

Exhibit No.:

Issue:

Witness:

Type of Exhibit:

Sponsoring Party:

Case No.:

Proposed Conditions

Christopher C. Pflaum

Rebuttal Testimony

Laclede Gas Company

GM-2001-585

**FILED<sup>3</sup>**

AUG 13 2001

Missouri Public  
Service Commission

LACLEDE GAS COMPANY

REBUTTAL TESTIMONY

OF

CHRISTOPHER C. PFLAUM

August 2001

**NP**

BEFORE THE PUBLIC SERVICE COMMISSION  
OF THE STATE OF MISSOURI

FILED<sup>3</sup>  
AUG 13 2001

Missouri Public  
Service Commission

In the Matter of the Joint Application of )  
Gateway Pipeline Company, Inc., ) Case No. GM-2001-585  
Missouri Gas Company and Missouri )  
Pipeline Company. )

AFFIDAVIT


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

Christopher C. Pflaum, of lawful age, being first duly sworn, deposes and states:

1. My name is Christopher C. Pflaum. My business address is 9401 Indian Creek Parkway, Suite 360, Overland Park, KS 66210; and I am President of Spectrum Economics, Inc.

2. Attached hereto and made a part hereof for all purposes is my rebuttal 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.

  
Christopher C. Pflaum

Subscribed and sworn to before me this 10<sup>th</sup> day of August, 2001.



JOYCE L. JANSEN  
Notary Public — Notary Seal  
STATE OF MISSOURI  
ST. CHARLES COUNTY  
My Commission Expires: July 2, 2005



1  
2 **REBUTTAL TESTIMONY**  
3 **OF**  
4 **CHRISTOPHER C. PFLAUM**  
5

6 **Q. Please state your name and business address.**

7 A. My name is Christopher C. Pflaum. My business address is 9401 Indian Creek  
8 Parkway, Suite 360, Overland Park, KS 66210.

9 **Q. What is your occupation?**

10 A. I am President of Spectrum Economics, Inc., a firm of consulting economists and  
11 financial analysts.

12 **Q. What is your educational background?**

13 A. I have an MBA with a concentration in Finance from the University of Miami and  
14 a Ph.D. in Finance and Operations Management from the University of South  
15 Carolina. Much of my post-graduate work was involved with public utility  
16 economics. My doctoral dissertation is entitled *The Cost of Capital to a Public*  
17 *Utility*.

18 **Q. What is your previous experience in utility rate matters?**

19 A. I have spent most of my professional life working in the area of public utility  
20 regulation. From 1982 through 1984, I was Senior Financial Economist and  
21 Acting Director in the Revenue Requirements Program of the Policy Analysis and  
22 Research Division of the Illinois Commerce Commission. In 1984 and 1985 I  
23 was employed as Director of Financial Analysis at the utility consulting firm of  
24 Lubow McKay Stevens and Lewis. Following that, I was employed by QED

1 Research, Inc., also a utility consulting firm. Through a series of spin-offs  
2 starting with QED, Spectrum Economics came into existence.

3 I have published and spoken extensively in the area of public utility regulation  
4 and finance including serving on the faculties of the NARUC Regulatory Studies  
5 and Advanced Regulatory Studies programs.

6 I have also presented papers at the Iowa State Regulatory Conference, The  
7 Biannual Regulatory Information Conference and annual meetings of the National  
8 Society of Rate of Return Analysts and the Mid-America Regulatory Conference.

9 While employed by the Illinois Commerce Commission, I served as chairman of  
10 the Subcommittee on Finance of the NARUC.

11 Over the last twenty years, I have testified in numerous cases in several  
12 jurisdictions including Missouri, Kansas, Illinois, Texas, Arizona, California,  
13 Indiana, Wisconsin and Arkansas, the Federal Energy Regulatory Commission  
14 and the Federal Communications Commission. I have also served as a consultant  
15 to the U.S. Department of Energy, the American Public Gas Association and  
16 numerous utilities and customer groups. A copy of my curriculum vita is attached  
17 to this testimony as Schedule 1.

18 **Q. What is the purpose of your rebuttal testimony in this proceeding?**

19 A. The purpose of my rebuttal testimony on behalf of Laclede Gas Company  
20 (Laclede) is twofold. First, I will discuss a number of concerns that the  
21 Commission should have regarding the proposed acquisition of Missouri Pipeline  
22 Company (MPC) and Missouri Gas Company (MGC) by Gateway Pipeline

1 Company, Inc. (Gateway) in light of its principal owner's experience in  
2 overseeing pipeline operations serving other local distribution companies (LDC)  
3 in Kansas and Missouri. Specifically, I will describe some of the financial,  
4 regulatory, litigation and reliability concerns that have arisen in connection with  
5 these operations that I believe warrant disapproval of the proposed acquisition.  
6 Second, if the Commission should nevertheless decide to approve Gateway's  
7 application, I will describe specific conditions to lessen any detrimental impact of  
8 the transaction on Missouri gas consumers that I believe the Commission should  
9 adopt in connection with any approval of the proposed acquisition.

10 **Q. Have you provided testimony in other cases regarding the pipeline operations**  
11 **that were previously owned and operated by the principal owner of the**  
12 **acquiring company in this matter?**

13 A. Yes. The applicant, Gateway is a Delaware corporation. Based on the  
14 information that I have received to date, it appears that Gateway would be  
15 principally owned and controlled by \*\*. \_\_\_\_\_ \*\*. is the  
16 prior owner of The Bishop Group (Bishop); an organization that owned and  
17 operated pipelines in Kansas, Missouri and Oklahoma. I have testified, on behalf  
18 of Williams Natural Gas, in three previous matters regarding Bishop, two in  
19 Kansas and once in Missouri.

20 **Q. Why is Laclede concerned with who owns Missouri Pipeline Company or**  
21 **Missouri Gas Company?**

22 A. Laclede is the largest recipient of the natural gas supplies delivered through  
23 MPC's facilities, with the right to take 55,000 MMBtu per day of the line's 85,000

1 Mcf/d capacity. While supplies delivered through MPC represent only about 10%  
2 of Laclede's total annual requirements, such supplies represent the only current  
3 source of gas for some of Laclede's customers. Therefore, it is an important  
4 component of the supply on which Laclede depends to meet the needs of its  
5 customers. Laclede has always striven to provide reliable, reasonably priced gas  
6 service to its customers. As part of that effort, Laclede is especially concerned  
7 with maintaining reliable access to the critical pipeline facilities that are necessary  
8 to deliver gas supplies to the Company's distribution system and with protecting  
9 its customers from inflated gas costs that are increased for reasons unrelated to  
10 competitive market conditions.

11 **Q. Why should the Commission be concerned about Gateway Pipeline**  
12 **Company?**

13 A. As I previously indicated, the pipelines previously overseen by the principal  
14 owner of Gateway have been involved in a significant array of litigation relating  
15 to gas supply and transportation arrangements. In some instances, the litigation  
16 preceded the implementation of these arrangements while in others it arose out of  
17 cost or reliability issues that emerged after the arrangements had gone into effect.  
18 In almost all instances, however, an overriding element in such litigation was that  
19 it resulted in the implementation of a gas supply and/or transportation  
20 arrangement that was either priced well above other service alternatives or was  
21 necessitated by the need to deal with the fallout from such an arrangement. To  
22 the extent the proposed acquisition is approved in this case, the Commission  
23 should make certain there are reasonable safeguards in place to ensure that similar

1 issues and concerns that could have a detrimental impact on its customers do not  
2 arise here.

3 **Q. Can you provide some examples of such litigation and the gas supply and/or**  
4 **transportation arrangements that followed or preceded them?**

5 **A.** Yes. Such examples include the following:

6 Kansas Pipeline Partnership (KPP), controlled by \*\*\_\_\_\_\_\*\*, received  
7 its first gas transportation contract with Western Resources, Inc. (WRI) after  
8 intervening in a rate application. After the contract was secured, KPP  
9 persuaded WRI to lift the price ceiling on its contract from the rate charged by  
10 the dominant pipeline, Williams Natural Gas (Williams), to a level based on  
11 cost of service. Subsequent to the lifting of the contract cap, in 1994, KPP  
12 filed for a further increase in rates based on a hypothetical cost of service.  
13 The contract amendment alone has resulted in over \$13 million per year in  
14 increased costs to Kansas gas consumers over the past six years.

15 KPP secured a transportation contract for gas with United Cities Gas (UCG)  
16 shortly after it intervened in UCG's Kansas rate case. After securing the  
17 contract, KPP withdrew its intervention. Although this contract was on far  
18 better terms than WRI's, it was still at a cost above that of Williams.

19 KPP secured contracts to construct a small pipeline and provide bundled gas  
20 and transportation services at very high rates to several Kansas communities  
21 in settlement of litigation with WRI regarding the so-called "Linchpin" and

1           “Wraparound” contracts. Once again, these contracts have cost consumers  
2           tens of millions of dollars in unnecessary costs over their duration.

3           Bishop affiliates, Mid-Kansas and Riverside Pipeline, secured high cost  
4           contracts with MGE as the result of settling the Linchpin and Wraparound  
5           contract lawsuits.

6           KPP is currently in litigation with WRI’s successor in Kansas, the Kansas Gas  
7           Service division of Oneok, over KPP’s alleged breach of the Linchpin and  
8           Wraparound settlements.

9           The total excess costs to consumers as a result of these arrangements have been  
10          substantial and according to my testimony in the dockets seeking KCC approval  
11          of these arrangements would have allowed KPP to earn 151% rate of return. In  
12          Case Nos. GR-94-101 and GR-94-228, it was also estimated that the total excess  
13          cost to Kansas and Missouri consumers of the various uneconomic contracts with  
14          \*\*\_\_\_\_\_\*\*-affiliated entities, barring regulatory intervention, would have been  
15          \$547 million. Because of claims made at the KCC and FERC that regulatory  
16          action would lead to financial ruin, however, both the KCC and FERC have  
17          maintained KPP, KNP, Riverside, etc. rates at levels well above any reasonable  
18          estimate of the cost of service.

19   **Q.   Have pipelines operated or owned by The Bishop Group experienced**  
20   **operational problems in Kansas?**



1 A. Yes, they have. Kansas Pipeline interrupted firm service to WRI (presently  
2 Kansas Gas Service) and United Cities Gas in the winter of 1993/94 in connection  
3 with a delivered supply arrangement.

4 **Q. How did this serious interruption occur?**

5 A. The interruptions by KPP seem to have occurred because it was using  
6 interruptible transportation on interstate pipelines to provide firm delivered  
7 service on KPP. During the time period in question, interruptible service was  
8 fairly firm and the risk associated with the mismatch was small but not non-  
9 existent. KPP risked service reliability to its customers and its customers would  
10 have been interrupted had Williams not stepped in to make up for the lost  
11 supplies. I have included in Schedule 2 to my rebuttal testimony, various  
12 materials which illustrate the seriousness with which this lapse in reliability was  
13 taken by the parties who were affected, including copies of the correspondence  
14 between Bishop and WRI, internal memos, and a copy of the complaint and  
15 request for emergency show cause proceeding that WRI filed with the KCC.

16 **Q. Please explain how Bishop entities have used claims of financial distress as**  
17 **the basis for rate increases.**

18 A. In its Kansas rate case, Bishop made numerous, nontraditional claims for why its  
19 rates should be increased. Among these were that it should be allowed to claim  
20 the capitalized losses of an unrelated predecessor as an element of rate base. The  
21 claim was framed that the losses were market entry costs. The KCC ultimately  
22 rejected these arguments and established a cost of service of \$22 million. Bishop  
23 then appealed to the KCC that the return on this level of investment would be

1 insufficient to meet the indenture coverage ratios on its debt. This debt greatly  
2 exceeded KPP's utility investment and KPP never did provide the KCC with an  
3 accounting of the uses of these funds. Rather than see a Kansas utility fall into  
4 bankruptcy, the KCC permitted a revenue requirement of \$31 million, an amount  
5 sufficient to cover the indenture requirements. After FERC asserted jurisdiction  
6 over KPP because of action undertaken by its management, KPP repeated these  
7 financial need arguments in its FERC case when the FERC found that the KPP  
8 rate base and cost of service were inflated.

9 **Q. Why is the possibility of financial distress claims of concern in this matter?**

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**Q. How could FERC exerting its jurisdiction lead to higher rates for Missouri gas consumers and burden other customers with stranded investment?**

A. First, FERC jurisdiction would virtually guarantee approval of any effort by Gateway to bypass Laclede or other LDCs – a result that would burden smaller customers with additional fixed cost responsibility as the revenues currently contributed by larger customers would be lost to Gateway. \*\*

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**Q. Has this Commission recognized the poor track record that the owners of Gateway have compiled with their previous ownership and management of pipeline facilities in Kansas and Missouri?**

**A.** Yes, according to the previously mentioned initial decision in FERC Docket No. RP99-485-000h the Commission has not only recognized these deficiencies, but has made every effort to bring them to FERC's attention. As the initial decision in that case notes:

1 According to MoPSC witness Morrissey, various actions by KPC's  
2 previous owners and managers have negatively affected the KPC's  
3 rates, its relationship with its customers, its regulatory affairs, and  
4 its business operations. MoPSC witness Morrissey contends that  
5 "various acquisitions and changes in KPC's ownership have  
6 produced increased costs that have not resulted in corresponding  
7 benefits to ratepayers.... [and that] KPC's owners and managers  
8 have repeatedly made decisions which have been to their benefit  
9 while being detrimental to its ratepayers." Moreover, the lack of  
10 adequate internal controls has allowed KPC's operating expenses  
11 to exceed reasonable levels, which has resulted in KPC's cost-of-  
12 service being driven to a level where it is not competitive with  
13 other pipelines.

14  
15 MoPSC believes that above-market prices have prevented KPC  
16 from increasing its market share and have eroded its current  
17 market. The increased prices have further caused dissension  
18 among KPC's customers and state regulatory bodies, thereby  
19 triggering contractual disputes and prudence reviews. MoPSC  
20 states that all of these factors are the result of KPC's own  
21 inefficient management. Commission policy requires that under  
22 such circumstances, KPC's owners, not its customers, must bear  
23 the burden of shouldering the costs that result from KPC's  
24 increased business risk. *Id p. 54.*

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26 Obviously, there is not a great deal that Laclede can add to the very serious  
27 concerns that have already been identified and expressed by the Commission  
28 itself regarding the track record of Gateway's owners other than to observe that  
29 they create a very strong presumption that the proposed acquisition would be  
30 detrimental to the public interest. Clearly any repetition of the kind of litigation,  
31 service problems and excess cost concerns described above in connection with  
32 MPC and MGC would present the LDC and potentially the Commission with a  
33 Hobson's choice. For the LDC it could be the choice of whether to enter into  
34 litigation over contractual matters relating to the cost or reliability of pipeline  
35 service, while simultaneously risking a potential loss of service, or to agree  
36 instead to a financial solution that may maintain service, but only at a potentially

1 significant increase in the cost of gas service to its customers. For the regulator,  
2 the Hobson's choice between cost and reliability could, of course, be just as  
3 severe. Those are choices, Missouri LDCs and their customers shouldn't have to  
4 face and to ensure they do not in this case, I recommend that the proposed  
5 acquisition not be approved.

6 **Q. Doesn't your recommendation result in an impairment of the existing**  
7 **owner's property rights to sell its facilities?**

8 A. As a general matter, I believe that utilities, just like other firms, should be given  
9 wide latitude in their exercise of such rights. However, property rights are not  
10 absolute. Every public utility that purchases or constructs facilities dedicated to a  
11 public use accepts certain limitations on how such facilities may be transferred to  
12 a new owner. Specifically, they must recognize that any subsequent sale of used  
13 and useful facilities will necessarily be conditioned on whether the proposed  
14 buyer has the requisite attributes to provide the Commission with reasonable  
15 assurances that the transfer will not be detrimental to the public interest. In some  
16 exceptional cases, such as this one, that minimum standard will not be met.

17 **Q. Should the Commission nevertheless decide to approve all or part of the**  
18 **proposed acquisition, what conditions do you believe the Commission should**  
19 **impose on this transaction?**

20 A. Given the legal uncertainties over the Commission's ability to formulate  
21 conditions that cannot be circumvented through an assertion of FERC jurisdiction  
22 or otherwise, I do view the imposition of conditions as an ineffective substitute  
23 for disapproval. Nevertheless, if the Commission decides to approve the

1 proposed transaction, I believe it is essential that very clear ground rules be  
2 established at the outset to govern the service relationship between MPC, MGC  
3 and its existing customers following their acquisition by Gateway. Specifically, I  
4 recommend that approval of the acquisition be conditioned on the following  
5 requirements:

6 1) MPC and MGC should be required to continue to provide firm  
7 transmission (FT) service to existing users of the pipelines, including Laclede, at  
8 rates reflecting their cost of service, provided that such rates should be capped for  
9 a period of not less than 5 years. This rate cap should include a prohibition on  
10 any type of rate restructuring, including any changes that would establish rate or  
11 zone boundaries or require an LDC to purchase services that have traditionally  
12 been included as part of MPC's or MGC's tariffs.

13 2) MPC and MGC should be at risk for any loss of transportation volumes or  
14 any incremental expenditures designed to increase the throughput capability of the  
15 pipelines. Should MPC's or MGC's revenues fall because customers leave it or  
16 its capital or operational costs increase above the amounts currently reflected in  
17 rates in order to serve new loads, the pipelines should not be permitted to raise  
18 their rates to existing users to make up that shortfall.

19 3) MPC and MGC's certificate should continue to forbid it from bypassing  
20 the LDCs it serves and from providing direct service to industrial customers.

21 4) MPC and MGC should be required to provide existing users, including  
22 Laclede, with a right of first refusal to continue to take up to their existing  
23 contract entitlements for firm transportation.



1           5)     MPC and MGC should be prohibited from taking any actions that would  
2     subject them to FERC jurisdiction without prior approval of the Commission.

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10          6)     MPC and MGC should be required to submit plans showing that its  
11     addition of any firm transportation customers that increase its peak throughput  
12     will not impose additional costs or lessen service reliability to existing users of  
13     the pipeline.

14          7)     Finally, to ensure reliability, MPC and MGC should be obligated to use  
15     firm services on interstate pipelines, whenever obligated to provide a firm  
16     delivered service to its customers.

17   **Q.     Why is it necessary to impose a rate cap on MPC and MGC?**

18   A.     The imposition of a rate cap will prevent litigation or threats of service  
19     interruptions from being used to secure rate increases. Given the history of  
20     litigation that I previously discussed, I believe such a condition is essential in that  
21     it greatly limits the effectiveness of this strategy.

22   **Q.     Why shouldn't MPC and MGC be permitted to establish rate territory**

1 **boundaries or restructure its rates?**

2 A. For the rate conditions to work effectively, it is critical that indirect increases not  
3 be sanctioned through the simple device of changing existing rate boundaries or  
4 restructure its rates. This condition will prevent such a result from occurring.

5 **Q. How can changing the existing rate boundaries or structure cause detriment?**

6 A. For example, Laclede takes service from MPC on various points including the St.  
7 Louis city gate and at connections on the boundaries of small towns outside the  
8 metropolitan area. All this service is at a single rate. By establishing rate  
9 boundaries, Gateway could raise additional revenues based on Laclede's take  
10 points. On two separate occasions, in relation to the assets involved in the instant  
11 proceeding, Case Nos. GR-92-314 and GA-95-231, this Commission has rejected  
12 the establishment of rate boundaries or zoned rates. Any attempt to establish rate  
13 boundaries should be considered as a form of "back door" increase in overall rates  
14 and a detriment to gas consumers. This detriment can be prevented by the  
15 Commission by not allowing the pipelines from establishing zoned rates or rate  
16 boundaries. Another form of "back door" increase that the Commission should  
17 guard against is a rate restructuring. By either unbundling or rebundling services,  
18 Gateway could attempt to extract additional monies without adding any value to  
19 its standard tariff services. The Commission should not permit any changes to  
20 standard tariff services during the 5 year rate cap.

21 **Q. How is public detriment avoided by preventing MPC and MGC from**  
22 **adjusting rates in response to lost volumes or to reflect the incremental costs**  
23 **required to serve new loads?**

1 A. Like the rate cap condition, such a requirement prevents the rates paid by existing  
2 users from being increased indirectly because service problems have driven  
3 customers off the system, thereby decreasing the volumes over which the fixed  
4 costs of the pipeline can be spread or because uneconomic decisions have been  
5 made to serve new loads that cannot pay for the incremental investment.

6 **Q. Why should Gateway be barred from serving retail load through MPC and**  
7 **MGC?**

8 A. MPC and MGC are certificated as intrastate pipelines not local distribution  
9 companies. It has been this Commission's policy that intrastate pipelines are not  
10 allowed to bypass the LDC's that they serve to directly connect with the LDC's  
11 customers. The benefit of such a policy is clear: it prevents the pipeline from  
12 cherry picking large profitable loads and leaving behind stranded LDC investment  
13 to be collected from captive, human needs consumers. The present owner is  
14 operating under such a restriction.

15 **Q Why should Gateway, through MPC and MGC, be required to provide**  
16 **existing users of their system with a right of first refusal?**

17 A. In the past, regulation has recognized the need to provide incumbent LDC users of  
18 pipeline facilities with a mechanism to preserve their traditional access to such  
19 facilities, particularly where such access is needed to maintain service to firm  
20 customers. A right of first refusal would accomplish this goal by giving existing  
21 users of the pipeline the opportunity to match any offer to take service by a new  
22 customer up to a level equal to the existing users contract entitlement. In light of  
23 the previous concerns I have expressed, I view this protection as critical.

1 Q. \*\* \_\_\_\_\_

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20 Q. What level of service will be necessary from Gateway Pipeline?

21 A. Gateway Pipeline must provide the same high-pressure supply, and hourly  
22 volume flexibility comparable to MPC's present service level in order for Laclede  
23 to meet its customers' demands. Any significant additional firm subscription to

1 the Gateway pipe in the future without additional compression or pipe installation  
2 would erode service to Laclede, thereby jeopardizing service to Laclede's  
3 customers.

4 **Q. Please discuss the condition that you believe the Commission should impose**  
5 **to address this concern.**

6 A. As part of any Order approving the proposed acquisition, the Commission should  
7 require that prior to adding any additional firm subscription that would increase  
8 peak throughput on MPC's or MGC's system above existing levels, Gateway  
9 must submit a plan for Commission approval detailing what measures will be  
10 taken to ensure that such increased throughput will not jeopardize service to  
11 existing users and verifying that any costs incurred to provide such assurance will  
12 not be paid by existing users.

13 **Q. Does this conclude your testimony?**

14 A. Yes, it does.