**MEMORANDUM**

TO: Missouri Public Service Commission Official Case File
Case No. GR-2005-0064, Southern Missouri Gas Company

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| /s/ Dave Sommerer 06/07/05 | /s/ Thomas R. Schwarz, Jr. 06/07/05 |
|---|---|
| Project Coordinator / Date | General Counsel's Office / Date |

SUBJECT: Staff Recommendation for Southern Missouri Gas Company's 2003/2004 Actual Cost Adjustment Filing

DATE: June 7, 2005

The Procurement Analysis Department (Staff) has reviewed Southern Missouri Gas Company's (SMGC or Company) 2003/2004 Actual Cost Adjustment (ACA) filing. This filing was made on September 14, 2004, for rates to become effective October 1, 2004, and was docketed as Case No. GR-2005-0064. The audit consisted of an analysis of the billed revenues and actual gas costs for the period of September 1, 2003, to August 31, 2004, included in the Company's computation of the ACA rate. SMGC provided natural gas to a maximum of 7,400 sales customers in the southern portion of the state including communities in Greene, Webster, Wright, Howell, Douglas and Texas counties.

In addition, Staff conducted a reliability analysis for SMGC including a review of information required to be submitted in response to the reliability recommendations in the 2002/2003 Staff ACA recommendation, Case No. GR-2004-0193, estimated peak day requirements and the capacity levels to meet those requirements.

Staff also conducted a hedging review to determine the reasonableness of the Company's hedging plans for this ACA period.

**REVENUES**

Staff believes that the revenue recovery reduction of $32,535 ($16,184 + $16,351) proposed by the Company should not be included in this filing. These were the Company's estimates of ACA revenues for September and October 2004. The Company's filing already includes 12 months of billed revenue recovery for the period of September 2003 to August 2004 so the adjustment is not necessary.

In its filing, the Company also included the revenue reduction as a decrease to an existing under-recovery balance. Revenue reductions should increase an existing under-recovery balance. As a result, Staff's adjustment increases the under-recovery balance by $32,535 (increase gas costs) to offset the revenue reduction entry proposed by the Company.

## ACA APPROACH FOR INTEREST CALCULATION

Effective September 27, 2003, per tariff sheet No. 22, the ACA approach for the interest calculation method replaced the Deferred Carrying Cost Balance (DCCB) method of calculating interest. The Company's computation of over/under recovery balances for ACA interest calculation is based on book activity that includes unbilled revenue recovery. Staff calculated interest based on billed revenues that resulted in $7,212 of interest costs due the Company. The Company filed $3,767 of interest costs due the Company. As a result, Staff proposes to increase gas costs due the Company by $3,445 ($7,212 - $3,767). Staff also believes that the cumulative ACA balance for the month ended August 2004 should reflect a $417,866 under-recovery balance. This should represent the beginning balance for the 2004/2005 ACA calculation.

## GAS SUPPLY DOCUMENTATION

The Company did not have adequate contract documentation from its supplier(s) to support its daily gas purchases. Staff believes that it is essential for the Company to provide details of the contract terms and conditions of all gas purchases made. This is typically made through an exhibit to the base contract. Staff will review those contract terms and conditions beginning in the 2004/2005 ACA review to insure that the Company provides adequate contract support for all purchases made.

## BID SOLICITATION

The Company has traditionally relied on 1-2 suppliers for its entire gas supply portfolio. As is mentioned in Staff's reliability section of this memorandum, this creates a reliability concern especially during extreme weather conditions. To help reduce its overall cost of gas while improving reliability of supply, Staff believes that the Company should aggressively solicit bids to better increase the number of gas suppliers in its supply portfolio. All bids should be fully documented and available for Staff's review.

## HEDGING

During the ACA period (September 2003 – August 2004), the Company hedged with fixed price purchases (contracts) from gas suppliers such as ** ______________________________
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**. However, it is recommended that the Company continue to evaluate the possibility of further diversifying its gas supply portfolios and to keep abreast of the market developments to help its gas procurement decision-making.

**RELIABILITY ANALYSIS**

To assure that sufficient capacity, but not excess capacity, is available to meet firm customer peak day capacity and natural gas supply requirements, Staff conducts a reliability analysis. The objective is to assure that a Company has adequate capacity to provide natural gas to its firm customers on even the coldest days, without maintaining excess capacity that would cost consumers money without any related benefit.

Staff has the following comments and concerns regarding the Company's reliability analysis and reserve margin:

1. Staff recommended in the 2001/2002 ACA, Case No. GR-2002-440, and in the 2002/2003 ACA, Case No. GR-2004-0193, that SMGC provide additional information for the peak day estimate for large general and large volume customers. SMGC provided additional data, but this data would not have been available when the Company was planning for the 2003/2004 ACA. However, since the data was offered by the Company to show that it was making progress in its peak day methodology, Staff will provide comments.

   The data evaluated was usage data for only two days in January 2004, one date with 51 heating degree days (HDD) and one date with 52 HDD. Two data points are not sufficient information for estimating peak day requirements. Although the data was extremely limited with only two data points for each customer, Staff used the only SMGC data that was available to calculate the average heat load factor. Absent any other data for base load, Staff used the SMGC base load estimate. Using the average heat load factor and the Company base load estimate, Staff estimates peak day usage of 2,436 Thousand cubic feet (Mcf) compared to the Company estimate of 2,200 Mcf (Response to 2002/2003 Staff Recommendation) and 2,180 Mcf (Data Request No. 86).

   Staff recommends that SMGC continue to make attempts to provide more data for large general and large volume customers for estimating peak day requirements. Staff recommends that this detail be provided for the Company's estimates for the 2005/2006 ACA.

2. Depending on the methodology used to estimate peak day, SMGC has a negative 2.5% to positive 5.5% reserve margin for the 2002/2003 ACA. For 2003/2004, no HDD

were experienced near the historic peak of 72 HDD. Looking out to 2004/2005 and 2005/2006, there is a much greater concern that should a historic peak cold day occur, SMGC will not have sufficient transportation capacity to provide for the usage requirements of its customers.

SMGC states that since the Southern Star tariff permits a 3% tolerance in excess of the Maximum Daily Transportation Quantity (MDTQ), there would be no penalty cost associated with exceeding the current contract Maximum Daily Quantity (MDQ) (Data Request No. 86). However, a 3% tolerance would be approximately 300 Mcf/day and most of the analyses show that SMGC is short more than 300 Mcf/day beginning in 2004/2005. SMGC states that if it experiences a peak day above the transportation contract MDQ it would (1) utilize line pack; (2) try to purchase gas at SMGC city gate from a supplier or another utility; (3) ask customers to voluntarily reduce consumption; and (4) curtail customers as noted in its tariff (Data Request No. 88).

SMGC estimates growth in residential and commercial customers of 2.8% from 2004 to 2005. The transportation contract term expired in April 2005 and was renewed for a 5-year term. SMGC recently informed Staff that it was pursuing additional pipeline capacity ** ____________________ **.

Staff is concerned about the negative reserve margin for this ACA and for the 2004/2005 winter heating season, the next ACA, and that additional capacity will not be available for SMGC customers until 2006 or later. Staff is also concerned that SMGC is increasing its capacity for future years by ** ____ **, which is much in excess of that needed for a peak cold day. Staff will review SMGC's decisions for increased capacity in light of SMGC's evaluation of peak day requirements and the capacity options available to it and the associated cost to customers. This review will take place in the ACA impacted by any increase in capacity.

Staff recommends that the Company's Reliability analysis continue to examine the issue of firm transportation capacity held by SMGC to cover a peak cold day and that

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SMGC continue to keep Staff informed of actions it is taking to address firm transportation capacity requirements on a short-term and long-term basis.

3. As in the prior ACA, Staff continues to have concerns with the SMGC gas supply plans for cold weather. The Company has agreements in place for fixed volumes of gas that address normal requirements, and SMGC purchases gas on the spot market when monthly imbalances dictate. But there are no firm agreements for this ACA period committing suppliers to swing volumes. In other words, Staff is concerned that the Company will not be able to purchase sufficient volume of natural gas to meet its customers' needs on the coldest days. ** ______________________________ **. Although SMGC has found firm gas supply on the spot market in the past, supplies can be extremely tight on a peak cold day, and pipelines may be issuing Operational Flow Orders (OFOs) requiring Local Distribution Companies (LDCs) to match confirmed nominations to deliveries. On a peak day, there are more customers looking for gas on the spot market which could further limit the availability of spot supplies, creating the risk that spot gas may not be available at any cost. This is a major reliability concern. Thus, there is a continued concern of whether SMGC will be able to find gas when the pipeline issues an OFO or when the temperature is very cold.

In response to Staff concerns regarding SMGC gas supply planning in the 2002/2003 ACA, Case No. GR-2004-0193, SMGC states that it agrees with Staff that gas supply could be extremely tight during peak cold days when pipelines may be issuing OFOs and requiring LDCs to match confirmed nominations to deliveries. To address extremely cold days, the Company offers the following to assure the gas will actually be available on a firm basis: (a) The Company plans to monitor the weather and to make first-of-month (FOM) and mid-month spot purchases for multiple days as appropriate; (b) ** ______________________________ **. Staff recommends that details of items (b), (c), and (d) be provided for the Company's gas supply plans for the 2004/2005 ACA and be provided to Staff by July 11, 2005.

An additional complication for SMGC in its gas supply function is that Southern Star Pipeline began daily allocation provisions in November 2004 that tightened monthly imbalance tolerance limits. Southern Star has penalty provisions for monthly imbalances outside of a limited tolerance. Thus, SMGC must monitor its gas supply more closely and make necessary changes to its supply to avoid being outside of tolerance.

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Staff recommends that the Company's Reliability analysis continue to examine the issue of supply availability for extremely cold days and detail how the Company plans to structure its supply contracts to assure that the gas will actually be available on a firm basis for extreme cold days and how it plans to adjust its gas supply plans for daily allocation provisions on the Southern Star Pipeline. Staff recommends that this detail be provided for the Company's gas supply plans for the 2004/2005 ACA and be provided to Staff by July 11, 2005.

## SUMMARY

The Staff has addressed the following concerns regarding Case No. GR-2005-0064 for Southern Missouri Gas Company, and proposes the following:

1. That SMGC should increase the filed under-recovery ACA account by $32,535 to reflect an adjustment to the revenue recovery balance.

2. That SMGC should increase interest costs by $3,445 to reflect billed revenue recovery under the ACA approach for interest calculation.

3. That SMGC should provide detailed documentation of its daily gas purchases. SMGC should also be more active in its bid solicitation and fully document those bids for Staff's review.

4. SMGC's overall hedging strategy was appropriate. It is recommended that the Company diversify and keep abreast of other market developments to help in its decision making.

5. That, even though Staff is proposing no dollar adjustments related to reliability, SMGC should address the Staff's concerns regarding the Company's reliability analysis, and should submit additional documentation regarding the reliability information by July 11, 2005.

## RECOMMENDATIONS

The Staff recommends that the Commission issue an order requiring Southern Missouri Gas to:

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

| Description (+) Under-recovery (-) Over-recovery | Company Ending Balances Per Filing | Staff Adjustments | Staff Recommended Ending Balances |
|---|---|---|---|
| **Prior ACA Balance 8/31/03** | $669,009 | | $669,009 |
| **Cost of Gas** | $3,992,557 | | $3,992,557 |
| **Cost of Transportation** | $1,059,398 | | $1,059,398 |
| **Revenues** | ($5,243,504) | | ($5,243,504) |
| **Revenue Adjustment** | ($32,535) | $32,535 | $0 |
| **Internal Transport Revenues** | ($119,808) | | ($119,808) |
| **ACA Approach for Interest Calculation** | $3,767 | $3,445 | $7,212 |
| **Total ACA Balance 8/31/04** | $328,884 | $35,980 | $364,864 |

| Refund Description | Refund Balance Per Filing | Staff Adjustments | Staff Recommended Refund Balance |
|---|---|---|---|
| **Prior Refund Balance 8/31/03 per settlement agreement-GR-2004-0193** | $ 54,016 | | $ 54,016 |
| **Refunds Received** | $ (2,243) | | $ (2,243) |
| **Refunds billed to Customers** | $1,230 | | $1,230 |
| **Total Refund Balance 8/31/04** | $ 53,003 | | $ 53,003 |

| | | | |
|---|---|---|---|
| **Total ACA + Refund Ending Balance 8/31/04** | $381,887 | $ 35,980 | $417,867 |

2. To submit information by July 11, 2005, to address Staff's comments and concerns listed in the reliability analysis summary section of this document.

3. File a written response to the above recommendations by July 11, 2005.