analysis Department
Kwang Choe, PhD, Regulatory Economist - Procurement Analysis Department

/s/ David M. Sommerer 12/29/05	/s/ Thomas R. Schwarz 12/29/05
Project Coordinator / Date	General Counsel's Office / Date

SUBJECT: Staff's Recommendation in Missouri Gas Energy's 2003-2004 Actual Cost Adjustment Filing

DATE: December 29, 2005

I. BACKGROUND

The Procurement Analysis Department (Staff) has reviewed the Missouri Gas Energy (MGE or Company) 2003-2004 Actual Cost Adjustment (ACA) filing. This filing was made on October 15, 2004, and was docketed as Case No. GR-2005-0104. The filing contains the Company's calculations of the ACA and Refund account balances. The 2003-2004 ACA filing rates became effective on November 1, 2004.

MGE serves approximately 500,000 customers in the Kansas City, Joplin and St. Joseph areas. MGE transports its gas supply over Panhandle Eastern Pipe Line (PEPL), Southern Star Central Gas Pipeline, Mid-Kansas Partnership/Riverside Pipeline Company (MKP/RPC) now called Enbridge Pipeline (most recently known as Kansas Pipeline Company (KPC) and Kinder Morgan Interstate Gas Transmission (KM).

Staff audited and evaluated MGE's billed revenues and actual gas costs for the period of July 1, 2003, to June 30, 2004. The Staff also reviewed MGE's gas purchasing practices to determine the prudence of the Company's purchasing and operating decisions. Staff conducted a reliability analysis of estimated peak day requirements and the capacity levels needed to meet those requirements; peak day reserve margin and the reasons for this reserve margin; and a review of normal and cold weather requirements. Staff also reviewed MGE's hedging for the period to determine the reasonableness of the Company's hedging plans.

Staff proposes two adjustments to MGE's gas costs, and makes six recommendations to improve MGE's gas supply planning. The adjustments are a reduction in gas costs of $2,233,540 for imprudently incurred transportation costs under MGE's contract with Kansas Pipeline Company (KPC), and a reduction of $2,044,795 in gas costs for excess reserve margin for unneeded pipeline capacity. The six planning improvements are to MGE's short-term gas purchasing practices, calculation of peak day gas supply estimates, planning for upstream pipeline capacity, storage usage planning, planning for non-normal weather needs, and hedging practices.

II. ADJUSTMENTS

A. MKP/RPC PIPELINE ADJUSTMENT

MGE incurred natural gas costs under its transportation contract with KPC that are substantially greater than comparable pipelines. For this reason, the Staff has proposed the following adjustments to reduce MGE's gas costs in its prior six ACA cases:

Case Number	ACA Period	Adjustment
GR-98-167	1997-1998	$4,330,732
GR-99-304	1998-1999	$5,914,200
GR-2000-425	1999-2000	$5,886,058
GR-2001-382	2000-2001	$5,341,128
GR-2002-0348	2001-2002	$6,099,369
GR-2003-0330	2002-2003	$3,570,936

The Staff proposes to reduce MGE's gas costs by $2,233,540 for this ACA period. This adjustment is necessary for the same reasons that the Commission made an adjustment in Case No. GR-93-140, that the initial 1991 contract resulted in imprudent excessive transportation charges from the KPC contract. Subsequent modifications to the contracts mitigated, but did not completely eliminate, effects of the imprudence of the KPC contract cited by the Commission in Case No. GR-93-140. Excessive transportation charges continued in the 1995 contracts, with some mitigation that Staff fully credits in its proposed adjustments for each relevant period. During 1998, the "bundled" sales/transportation service with KPC was replaced with a "transportation only" service.

The Federal Energy Regulatory Commission (FERC) has significantly reduced KPC's transportation rates and ordered refunds for service during several of the ACA periods discussed above. On December 13, 2004, Enbridge Pipeline (formerly KPC) filed tariff sheets and a refund plan covering the period of December 2, 1997, through November 8, 2002. The following is a summary of refund obligations to MGE:

- FERC approved principal and interest through December 31, 2004, totaling $13,523,203;
- Incremental interest from January 1, 2005, through payment date of January 28, 2005, totaling $49,276;
- Total payment to MGE of $13,572,479.

In compliance with FERC's January 21, 2005, order, Enbridge shall file effective tariff sheets within 30 days of the order. The refunds should therefore become effective beginning with the

2004-2005 ACA. The refunds flowed back to the customers will reduce the disallowances summarized in the table above.

B. EXCESS RESERVE MARGIN

Staff has documented concerns with the Company's peak day planning/reliability analysis in the previous four cases: Case No. GR-2003-0330 (2002-2003 ACA), Case No. GR-2002-348 (2001-2002 ACA), Case No. GR-2001-382 (2000-2001 ACA), and Case No. GR-2000-425 (1999-2000 ACA). Staff's concern with MGE's peak day planning/reliability analysis continues for the 2003-2004 ACA, Case No. GR-2005-0104.

MGE revised and extended the terms of transportation contracts beginning with the 2001-2002 ACA and continuing through 2005-2006. The decision to contract for this level of capacity results in an excess reserve margin and increases costs to customers beginning with the 2001-2002 ACA and continuing through the 2005-2006 ACA. MGE has not adequately calculated its peak day requirements and has not provided justification for its excess reserve margin.

Staff recommends a disallowance in this case for excess capacity because the Southern Star capacity decision continues to needlessly increase customer costs because MGE purchased more capacity than it needed to meet peak day requirements. Excess capacity for the Kansas City and St. Joseph service areas totals ** ______ ** Dth day. Staff evaluated the cost of this excess reserve margin and recommended that $2,041,931 be refunded to customers for the 2001-2002 ACA period and $2,015,661 for the 2002-2003 ACA period.

Because Staff's disallowance considered that the Company reviews capacity over several years to allow for contracting of capacity in blocks, more reserve is acceptable in the 2001-2002 ACA (the ACA first impacted by the contract extension) to allow for a sufficient reserve in the 2005-2006 ACA. The excess capacity disallowed for the 2003-2004 ACA would be the same as the volume disallowed for the 2001-2002 ACA and 2002-2003 ACA, which is ** ______ ** Dth/Day for the Kansas City portion of MGE's service area and ** ______ ** Dth/Day for the St. Joseph portion of MGE's service area, for a total disallowance of ** ______ ** Dth/Day. No disallowance is proposed for the Joplin portion of MGE's service areas because the analysis shows there is a shortfall of capacity beginning in the 2004-2005 ACA for the Joplin area. A summary follows of the reserve margins for each of the three areas.

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The disallowance is $2,044,795 for this excess capacity for the 2003-2004 ACA period, which is approximately $4.03 per customer.

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III. PLANNING IMPROVEMENT RECOMMENDATIONS

A. SHORT-TERM GAS PURCHASING PRACTICES

For gas supply purchases of less than a month, Staff believes that MGE should document in writing all details of the gas supply transactions (including volumes and pricing) between the

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Company and the supplier. Written documentation in the form of supply confirmations or Instant messages (online messages between the Company and supplier negotiating the contract) are examples. Staff believes that the Company should maintain documentation of all gas supply transactions, whether long or short term transactions, until the Staff completes its review. This documentation should not replace the "Deal Sheets" currently provided by MGE but should act as a supplement to those documents.

B. PEAK DAY ESTIMATES

For the 2003-2004 ACA period the Company refers to the 2002-2003 Reliability Report that shows peak day estimates for the 12 years of 2001-2002 through 2012-2013. This is the same report that MGE referred to in the 2002-2003 ACA review, GR-2003-0330.

Staff reviewed and commented on the 2002-2003 Reliability Report in the prior ACA, the 2002-2003 ACA, GR-2003-0330. Additionally, Staff reviewed and commented on the MGE March 2004 Draft Demand/Capacity Analysis (March 2004 Analysis) and subsequent data and information in the 2002-2003 ACA review. Although the peak day estimates in the March 2004 Analysis were not for the 2002-2003 ACA period, some of the daily data provided should have been available to MGE for the 2002-2003 ACA period. Since these reports were reviewed in the 2002-2003 ACA, Staff comments will be the same. Please refer to the Staff ACA recommendation from the 2002-2003 ACA, Case No. GR-2003-0330.

C. UPSTREAM PIPELINE CAPACITY

MGE does not record how it evaluates the upstream pipeline capacity to assure that it has sufficient capacity for the winter months and the summer months at an acceptable cost. Staff recommends that MGE provide more details of its evaluation of the upstream pipeline capacity to assure that it has sufficient capacity for the winter months and the summer months with acceptable cost. Staff recommends that MGE submit such information for 2004-2005 and 2005-2006 not later than May 1, 2006. If MGE does not have such an analysis for the 2004-2005 or 2005-2006 ACA periods, Staff recommends that the Commission order MGE to provide, no later than May 1, 2006, a more detailed analysis for the 2006-2007 ACA period.

D. STORAGE PLANNING/ USAGE

MGE's planned and actual storage withdrawals for normal weather continue to be a concern. For normal weather, MGE plans to have the largest storage withdrawal in November, the heating season month with the second fewest number of heating degree days (and very near March, the month with the fewest HDD). Staff raised similar concerns in Case No. GR-2003-0330 (2002-2003 ACA), Case No. GR-2002-348 (2001-2002 ACA), and Case No. GR-2001-382 (2000-2001 ACA).

A summary from recent Reliability Reports, shown in the table below, illustrates that the planned withdrawal for November, beginning with the 2000-2001 Reliability Report was higher than that shown for November in the previous three Reliability Reports (1998-1999, 1997-1998, and 1996-1997). Staff would expect the plan for storage withdrawals to follow a similar distribution to that of normal heating degree days.

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The Company has suggested that it withdraws a substantial quantity of storage gas during the month of November to ensure that it can contract for a high level of flowing gas volumes for the remaining winter months. It seems more reasonable for MGE to conserve storage for the later winter months, months with a real possibility of having extremely cold temperatures, so that it can meet the Southern Star requirement of having one-half to two-thirds supply from storage for cold days in the later winter months.

To compound matters, MGE's actual withdrawals for 2003-2004 differ from the Company's plan for normal storage withdrawals. November 2003 had normal weather, but MGE storage withdrawals were ** _____ ** of the MSQ, instead of the normal plan of ** _____ ** of the MSQ. Thus, MGE departed from its own plan, but has provided no reason for doing so.

Staff recommends that MGE explain whether its storage plan has changed or why MGE did not follow its stated storage plan, within thirty days. If the storage plan has been revised, Staff recommends that MGE submit to Staff the revised storage plans no later than May 1, 2006.

E. PLANNING FOR NON-NORMAL WEATHER

In Case No. GR-2003-0330 (2002-2003 ACA) and Case No. GR-2002-348 (2001-2002 ACA), Staff expressed concerns that the Company does not document its plans for each month for meeting natural gas requirements other than normal weather. This remains a concern for the 2003-2004 ACA because the Company has not provided any supply plans for meeting demand if the weather is extremely warm or extremely cold.

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Combined deliverability of MGE's storage and flowing supply could have provided 80.7% of the 2003-2004 peak day requirements. MGE does not elaborate on how the remaining 19.3% of the supply requirements would have been met had a peak historic cold day occurred.

Staff recommends that the Company's Natural Gas Supply Plan more fully document the flowing supply targeted volumes (base load, term, swing, and spot) and planned storage withdrawals for the extremes of warm and cold weather months. Staff recommends that, for subsequent ACA reviews, MGE provide more details of its analysis and plans to address these issues. Staff further recommends that this information for 2004-2005 and 2005-2006 be submitted no later than May 1, 2006. If MGE does not have such an analysis for the 2004-2005 or 2005-2006 ACA periods, Staff recommends that the Commission order MGE to provide, no later than May 1, 2006, a more detailed analysis for the 2006-2007 ACA period.

F. HEDGING

In its review of MGE's purchasing practices, the Staff reviewed the Company's hedging transactions. The Staff also reviewed the Company's natural gas trading procedures, price risk management, procurement program and 2003 hedging strategies. MGE did a reasonable job of hedging for this ACA period.

Based upon information the Staff has reviewed, the Company assessed which direction prices were going to move in the market. MGE used storage and fixed forward prices for most of the volumes needed for the winter heating season November 2003 through March 2004, supplementing the December 2003 through March 2004 volumes with financial instruments. The Company started using the financial instruments at the beginning of November 2003 and continued purchasing them through most of February 2004.

Overall, the winter hedge covered about 72% of gas actually delivered for the winter heating season from November 2003 through March 2004. This winter season experienced heating degree days that were 96% of normal (somewhat warmer than normal). The Company relied heavily on storage for the month of November 2003, then substantially less on storage and more on financial instruments by March 2004.

Although the Company used a diversified portfolio approach to hedge against market risks for the winter heating season November 2003 through March 2004, Staff recommends that the Company analyze its hedging risk for each winter month under normal conditions and cold weather conditions, including cold weather that may occur late in the winter season. This analysis should include a review of the volumes hedged and the associated cost. Finally, MGE should analyze each month where price exposure exists, to evaluate the costs and risks of not covering, or minimally covering, the unhedged price volatility for that particular month. The Staff further recommends that the Company continue to update and document its hedging decisions and provide the documentation to the Staff during each ACA review. This documentation should include an overall hedging plan that addresses hedging goals, objectives, and strategies for each month of each ACA review. The Company should also evaluate longer term time horizons for placing hedges. Historical Company practice has shown that hedging for the winter is generally not started until the spring prior to the winter that is hedged. In essence, most of the hedging would be done from the time period between spring and fall just prior to the winter under consideration. This tends to compress the Company's hedging in a relatively short time frame with substantial amounts left to be placed in the fall season, just before winter commences. Finally, the Company should test for hedge effectiveness for any financial instruments that attempt to hedge the physical price risk exposure. The plan should be documented and completed well in advance of each approaching winter season.

IV. RECOMMENDATIONS

The Staff recommends that this ACA case remain open pending an Order from the Commission in Case Nos. GR-98-167, GR-99-304, GR-2000-425, GR-2001-382, GR-2002-0348 and GR-2003-0330.

Additionally, it is Staff's opinion that the Company should do the following:

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

Account	6-30-04 Ending Balances per MGE Filing	Staff Adjustments Current ACA Period	Staff Adjustments Prior ACA Periods	Staff Recommended Ending Balances at 6-30-04
2003-2004 ACA Adjustments: MKP/RPC Pipeline Excess Reserve Margin	$ 4,375,105	 $(2,233,540) $(2,044,795)	$(39,112,707)[A]	$(39,015,937)
Residential, Small General Service & Large General Service Refund	$ 381,150	$0	$ 0	$ 381,150
Large Volume Refund	$(737,199)	$0	$0	$(737,199)

Notes to Staff Adjustments:

A) ACA beginning balance 6-30-03 adjustment to agree with current status of prior year issues in Case No. GR-2003-0330. (Per Staff's "ACA-1" worksheet).

2. Address gas supply documentation concerns. Staff recommends that the Company maintain detailed documentation of all gas supply transactions (long or short term) between itself and suppliers.

3. Improve its estimation of peak day requirements.

4. Provide more details of its evaluation of the upstream pipeline capacity to assure that it has sufficient capacity for the winter months and the summer months with acceptable cost. Staff recommends that MGE submit such information for 2004-2005 and 2005-2006 no later than May 1, 2006. If MGE does not have such an analysis for the 2004-2005 or 2005-2006 ACA periods, Staff recommends that MGE provide, no later than May 1, 2006, a more detailed analysis prior to the 2006-2007 ACA period.

5. Explain whether its storage plan has changed or why MGE did not follow its stated storage plan, and submit this explanation within thirty days. If the storage plan has been revised, Staff recommends that MGE submit to Staff the revised storage plans no later than May 1, 2006.

6. Provide more details of its analysis and plans for meeting natural gas requirements from flowing supplies and storage for situations involving other than normal weather each month of the winter, and submit this information for 2004-2005 and 2005-2006 no later than May 1, 2006. If MGE does not have such an analysis for the 2004-2005 or 2005-2006 ACA periods, Staff recommends that MGE provide, no later than May 1, 2006, a more detailed analysis for the 2006-2007 ACA period.

7. Analyze its hedging risk for each winter month under normal conditions and cold weather conditions, including cold weather that may occur late in the winter season. This analysis should include a review of the volumes hedged and the associated cost. MGE should analyze each month where price exposure exists, to evaluate the costs and risks of not covering, or minimally covering, the unhedged price volatility for that particular month. The Staff further recommends that the Company continue to update and document its hedging decisions, and provide the documentation to the Staff during each ACA review. This documentation should include an overall hedging plan that addresses hedging goals, objectives, and strategies for each month of each ACA review. The Company should also evaluate longer term time horizons for placing hedges. Historical Company practice has shown that hedging for the winter is generally not started until the spring prior to the winter that is hedged. In essence, most of the hedging would be done from the time period between spring and fall just prior to the winter under consideration. This tends to compress the Company's hedging in a relatively short time frame with substantial amounts left to be placed in the fall season, just before winter commences. Finally, the Company should test for hedge effectiveness for any financial instruments that attempt to hedge the physical price risk exposure. MGE should prepare and complete the plan well in advance of each approaching winter season.

   Staff recommends that MGE's hedging information for 2004-2005 and 2005-2006 be submitted no later than May 1, 2006. If MGE does not have such an analysis for the 2004-2005 or 2005-2006 ACA periods, Staff recommends that MGE provide, no later than May 1, 2006, a more detailed analysis prior to the 2006-2007 ACA period.

8. Respond to the recommendations herein within 30 days.