BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of the PGA Filing for Laclede Gas Company.	))	**Case No. GR-2004-0273**

STAFF'S PREHEARING BRIEF

COMES NOW the Staff of the Missouri Public Service Commission (Staff), by and through counsel, and for its Prehearing Brief states:

THE ISSUE

Laclede paid excessive prices for the right to **________________________ ____________________ ** for the 2003-2004 ACA period. Because these costs were easily avoided through prudent management decision-making, the Commssion should disallow the excessive costs from the rates charged by Laclede to its customers.

Laclede paid over **____ ________________________** In the three previous years, Laclede had paid only **____**. In spite of the tremendous increase in **____________________** facing Laclede as it sourced its supply for the 2003-2004 ACA, Laclede didn't even flinch. Instead, Laclede pressed on with its past practice and without adequate analysis paid over **________________ ________** Now Laclede seeks to pass the costs on to its customers. The Staff proposes that $2,055,864 of these **__________________** be disallowed in rates and should be refunded to customers.

Summary of Staff's Position

The facts show that Laclede was imprudent in its planning and decision-making

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for the 2003-2004 ACA period because: 1) Laclede did not perform an updated analysis for **____,** and 2) Laclede instead relied on a seriously flawed 1996 study to plan its **____________________** gas in 2003, and 3) Laclede ignored the tremendous increase in **______________________________** in order to continue making off-system sales that primarily benefitted its shareholders while customers footed the **____________** bill to make the off-system sales possible.

Laclede should have reassessed its gas procurement strategy based on the information readily available to it and opted for **______________________.**

BACKGROUND

Natural Gas Pricing

The natural gas commodity is unregulated and LDCs such as Laclede negotiate and contract with natural gas producers for their gas supply.[1] Index pricing is often used by LDCs to set the commodity price for natural gas from producers and marketers. A first of the month (FOM) index price is established during a "bid-week" during the last few days of a month prior to the beginning of the month that the gas flows.[2] The FOM price will remain fixed for the entire month that the gas flows and be reset at the end of the month during the next bid-week. On the other hand, a daily index price is calculated for each day and may change daily. In both FOM and daily pricing, the price the LDC will eventually pay for the gas is an "absolute unknown", until after the index price is set.[3]

FOM and daily index pricing are not hedging, contrary to what some LDCs would

[1] Sommerer Direct, p. 4.
[2] Id.
[3] Id. at p. 6.

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have us believe. Because the price is unknown until the time it is set, it is subject to the volatility of the natural gas market and may be set higher or lower relative to the previous day's or month's price. For instance, if prices spike during bid-week, the FOM price will be set high for the remainder of the month.

Both FOM and daily pricing for natural gas share the same volatility as demonstrated by the graph attached as Exhibit 1. An FOM price might be set high for a given month based on price peaking during bid-week. FOM price spikes last for the entire month, while daily price spikes tend to spike for a few days and then decline. The FOM price doesn't actually "hedge" the price because the price is absolutely unknown until set during bid-week. And once locked in to the FOM price, the LDC is locked in until the price is reset at month's end during the next bid-week.

Laclede uses **________________________** to provide gas to its customers. Baseload is the gas taken everyday in the same amount. Another type of supply is **_____** supply, which offers more flexibility. **______** gas allows Laclede to take anywhere from 0 to its maximum daily quantity (MDQ) under the **_____** contract. **___________________________________ ** used to meet demand on particularly cold days. But the evidence in this case will establish that Laclede is using **_____** for other purposes and foisting the fixed costs, **____________________,** associated with **________** gas onto its customers. Laclede also purchases gas it calls **________________________** supply, which has characteristics of baseload and **____** in that it has mimimum take provisions but allows flexibility in how and when it is nominated.[4]

Laclede has traditionally used a **__________________________________

[4] Id.

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____________________.** Purchasing gas at **____________________

__________ ** requires Laclede to pay additional **____________________

__________." ** **______________________________

____,** even if the price of gas has risen later during the month.

__________ supplies usually have little if any **____________________

____

____

____

______________________________.[5]**

An alternative method to buying **_____** gas at **____________________

____** at daily index prices. Daily pricing carries mimimal **____________________.** Gas can be scheduled to reduce the impact of intramonth price spikes.

The PGA/ACA Process

The cost of natural gas is passed directly to customers through the purchased gas adjustment/actual cost adjustment mechanism (PGA/ACA). "Natural gas distribution companies … are allowed to recoup approved costs for obtaining natural gas from their suppliers as part of the rate they charge their customers."[6] Laclede periodically adjusts the cost of gas passed on to customers through the PGA process. During the course of a year, Laclede makes PGA filings designed to increase or decrease the cost of gas that customers pay based upon Laclede's costs to procure the gas. At the end of the PGA

[5] Godat Direct, pp. 5-6.
[6] *State ex rel. Riverside Pipeline Co., L.P. v. PSC of Mo.*, 165 S.W.3d 152, 153 (Mo. Banc 2005).

period under review, the Staff of the PSC conducts an Actual Cost Adjustment (ACA) review to determine what costs Laclede should be allowed to recover from their customers.[7] The ACA review includes a "prudence review" to evaluate contracts with suppliers and then decide whether the costs associated with the contracts should be disallowed in whole or part.[8]

THE STANDARD FOR A PRUDENCE REVIEW

A prudence review begins with the presumption that Laclede's costs to procure gas for its customers are prudent. Once "some other participant in the proceeding creates a serious doubt as to the prudence of the expenditure, then [Laclede] has the burden of dispelling these doubts and proving the questioned expenditure to have been prudent."[9] So, the Staff must first show that Laclede "acted imprudently in making gas supply arrangements which caused higher gas costs than if prudent decisions had been made."[10]

The Staff can meet its burden to rebut the initial presumption of prudence by producing evidence such as excessive cost overruns. "In the Union Electric case, the Commission found that the showing of two billion dollars in cost overruns associated with the building of the Callaway Nuclear Plant was sufficient to raise serious doubts about the prudence of Union Electric's expenditures."[11]

As the U.S. Supreme Court stated regarding prudence, "[t]here should not be excluded from the finding of [rate] base, investments which, under ordinary circumstances, would be deemed reasonable. The term is applied for the purpose of excluding what might be found to be dishonest or obviously wasteful or imprudent

[7] *Id.*
[8] *Id.*
[9] *State ex rel. Associated Natural Gas Co. v. PSC*, 954 S.W.2d 520, 529 (Mo. App. 1997).
[10] *Id.*
[11] *In the Matter of Missouri Gas Energy*, 11 Mo. P.S.C.3d 206, 223 (2002)

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expenditures."[12] Thus, prudent expenditures are reasonable, honest and not wasteful. If the Staff shows they are not, the presumption of prudence is rebutted.

Once the initial presumption of prudence is rebutted by Staff's evidence of imprudence, through unreasonable, dishonest or wasteful spending, Laclede must come forward to affirmatively prove that its actions were prudent.[13]

How is prudence evaluated? Prudence is evaluated by evaluating Laclede's conduct using a standard of reasonable care requiring due diligence.[14] Management decisions will be assessed "at the time they are made and ask the question, 'Given all the surrounding circumstances existing at the time, did management use due diligence to address all relevant factors and information known or available to it when it assessed the situation?'"[15] The responsibility is really one of determining "how reasonable people would have performed the tasks that confronted the company."[16]

ARGUMENT

Laclede did not exercise reasonable care exercising due diligence to assess the information available to it when it planned its gas purchases for the 2003-2004 period. **____ ____________________________.** Laclede knew this and yet proceeded as if nothing had changed. Laclede's decision raises serious doubts about its prudence and whether its customers should have to pay for Laclede's inept planning. Laclede's imprudence lies in 1) Failure to perform an updated analysis of gas costs, in particular **______________,** prior to the 2003-2004 ACA period, 2) Reliance on an outdated and flawed 1996 study

[12] *Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Commission*, 262 US 276 (1923)
[13] *Id.* at 223
[14] *In the Matter of Missouri-American Water Co.*, 9 Mo. P.S.C. 3d 254, 280 (2000)
[15] *In the Matter of Union Electric*, 27 Mo. P.S.C. (N.S.) 183, 194 (1985).
[16] *In the Matter of Missouri Gas Energy*, 11 Mo. P.S.C. 3d 206, 222.

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that bore no relation to the gas market in 2003, and 3) Payment of over**__________ ________________________,** nearly double the amount paid the prior year, in order to facilitate off-system sales.

1. Lack of Analysis

Laclede didn't bother to perform an analysis justifying its decision to **_____ ____.** When asked by the Staff whether the company had performed a study to justify the continued payment of exhorbitant **___________________,** Laclede produced a 1996 study.[17] Laclede admits it relied on a 1996 study to schedule gas for 2003-2004.[18] Besides being woefully out of date and stale, the 1996 study proves that Laclede had not performed an updated analysis of the gas market for over seven (7) years. As Staff witness Sommerer points out in his direct, "supply and demand fundamentals, pricing, trading, and a host of other factors had changed. The Enron collapse had not occurred. Supply and demand was not perceived as being nearly as tight in the mid-1990's. Gas demand for electric generation was changing during this time period."[19] Laclede ignored these factors.

The result of relying on an outdated 1996 study that did not consider the current conditions of the natural gas market was that Laclede blindly paid the **____________ _____________________** without question. The 1996 study analyzed only the 1995 to 1996 heating season. How could the 1996 study possibly consider the recent skyrocketing of **______________________ ** in 2003 that should have been readily apparent to Laclede? Had Laclede fully assessed the situation based upon the information readily available to it, it would plainly see that **____________________

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17 Sommerer Direct, p. 7.
18 Godat Direct, p. 8.
19 Sommerer Direct, p. 7.

_______** is nearly twice what it had paid the year before.

Though Laclede did establish its **_____________________ **through a competitive bidding process,[20] it did not even consider a daily pricing scenario for its **__________.** Laclede's after-the-fact analysis quantified **________________ ____.** Laclede did not consider **______________________ ** because seven (7) years earlier a study of the 1995-1996 season showed that Laclede saved money that year.

2. The Flawed and Outdated 1996 Study

Curiously, Laclede's 1996 study, upon which Laclede erected their gas supply portfolio 2003-2004, was provided to the Staff for the first time in 2005, nearly ten (10) years after its preparation.[21] Even more curious is the fact that the footnotes to the study itself proclaim its flaws: **____ ____ ____.** It's no wonder the study was kept from Staff for 10 years.

The footnotes proclaim the obvious: **_________________________________ ____ ____ ____ ____ ____.** The 1996 study itself begs additional study of these footnoted issues. Laclede did no additional study in

[20] Godat Direct, p. 8.
[21] Sommerer Direct, p. 8.

1996 or for the 2003-2004 ACA. Instead, it paid the **____________________** and hopes the Commission will pass the costs on to customers.

In addition to the obvious flaws in the study set forth in prominent footnotes, the 1996 study contains a signficant mathematical error. Ten years after the study was prepared, the Staff reviewed the study and determined that the calculation of **______ ____________________________** used by Laclede is overstated by 800%. Laclede's calculations assume that it would pay the same price for **________________** whether it bought gas at **______________,** when in fact, **__________________ ____.**

The 1996 study relied upon by Laclede compares **______________________ ______** scenarios for the months October 1995 to April 1996 and declares that even though Laclede paid **____ ____ ____________________________.** Of course, Laclede's study assumes that Laclede would have purchased gas on the daily market when its price was the highest.

Another factor the 1996 study fails to address is that paying **______________ ____ ____** And the 1996 study is limited to only one year, the 1995-1996 heating season, and ignores the possibility that **______________** will rise and the market will change by 2003.

Laclede's argument made by Mr. Godat is that "a study conducted by Laclede in the winter of 1995-1996 **____ ____** and that since that time

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"Laclede...had seen no evidence to indicate that such a hedging strategy had become imprudent or was not cost-effective."[22] Apparently, Laclede considers a 500% increase, from $4 million to $20 million, in **______________** "no evidence" of any change. The Staff suggests that a fivefold increase in costs invites some consideration when planning gas purchases. And to call a strategy "hedging" when Laclede pays **______ ____________________________** at a price that is an "absolute unknown" when the **___** million is paid almost shocks the conscience.

Laclede argues that paying the **___** million for an absolutely unknown price is what the Commission had in mind when it approved the Natural Gas Price Volatility Mitigation rule in December 2003.[23] 4 CSR 240-40.018 encourages natural gas utilities to "balance market price risks, benefits, and price stability..." and warns utilities that "each has unique risks and costs that require evaluation by the natural gas utility in each circumstance." Laclede fails to comprehend the rule. First, evaluation of the risk should be a ***current*** evaluation, not a seven year old evaluation. Second, the evaluation should consider the ***current*** market, not the market seven years ago. Third, paying **_____ ____** urges additional ***current*** analysis to comply with the rule.

Finally, the 1996 study fails to separate the **____________________________ ____ ____________** pricing scenarios should have been isolated and compared, with a view toward the risks involved with each pricing mechanism. Laclede failed to perform such an analysis.

[22] Godat Direct, p. 8.
[23] Id, at p. 12.

3. **__________________**

How high would **________________ ** have to go before Laclede sought a different course of action? As Laclede entered the 2003-2004 ACA the **____________ ____.** Would Laclede pay $30 million? Or $40 million? Laclede's reliance upon the 1996 study answers that question with a resounding "YES". No matter how high the **_______** went, the 1996 study tells Laclede to pay and that's what Laclede did.

A focus on the facts and circumstances known to Laclede at the time they make gas supply decisions for 2003-2004 clearly shows that **_____________ ** charges had increased by nearly $10 million over last year. Laclede's choice was to enter the **___ ____________________________** and avoid daily price spikes by using storage when needed, thereby saving save **____ ____ ____.** Because Laclede has structured its gas purchasing practices in order to facilitate off-system sales it chose to **____ ________________** on to its customers in the PGA and Laclede buys the **_______ ____** and make a profit. The problem is the customers pay the outrageous fixed costs and Laclede's shareholders keep the profit. In fact, Laclede's customers paid over **______________________________ ________** while its shareholders paid $0. And while the customers paid over **___ ____**from capacity release and off-system sales.

Laclede argues that the imputation of $3.8 million in revenues to Laclede in the

2002 rate case guarantees customers $3.8 million in lower rates.[24] But this argument overlooks the fact that Laclede's customers paid over $20 million in **____________ ______** in order for Laclede to make **__** million in off-system sales. Only a portion of the $3.8 million imputed in revenues is properly attributed to off-system sales. The rest is to come from capacity release. For **________** in particular, which Laclede argues make off-system sales possible, customers paid **________________________ _____________** to obtain the portion of $3.8 million imputed in revenues. Laclede is not restricted to using only its **__________ ** for off-system sales. Laclede can use its **_________ ** and save its customers millions.

Laclede characterizes the **___________________________ ** as "miniscule" compared to the overall cost of gas.[25] As Staff witness Sommerer points out in his testimony a nearly $10 million increase in **____________________** is hard to view as miniscule. Unless, of course, someone else is paying the $10 million – like customers.

CALCULATION OF THE ADJUSTMENT

The following chart prepared by Staff shows the calculation of Staff's adjustment based upon the difference between paying outrageous **_______________________

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_________________________,** the Staff has determined that only that portion of the **_______________________________** should be disallowed. **_____________ ____________________________________.**[26] Had Laclede exercised reasonable care exercising due diligence it would have opted for **____________________________ _________________________,** and customers would have saved $2,055,864. It is

[24] Godat Direct, pp. 10-11.
[25] Godat Direct, p. 9.
[26] Sommerer Direct, p. 10.

important to note that Staff's calculation of the damages caused by Laclede to its customers are calculated in a way that is extraordinarily generous to Laclede: the commodity savings for **___________ ** were calculated assuming that Laclede would have purchased **____ ________________** even if the daily price was high. No doubt, had Laclede purchased **______________________** on the market it would have reduced the impact of any price spikes and bought gas when the daily price was low, using its **______________ _______________________** when prices were highest.

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WHEREFORE, the Staff of the Commission urges the Commission to find Laclede was imprudent and disallow $2,055,864 in the rates charged by Laclede.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that copies of the foregoing have been mailed with first class postage, hand-delivered, transmitted by facsimile or electronic mail to all counsel and/or parties of record this this 22nd day of January, 2007.

/s/ Steven C. Reed

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EXHIBIT 1

IS

HIGHLY CONFIDENTIAL

IN ITS ENTIRETY