Exhibit No.:
Issues: Incentive Plan Benchmark
Witness: Michael J. Wallis
Sponsoring Party: MO PSC Staff
Type of Exhibit: Direct Testimony
Case No.: GC-98-335

MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

DIRECT TESTIMONY

OF

MICHAEL J. WALLIS

MISSOURI GAS ENERGY

A division of

SOUTHERN UNION COMPANY

CASE NO. GC-98-335

Jefferson City, Missouri
February, 1998

DIRECT TESTIMONY

OF

MICHAEL J. WALLIS

MISSOURI GAS ENERGY,

a division of

SOUTHERN UNION COMPANY

CASE NO. GC-98-335

Q. Please state your name and business address.

A. Michael J. Wallis, P.O. Box 360, Jefferson City, Missouri 65102.

Q. By whom are you employed and in what capacity?

A. I am a Regulatory Auditor with the Missouri Public Service Commission (Commission).

Q. Please describe your educational and professional background.

A. I graduated from Central Missouri State University at Warrensburg, Missouri and received a Bachelor of Science degree in Business Administration, with a major in Accounting, in July, 1986. I am currently a licensed Certified Public Accountant in the state of Missouri.

Q. What has been the nature of your duties while in the employ of the Commission?

A. Under the direction of both the Manager of the Accounting Department (August 1987 to November 1992) and the Manager of the Procurement Analysis Department (October 1993 to the current time), I have assisted with audits and examinations of the books and records of utility companies operating within the state of Missouri.

Q. Have you previously filed testimony before this Commission?

A. Yes. Schedule 1, attached to my direct testimony, is a list of cases in which I have filed testimony before this Commission.

Q. What is the purpose of your direct testimony?

A. The purpose of my direct testimony is to address a number of weaknesses in Missouri Gas Energy's (MGE or Company) incentive plan benchmark.

Q. How is MGE's incentive plan benchmark derived?

A. MGE's incentive plan benchmark is derived by (1) multiplying the first of the month index price in *Inside FERC's Gas Market Report* (IFGMR) for Williams Natural Gas Company (WNG) by 70% and for Panhandle Eastern Pipeline Company (PEPL) by 30%, and adding the products together, to arrive at a weighted average index price; and (2) multiplying the weighted average index price, calculated in (1) above, by a 4% premium allowance to arrive at the total incentive plan benchmark price.

Q. What are the weaknesses in MGE's incentive plan benchmark?

A. First, the benchmark upon which the entire incentive plan sharing grid is based, has no cap and thus, has no limit on upward price movement. For example, as a result of a period of extremely cold weather, the benchmark could rise to $10 per MMBtu and MGE, by incurring actual gas costs of $9.95 per MMBtu, would receive 50% of the savings between the $9.95 per MMBtu actual gas costs and the $10 per MMBtu benchmark gas costs. Thus, MGE would be retaining 2.5 cents per MMBtu in profits (funded by its customers through a future ACA filing) from its incentive plan, while its customers were struggling to pay their excessively high gas bills.

Second, because the benchmark is not capped, MGE will make a windfall in profits by following its normal practice of negotiating premiums in its gas supply contracts which are not based on the index price plus a percentage. For example, if the first of the month index price in IFGMR was $10 per MMBtu, the premium portion of the benchmark would be $.40 per MMBtu ($10 times 4%) and thus the benchmark would be $10.40 per MMBtu. MGE would take advantage of the high level of the $.40 per MMBtu premium by negotiating premiums in its gas supply contracts which were not based on a percentage of the index price but were specified as a certain number of cents to be added to the index price. For example, an MGE gas supply contract could specify index plus $.10, thus MGE would save $.30 on the premium. MGE would receive 50% of the savings from beating the premium simply because of the fact that the premium is tied to the index price on a percentage basis. MGE will automatically retain, as profit, 2 cents per MMBtu for every dollar [($1 x .04) x 50%] by which the benchmark weighted average IFGMR index price exceeds the historical index price upon which the 4% premium is based. This situation could arise primarily because of periods of extremely cold weather and since, MGE has no control over the weather, the Company should not be allowed to profit, through its incentive plan, when the price of natural gas escalates due to actual or expected changes in the weather.

Third, the incentive plan benchmark does not consider, as a part of the total weighted average IFGMR index price, any of the MGE non-Tight Sands gas supplies which are sourced from the Rocky Mountain supply area and which should be priced at first of the month index prices in IFGMR for Colorado Interstate Gas Company (CIG).

MGE purchased approximately 5% of its non-Tight Sands gas supplies from the Rocky Mountain supply area during the first year of its incentive plan, yet its benchmark calculation is only based on a 70% WNG-30% PEPL first of the month weighted average IFGMR index price. This flaw in MGE's incentive plan benchmark is significant because over the course of the last 52 months (November 1993 to February 1998), the WNG IFGMR index prices have been an average of 39 cents higher than the CIG IFGMR index prices (see Schedule 2 attached to my direct testimony). MGE will purchase an even greater percentage of its non-Tight Sands gas supplies from the Rocky Mountain supply area in the second and third years of its incentive plan because KN Interstate Gas Transmission Company's Pony Express pipeline project (which was completed in October 1997) will provide MGE with over 100,000 MMBtu per day of additional Rocky Mountain based pipeline capacity.

Q. Do you have any other comments with regard to MGE's incentive plan?

A. Yes. MGE's incentive plan acts as a disincentive for MGE to hedge its gas supply portfolio. The costs that MGE would have to pay for premiums, commissions, and brokerage fees would be added to the actual costs of gas and thus, would deduct from any savings which MGE would experience if the actual gas costs were below the benchmark gas costs and would add to any losses which MGE would experience if the actual gas costs were above 104% of the benchmark gas costs.

Q. Please summarize your direct testimony.

A. The Staff believes there are a number of weaknesses with regard to MGE's incentive plan benchmark in that (1) the benchmark upon which the entire incentive plan sharing grid is based, has no cap and thus, has no limit on upward price movement, (2) because the benchmark is not capped, MGE will make a windfall in profits by negotiating premiums in its gas supply contracts which are not based on an index price plus a percentage, but instead are specified as a certain number of cents to be added to the index price, and (3) the incentive plan benchmark does not consider, as a part of the first of the month weighted average IFGMR index price, any of the MGE non-Tight Sands gas supplies which are sourced from the Rocky Mountain supply area.

Q. Does this conclude your direct testimony?

A. Yes, it does.

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

STAFF OF THE MISSOURI PUBLIC SERVICE COMMISSION, COMPLAINT,	)	
vs.	)	Case No. GC-98-335
THE MISSOURI GAS ENERGY DIVISION OF SOUTHERN UNION COMPANY, RESPONDENT.	)	

AFFIDAVIT OF MICHAEL J. WALLIS

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Michael J. Wallis, is, of lawful age, on his oath states: that he has participated in the preparation of the foregoing Direct Testimony in question and answer form, consisting of 5 pages to be presented in the above case; that the answers in the foregoing Direct 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.

RANDALL Z. WRIGHT NOTARY SEAL NOTARY PUBLIC STATE OF MISSOURI

Michael J. Wallis
MICHAEL J. WALLIS

Subscribed and sworn to before me this 19th day of February, 1998.

Randall Z. Wright
Notary Public

My Commission Expires: 1/2/2001

Randall Z. Wright
Notary Public, State of Missouri
County of Cole
My Commission Exp. 01/02/2001

SUMMARY OF RATE CASE INVOLVEMENT

MICHAEL J. WALLIS

COMPANY NAME	CASE NO.
St. Joseph Light & Power Company	GR-88-115
Capital City Water Company	WR-88-215
GTE North Incorporated	TR-89-182
The Empire District Electric Company	WR-90-56
The Empire District Electric Company	ER-90-138
Ozark Natural Gas Company	GA-90-321
United Cities Gas Company	GR-91-249
St. Joseph Light & Power Company	EC-92-214
Western Resources Inc.	GR-93-140
Tartan Energy Company, L.C.	GA-94-127
Associated Natural Gas Company	GR-94-189
Associated Natural Gas Company	GR-95-213
Missouri Public Service	GR-95-273
Union Electric Company	EM-96-149
Missouri Public Service	GR-96-192
Laclede Gas Company	GR-96-193
Associated Natural Gas Company	GR-96-227
Atmos Energy Corporation and United Cities Gas Company	GM-97-70
Associated Natural Gas Company	GR-97-272
Missouri Gas Energy	GO-97-409
United Cities Gas Company	GO-97-410

Case No. GC-98-335 **INDEX PRICE COMPARISON**

Source: Inside FERC Gas Market Report

Month	Mid-Cont. WNG	Rky Mtn. CIG	Index Pricing Difference
November, 1993	1.83	1.70	-0.13
December, 1993	2.25	2.23	-0.02
January, 1994	1.94	1.88	-0.06
February, 1994	2.10	1.76	-0.34
March, 1994	2.11	1.86	-0.25
April, 1994	1.76	1.52	-0.24
May, 1994	1.77	1.55	-0.22
June, 1994	1.53	1.32	-0.21
July, 1994	1.61	1.39	-0.22
August, 1994	1.55	1.39	-0.16
September, 1994	1.33	1.33	0.00
October, 1994	1.24	1.16	-0.08
November, 1994	1.45	1.44	-0.01
December, 1994	1.60	1.57	-0.03
January, 1995	1.51	1.35	-0.16
February, 1995	1.23	1.06	-0.17
March, 1995	1.24	1.05	-0.19
April, 1995	1.27	1.05	-0.22
May, 1995	1.40	1.07	-0.33
June, 1995	1.44	1.14	-0.30
July, 1995	1.23	0.98	-0.25
August, 1995	1.18	0.84	-0.34
September, 1995	1.42	0.95	-0.47
October, 1995	1.49	1.04	-0.45
November, 1995	1.60	1.25	-0.35
December, 1995	1.88	1.31	-0.57
January, 1996	2.03	1.26	-0.77
February, 1996	1.84	1.16	-0.68
March, 1996	1.90	1.16	-0.74
April, 1996	2.15	1.06	-1.09
May, 1996	2.00	1.06	-0.94
June, 1996	2.03	1.06	-0.97
July, 1996	2.18	1.18	-1.00
August, 1996	2.14	1.21	-0.93
September, 1996	1.67	1.19	-0.48
October, 1996	1.68	1.25	-0.43
November, 1996	2.50	2.25	-0.25
December, 1996	3.68	3.50	-0.18
January, 1997	4.30	4.18	-0.12
February, 1997	2.81	2.48	-0.33
March, 1997	1.63	1.40	-0.23
April, 1997	1.70	1.43	-0.27
May, 1997	1.92	1.63	-0.29
June, 1997	2.11	1.46	-0.65
July, 1997	2.04	1.44	-0.60
August, 1997	2.06	1.38	-0.68
September, 1997	2.38	1.47	-0.91
October, 1997	2.98	2.10	-0.88
November, 1997	3.15	2.99	-0.16
December, 1997	2.37	1.94	-0.43
January, 1998	2.15	2.04	-0.11
February, 1998	1.92	1.70	-0.22

Total Monthly Average → **-0.39**

footnote: WNG is Williams Natural Gas Company 1st of month index
CIG is Colorado Interstate Gas Company 1st of month index