Exhibit No.:
Issues: *Hedging Authority; and Capacity Release*
Witness: *David Sommerer*
Sponsoring Party: *MoPSC Staff*
Type of Exhibit: *Surrebuttal Testimony*
Case Nos.: *GR-2001-382, GR-2000-425, GR-99-304 & GR-98-167 (Consolidated)*
Date Testimony Prepared: *April 22, 2003*

MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

SURREBUTTAL TESTIMONY

OF

DAVID SOMMERER

MISSOURI GAS ENERGY
CASE NOS. GR-2001-382, GR-2000-425, GR-99-304 & GR-98-167
(Consolidated)

Jefferson City, Missouri
April 2003

****Denotes Highly Confidential Information****

NP

Exhibit No. 11 NP
Case No(s). GR-2001-382
Date 5-12-03 Rptr KF

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of Missouri Gas Energy's Purchased Gas Adjustment Tariff Revisions to be Reviewed in its 2000-2001 Actual Cost Adjustment	)))	**Case No. GR-2001-382**
In the Matter of Missouri Gas Energy's Purchased Gas Cost Adjustment Factors to be Reviewed in its 1999-2000 Actual Cost Adjustment	)))	**Case No. GR-2000-425**
In the Matter of Missouri Gas Energy's Purchased Gas Cost Adjustment Factors to be Reviewed in its 1998-1999 Actual Cost Adjustment	)))	**Case No. GR-99-304**
In the Matter of Missouri Gas Energy's Purchased Gas Cost Adjustment Tariff Revisions to be Reviewed in its 1997-1998 Actual Cost Adjustment	)))	**Case No. GR-98-167**

AFFIDAVIT OF DAVID M. SOMMERER

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

David M. Sommerer, of lawful age, on his oath states: that he has participated in the preparation of the following surrebuttal testimony in question and answer form, consisting of 9 pages to be presented in the above case; that the answers in the following surrebuttal testimony were given by him; that he has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of his knowledge and belief.

David M. Sommerer

Subscribed and sworn to before me this 8th day of April 2003.

Notary Public

My Commission Expires: ____________

TONI M. CHARLTON
NOTARY PUBLIC STATE OF MISSOURI
COUNTY OF COLE
My Commission Expires December 28, 2004

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CASE NOS. GR-2001-382, GR-2000-425, GR-99-304, GR-98-167

(CONSOLIDATED)

LIST OF SCHEDULES

SURREBUTTAL TESTIMONY

OF

DAVID SOMMERER

MISSOURI GAS ENERGY

CASE NOS. GR-2001-382, GR-2000-425, GR-99-304, GR-98-167

(CONSOLIDATED)

Q. Please state your name and business address.

A. David Sommerer, P.O. Box 360, Jefferson City, MO 65102.

Q. Are you the same David Sommerer who filed direct and rebuttal testimony in the consolidated Case Nos. GR-2001-382, GR-2000-425, GR-99-304, and GR-98-167?

A. Yes, I am.

Q. What is the purpose of your surrebuttal testimony?

A. The purpose of my surrebuttal testimony is to respond to the rebuttal testimony of Missouri Gas Energy witness Michael T. Langston related to Staff's proposed adjustments for Missouri Gas Energy (MGE or Company), Case No. GR-2001-382. My surrebuttal testimony is specifically related to the issues of "Hedging Authority" and "KPC Capacity Release."

<u>HEDGING AUTHORITY</u>

Q. Mr. Langston argues on page 36, lines 10-12 of his surrebuttal testimony, "Therefore, at no time has MGE ever had the automatic or clear and unequivocal authority to hedge natural gas costs as an ongoing part of the overall management of its natural gas supply portfolio." Is that an accurate portrayal of MGE's situation?

A. No. The Staff believes it is instructive to return to MGE's philosophy about hedging from several years ago. In his surrebuttal testimony filed back on May 30, 1997 in MGE Case No.GO-97-409, Mr. Langston stated, "I would just like to reiterate that hedging activities essentially represents speculation on gas prices within the market place." Instead of recognizing that hedging is a fundamental requirement of a sound purchasing strategy, Mr. Langston continues to extol the virtues of index (spot market) pricing. This is after the natural gas market itself provided a significant warning during February of 1996 and the winter of 1996-1997 that the indexes were highly volatile and subject to severe price spikes.

Naturally, I responded back in June of 1997 on page 2 of my surrebuttal testimony in MGE Case No. GO-97-409 that:

> … the market should not "beat up" the customer. Price spikes of short duration but large impact can be avoided through proper hedging. Furthermore, a market price could be considered to be a combination of fixed prices, capped variable prices, and monthly index prices.

I went on to say that, "the Company should not have guarantees that no matter how high the spot market goes, the consequences will be borne by the customer." Hedging or diversifying the gas supply portfolio is at the core of reasonable purchasing plans and practices. To say that such an action requires specific Commission authority implies that basic day-to-day decisions of management must be pre-approved. Mr. Langston has complained about the lack of specific Commission authority to hedge. The Staff believes that the Company was authorized to make critical decisions regarding gas contracting when it acquired the Missouri properties from Western Resources. Heavy reliance on a certain pricing structure is a management choice and a business decision.

Q. Mr. Langston discusses concerns about tariff language on page 40 of his rebuttal testimony. Please address the concerns about specific tariff authority.

A. Mr. Langston has totally ignored the idea of fixed pricing as an alternative to index pricing. By reading Mr. Langston's testimony, one would assume that the tariffs required that MGE purchase gas supply at an index price. The tariffs state no such thing. MGE has complete discretion over the pricing provisions in its gas supply contracts. It is not constrained by any tariff language. The PGA tariffs simply say that gas supply is a type of service that is part of PGA cost recovery. By focusing on financial instruments, Mr. Langston has implied that hedging is something novel and outside the bounds of gas supply decision-making. There is no statute or rule that states that gas must be purchased at index and no Missouri Commission Order that mandates this. Mr. Langston claims that index pricing is the only reasonable course of action absent pre-approvals and ratemaking guarantees. Mr. Langston's argument ignores price diversification as a fundamental concept of gas procurement. Fixed prices can be part of a physical gas supply contract just as easily as index prices.

Q. How then do you address Mr. Langston's discussion on page 41, lines 16-19 of his rebuttal testimony that, "The Commission approved very specific tariff language each and every time MGE has been authorized to financially hedge natural gas prices and recover the associated hedging costs since MGE began financially hedging during the winter of 1997/1998?"

A. First, Mr. Langston carefully adds the term "financially" to the hedging concept. It appears that he is implying that MGE was in some way prohibited from using storage to hedge or from obtaining part of its gas supply with a fixed price contract. Such is not the case.

Second, the discussion assumes that the approval of the historical price stabilization programs was MGE's assurance that no prudence review would be conducted as to its gas pricing provisions. The Staff's understanding of those agreements (call option programs) is that the LDC was *authorized but not required* to obtain the financial hedges. If it chose to use the pre-authorized tool, the Staff was limited in how it could subsequently question the timing and amount of expenditures under the program. Assuming that MGE, for some reason, chose not to acquire all call options in a particular year, the Staff could not, under the program terms, make a disallowance of the funds expended for the purchase of the call options that were purchased consistent with the program terms. The Staff could however, absent any other restriction on prudence reviews, claim that MGE's pricing provisions were imprudent and resulted in detriment.

In fact, the Staff's interpretation is wholly consistent with its insistence that prudence reviews continue as long as MGE did not freeze prices pursuant to the Fixed Commodity Price Plan (FCP). The FCP has been characterized by MGE as its formal hedging plan. This is not a reasonable description. The FCP contained a trigger that essentially required the commodity cost of the PGA rate to be frozen if price reached historically favorable levels. The program was meant to ensure that if 100% of the customers' requirements were locked in, then it would be at rates that were at least consistent with historical commodity rates. Since the commodity feature of the FCP did not otherwise *require* a lock-in of prices, the customers continued to be exposed to price spikes if the trigger was not invoked. The FCP did not require MGE to hedge its gas costs even in the event it was required to freeze its gas commodity price at the $2.40/MMBtu level. The fixed PGA sales rate would be the customers' protection while MGE would be at risk for differences between its gas supply costs and the rate it was charging its customers. There was an incentive aspect to this concept because it would be possible for MGE to obtain a cheaper gas cost from its suppliers than was being collected pursuant to the triggered fixed PGA rate. Of course, there was risk for MGE as well because it would have to absorb any gas commodity cost in excess of the frozen gas commodity PGA rate. In addition to the trigger concept, which by definition offered no protection for customers if not triggered, MGE was authorized to implement its historical call option program, the price stabilization fund, under parameters in place from the previous year (1999-2000). This program did not require hedging but merely authorized and pre-approved certain expenditures for call options. Thus, it was a distinct possibility that the FCP would offer no protection because the trigger price might not be reached. In the same way, it was also a distinct possibility that the historical call option program might not be implemented because of MGE's discretion or because of conditions in the gas market. If those two events happened, MGE would then be on the same footing as almost every other LDC in Missouri. It would need to evaluate the risk of its gas supply pricing provisions and make decisions subject to a prudence review.

Q. Wouldn't MGE then be at risk for hedges that were acquired in excess of the FCP trigger?

A. If MGE acquired hedges above the trigger price, and ultimately the trigger price was effective, MGE would be charging less for those volumes hedged compared to the fixed PGA rate it would be charging its customers. This was a risk of the FCP, and the Staff therefore insisted on the ability to propose prudence disallowances. Another risk for MGE was that it would be subject to a prudence review if there was no triggering event.

Q. Please explain what you mean by the Staff's "insistence" that prudence reviews continue.

A. The gas supply commodity would be subject to prudence review even if MGE hedged pursuant to the historical call option program. Any other interpretation takes all the meaning away from that critical provision. Ultimately, responsibility for provisions in gas supply contracts cannot be magically reassigned to the Commission, nor can MGE blame the Commission for failing to require in advance that MGE diversify its gas supply contract pricing provisions. Nor should the Staff be criticized for not supporting a last minute radical modification of the historical call option program. That program was only one tool that could be used to address natural gas price volatility and it certainly wasn't the only tool. ** HC-----
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HC--** It simply represents one of a multitude of significant management decisions ultimately subject to prudence review.

Q. What other comment do you have regarding the historical price stabilization plans?

A. Mr. Langston states on page 41, lines 19-23 that, "Based on these Commission orders from August 1997 and up to the winter of 2000/2001, and the entire history of how the Commission has operated by requiring specific provision in tariffs, it was reasonable for MGE to believe that prior Commission authorization was a necessary and appropriate part of the hedging process." When viewed in the context of other Missouri LDCs action, I do not see how MGE can draw this conclusion. By the 1999-2000 ACA period, AmerenUE was no longer asking for tariff approval for the pre-approved price stabilization program. By 1999-2000 Laclede's program was substantially altered into a program of its own design with major incentive features. Other LDCs in Missouri *never* operated under the price stabilization program. Thus MGE's interpretation that it was not free to hedge because of the absence of pre-approved programs is not consistent with the provisions of the original price stabilization programs, is counter to the actual practice of other Missouri LDCs, and ignores the use of fixed price contracts and storage operations as a viable supplement to index pricing.

Q. Did MGE itself understand the inherent problems in delaying implementation of the traditional call option programs?

A. Yes. On page 4 of its final report of the experimental price stabilization fund filed June 2, 1998 in MGE Case No. GO-97-409, it was said, "MGE, however, suggests that any subsequent authorization of this program be obtained and implemented for any winter period by May 1 prior to the winter in which price caps are to be obtained."

Q. Did MGE follow its own advice in the spring of 2000 in terms of implementing hedges early?

A. No. Even if the original Stipulation And Agreement in Case No. GO-2000-405 had been approved and made effective the same day it was filed, it would have been after MGE's previously recommended deadline for implementation of May 1. In addition, a review of call option premium prices during that time frame shows that MGE would have been hard pressed to obtain call options during the very month the Stipulation And Agreement in Case No. GO-2000-705 was being finalized. Schedule 1, attached provides a chart of call option premiums prevailing from the spring of 2000 through the summer. In March and April of 2000, options prices generally exceeded 12 cents/MMBtu for the type of strike prices or caps previously considered. Therefore, by the time the Stipulation was filed, and even prior to that date, the implementation of the call option program was questionable at best. Thus the Staff insisted that regardless of whether the call option program ever became operational, a prudence review of gas commodity price issues would take place absent the locking in of a fixed price pursuant to the FCP.

Q. Was the Staff's position inconsistent with a Stipulation And Agreement signed in Laclede Case No. GO-2000-394?

A. No. MGE was not in the same position as Laclede during September of 2000. Laclede's Gas Supply Incentive Plan in place for the winter of 2000-2001, that plan was dramatically different than MGE's. Laclede's program was also experiencing pressure in the summer of 2000, construction of the program modifications have been the subject of recent litigation.

KPC CAPACITY RELEASE

Q. Do you have comments regarding Mr. Langston's rebuttal testimony discussion of capacity release found on pages 43 and 44?

A. Yes. Mr. Langston indicates that staff's position is "...entirely arbitrary and derived without any factual or supporting market information." The fact that there is limited information about MGE's attempts to market idle KPC capacity is not unusual given that MGE made no significant attempts to market the capacity in the ACA period in question. In addition, the Staff already provided MGE with extensive data of capacity release activity on the Williams Pipeline system. This is attached Schedule 2. Schedule 2 is a download of capacity release activity on the Williams Pipeline system for the months of July 2000 through June of 2001. The recall codes are listed on the last page of each month. The area codes indicate and "M" for Market area and "P" for Production area. As can be seen, there are no large non-recallable capacity release deals. This is likely because a primary shipper would probably not have firm capacity on a long-term basis unless it needed that capacity. For those non-recallable transactions that are available, the maximum FERC rate appears to be a reasonable estimate of the transactional revenues.

Q. Does this conclude your surrebuttal testimony?

A. Yes, it does.

SOMMERER SCHEDULES 1 AND 2

ARE DEEMED

HIGHLY CONFIDENTIAL

IN THEIR ENTIRETY