

Exhibit No.: _____
Issues: KPC Capacity Release
Purchasing Practices – Hedging
Purchasing Practices – Storage
Witness: John J. Reed
Sponsoring Party: Missouri Gas Energy
Case No.: GR-2001-382

MISSOURI PUBLIC SERVICE COMMISSION

MISSOURI GAS ENERGY

CASE NO. GR-2001-382

SURREBUTTAL TESTIMONY OF

JOHN J. REED

Jefferson City, Missouri
April 22, 2003

Exhibit No. 2
Case No(s) GR-2001-382
Date 5-12-03 Rptr 45

**SURREBUTTAL TESTIMONY OF
JOHN J. REED**

Table of Contents

	<u>Page</u>
1. PURCHASING PRACTICES – STORAGE.....	1
2. PURCHASING PRACTICES - HEDGING.....	4

1 **TESTIMONY IS NOT RELEVANT TO HOW MGE UTILIZED ITS STORAGE**
2 **INVENTORY IN THE WINTER OF 2000/2001. PLEASE COMMENT.**

3 A. As stated in my direct testimony, the AGA storage data shows that MGE utilized its
4 storage inventory in relatively the same manner as LDCs across the United States, i.e.,
5 there was a heavy reliance on storage in November and December of 2000. While I
6 agree with Ms. Jenkins and Mr. Herbert that there are obviously specific circumstances
7 that apply to each of the individual LDCs that are accounted for in the AGA data, I
8 utilized the AGA storage data to demonstrate that MGE's utilization of its storage
9 inventory in November and December basically reflected the trend of LDCs across the
10 United States.

11
12 While this fact alone does not necessarily demonstrate that MGE's actions were prudent,
13 MGE Witness Langston and I have also explained in detail other factors that show that
14 MGE's actions regarding its storage purchasing practices were in fact prudent based on
15 the circumstances that existed at the time. For example:

- 16 • MGE has developed a balanced storage plan that accounts for the weather
17 and demand volatility throughout the winter heating season and the
18 flexibility that MGE has in its supply portfolio;
- 19 • Planning on, and utilizing, more storage in November relative to other
20 winter months is appropriate because of the volatility in MGE's demand
21 that is experienced in November;
- 22 • MGE has utilized essentially the same storage plan since the winter of
23 1998/1999, and at no time has Staff communicated to MGE that it
24 believed the storage plan was deficient;
- 25 • Based on information available at the time through trade publications,
26 weather projections, pricing projections, and past experience, MGE's high
27 utilization of storage in November 2000 and the decision to order less
28 first-of-month flowing supplies for December 2000 were reasonable.

1 The point of showing the AGA data is simply that many other natural gas system
2 operators, faced with similar circumstances, made similar utilization decisions.

3
4 **Q. MR. HERBERT STATES THAT THE COMMISSION RESPONSES TO LDC**
5 **PURCHASING PRACTICES IN OTHER STATES FOR THE WINTER OF**
6 **2000/2001 THAT YOU PRESENTED IN YOUR DIRECT TESTIMONY ARE NOT**
7 **REPRESENTATIVE OR RELEVANT TO THIS PROCEEDING. DO YOU**
8 **AGREE?**

9 A. No. Mr. Herbert claims that they are not complete, and thus irrelevant, by providing five
10 examples of cases in other states in which the respective utility regulatory commission
11 disallowed gas purchasing costs for the winter of 2000/2001. However, in each of the
12 cases that Mr. Herbert cited in his rebuttal testimony, the circumstances of those cases
13 were in no way similar to the circumstances of MGE in this proceeding:

- 14 • In the Southwest Gas Company ("Southwest") proceeding, the California
15 Public Utility Commission ("CPUC") disallowed gas purchasing costs for
16 Southwest because the CPUC concluded that it was imprudent for Southwest
17 to only fill its storage to 11% of its maximum inventory level prior to the
18 winter of 2000/2001, and the fact that Southwest made no storage injections
19 from May through September 2000. Unlike Southwest, MGE's storage was
20 effectively 100% filled entering the winter of 2000/2001. Thus, the
21 circumstances in this case are not consistent with, or relevant to, the facts in
22 MGE's ACA proceeding.¹
- 23 • In the Valley Gas Company ("Valley") and Providence Gas Company
24 ("ProvGas") proceeding, the case was not an adjudicated Commission
25 decision, but rather a Commission approval of a settlement.² Therefore, the
26 circumstances are not similar, nor relevant, to MGE's situation in this ACA
27 proceeding.

¹ California Public Utilities Commission, "Investigation into the Natural Gas Procurement Practices of the Southwest Gas Company", Investigation 01-06-047/Decision 02-08-064, August 22, 2002.

² Rhode Island Public Utilities Commission, "Providence Gas Company Annual Gas Charge Clause Filing, Valley Gas Company Annual Purchased Gas Price Adjustment Clause Filing, and Provide Gas Company's Transportation Tariff Revision", Docket Nos. 1673, 1736 and 3347, October 17, 2001.

- 1 • In the Oklahoma Natural Gas ("ONG") proceeding, the Oklahoma
2 Corporation Commission ("OCC") disallowed gas purchasing costs for ONG
3 because ONG abandoned its storage and took absolutely no other action to
4 provide price stability for the winter of 2000/2001. Again, unlike ONG, MGE
5 not only had storage, but its storage was effectively 100% filled entering the
6 winter of 2000/2001, and MGE undertook additional hedging actions. Thus,
7 the circumstances in this case are also not consistent with, or relevant to, the
8 facts in MGE's ACA proceeding.
- 9 • Mr. Herbert cites a Nevada Power Company proceeding in which a review by
10 the Nevada Public Utilities Commission ("NV PUC") resulted in a substantial
11 disallowance. This proceeding is an electric proceeding and not a natural gas
12 LDC proceeding, nor did it cover purchasing practices for the winter of
13 2000/2001. Thus, it has nothing to do with MGE's purchasing practices for
14 the winter of 2000/2001.³
- 15 • Lastly, Mr. Herbert notes that while I referenced the Illinois Commerce
16 Commission, there is still a company in Illinois under review for its
17 purchasing practices in 2000/2001. However, the company to which Mr.
18 Herbert is presumably referring, i.e., NICOR Gas, is being investigated due to
19 alleged fraudulent behavior, which, once again, is not relevant to MGE's
20 circumstances in this ACA proceeding.

21 Clearly, as described above, none of the cases Mr. Herbert has identified are relevant to
22 the circumstances in MGE's proceeding.

23
24 Purchasing Practices - Hedging

25 **Q. WHAT HAS STAFF ARGUED WITH REGARD TO MGE'S HEDGING**
26 **PRACTICES FOR THE WINTER OF 2000/2001?**

27 A. Staff has claimed that MGE did not have a documented hedging plan in place for the
28 winter of 2000/2001, and has argued that MGE should have, at a minimum, hedged 30%
29 of its firm volumes each month during the winter of 2000/2001 (see, e.g., Rebuttal
30 Testimony of David Sommerer at pp. 7 and 10). While MGE had more than 30% of its
31 volumes hedged in certain months, and had significantly more than 30% of its total

1 winter volumes hedged, MGE did not have more than 30% of its volumes hedged in
2 certain individual months. Therefore, Staff has claimed that MGE's hedging conduct for
3 the winter of 2000/2001 was imprudent. I will address Staff's complete lack of support
4 for its 30% minimum monthly hedging level, while MGE Witness Langston will address
5 Staff's gross mischaracterization that MGE did not have a documented hedging plan prior
6 to the winter of 2000/2001.

7
8 **Q. HAS STAFF PROVIDED ANY SUPPORT FOR ITS POSITION THAT A**
9 **MINIMUM OF 30% HEDGING WAS APPROPRIATE FOR THE WINTER OF**
10 **2000/2001?**

11 A. No. As detailed in my direct testimony, Staff's 30% monthly hedging figure was simply
12 picked based on a conference call discussion after the winter of 2000/2001. Staff's
13 position suffers from a complete lack of support or foundation. The so-called "support"
14 that Staff has offered to date regarding the 30% monthly hedging figure is highlighted in
15 the rebuttal testimony of Staff Witness Herbert:

16 Q. Do you think that the 30% of normal requirements as a volume to
17 hedge is arbitrary?

18 A. No. It represents a volume of gas requirements that can be
19 effectively hedged across companies. It is a conservative minimum
20 volume. That a company or a Commission may not articulate such a
21 percentage is beside the point. ...it goes without saying that
22 Companies should almost always be expected to hedge at least 30%
23 of their normal requirements. (emphasis added) (Rebuttal
24 Testimony of John Herbert, Case No. GR-2001-382, March 18,
25 2003, page 23, ll. 10-22).

³ Public Utilities Commission of Nevada, "Application of Nevada Power Company for authority to establish a Deferred Energy Accounting Adjustment rate", Docket No. 01-11029, March 29, 2002.

1 Mr. Herbert apparently has no regard for the Commission's prudence standards, as he
2 believes that it is irrelevant that the neither the Staff nor the Commission communicated
3 the benchmark against which it was going to measure MGE's conduct to MGE prior to
4 the winter of 2000/2001. In addition, without any support whatsoever, Mr. Herbert
5 makes the egregious assertion that "it goes without saying" that 30% is the appropriate
6 hedging level. In effect, Mr. Herbert is suggesting that the 30% hedging level should
7 have been the benchmark against which LDC actions should be compared, regardless of
8 whether the benchmark was in place prior to the winter of 2000/2001. The only thing
9 that "goes without saying" is that an appropriate hedging level is not clear and has never
10 been communicated to MGE.

11
12 **Q. WHAT HAS MR. SOMMERER STATED IN HIS REBUTTAL TESTIMONY**
13 **WITH REGARD TO STAFF'S PROPOSED 30% HEDGING LEVEL?**

14 **A.** Mr. Sommerer has stated in his rebuttal testimony that:

15 MGE has mischaracterized the 30% hedging level as some sort of new and
16 unannounced prudence standard conjured up by the Staff after-the-fact.
17 The 30% level is in fact a measurement (or estimate) of the damages
18 resulting from MGE's failure to hedge sufficient volumes for each heating
19 season month. A measurement of damages is required in any
20 disallowance, and by its very nature may involve some range of
21 reasonable damages. The Staff has stated that this was a "minimal" level.
22 The level is very minimal, is readily achievable, but it must be stressed
23 that this level is not a "standard" that the Staff would suggest as providing
24 adequate protection in all circumstances. (Rebuttal Testimony of David
25 Sommerer, Case No. GR-2001-382, March 18, 2003, page 10, line 19
26 through page 11, line 4).

27
28 Mr. Sommerer asserts that the 30% level is solely a damages calculation rather than a
29 benchmark or standard against which MGE's hedging conduct for the winter of
30 2000/2001 is being compared against. However, this is simply not true.

1
2 As stated above, Staff has argued in this proceeding that MGE's hedging conduct for the
3 winter of 2000/2001 was imprudent. Staff has based its finding of imprudence on the fact
4 that MGE did not hedge a minimum of 30% of its volumes in each month during the
5 winter of 2000/2001. (See, e.g., Direct Testimony of Lesa Jenkins, p. 5, ll. 1-16; p. 9,
6 line 4 through p. 10, line 11). In fact, Ms. Jenkins stated in her direct testimony that:

7 Staff wanted a standard that was reasonable for all Missouri local
8 distribution companies to follow even if the companies wanted to be
9 extremely conservative in their use of hedging instruments because of
10 their experience. (Direct Testimony of Lesa Jenkins, Case No. GR-2001-
11 382, January 15, 2003, page 10, ll. 1-4).
12

13 Therefore, the 30% hedging level, while also used as a proposed damages calculation, has
14 in fact been utilized by Staff as the benchmark against which it is determining that
15 MGE's hedging conduct was imprudent.
16

17 **Q. IS STAFF'S PROPOSAL CONSISTENT WITH THE COMMISSION'S**
18 **PRUDENCE STANDARD?**

19 A. Absolutely not. Staff's proposed 30% hedging level is clearly inconsistent with the
20 Commission's prudence standard. As I explained in detail in my direct testimony, the
21 Commission's prudence standard requires that an LDC's actions be considered based on
22 the circumstances that existed at the time. At no time prior to, or even during, the winter
23 of 2000/2001, was MGE ever made aware that its gas purchasing practices would be
24 evaluated based on a 30% monthly minimum hedging level. In fact, Staff has admitted
25 that it did not "develop" the 30% level that it has proposed in this proceeding until a
26 conference call well after the winter of 2000/2001 (see, e.g., pages 31-32 of the Rebuttal

1 Testimony of Michael T. Langston; and page 38 of the Direct Testimony of John J.
2 Reed). Therefore, while dismissed by Mr. Sommerer in his rebuttal testimony referenced
3 above, Staff's 30% hedging proposal was in fact "some sort of new and unannounced
4 prudence standard conjured up by the Staff after-the-fact."

5
6 In addition, as noted in my direct testimony, Staff's "standard" has not even been applied
7 consistently considering that Staff signed a settlement with Laclede Gas Company
8 ("Laclede") in September 2000 that permitted Laclede to hedge as low as zero volumes in
9 any particular month. Therefore, Staff signed an agreement with Laclede immediately
10 prior to the winter of 2000/2001 (i.e., in September 2000) that permitted Laclede to hedge
11 varying levels of volumes throughout the winter, including no volumes at all in certain
12 months, even though in this proceeding Staff has argued that MGE should be held to a
13 higher and different standard.

14
15 **Q. REGARDLESS OF WHETHER THE 30% MONTHLY HEDGING FIGURE WAS**
16 **THE BENCHMARK AGAINST WHICH STAFF HAS MADE ITS FINDING OF**
17 **IMPRUDENCE OR WHETHER IT IS SOLELY A DAMAGES CALCULATION,**
18 **WAS MGE'S HEDGING CONDUCT PRUDENT?**

19 **A.** Yes. Regardless of whether the 30% was or was not the benchmark or standard against
20 which Staff was making its determination of hedging prudence, MGE's conduct has been
21 shown to be reasonable and prudent based on the circumstances that existed at the time.
22 As an individual with significant experience and expertise in gas supply and regulatory

1 matters generally, and in prudence reviews specifically, I find the following facts to be
2 most relevant in this proceeding regarding MGE's hedging conduct:

- 3 • For the winters of 1997-1998, 1998-1999 and 1999-2000, MGE's
4 experience with price stabilization was consistently based upon specific
5 authorization by the Commission of a Price Stabilization Fund, including
6 express provisions regarding cost recovery (See, e.g., Case Nos. GO-97-
7 409, GO-98-364 and GO-2000-231);
- 8 • Six months prior to the winter of 2000-2001, MGE completed negotiations
9 with Staff and the Office of Public Counsel resulting in the submission of
10 a settlement in May of 2000 regarding the Fixed Commodity Price PGA
11 ("FCP Settlement");
- 12 • The FCP Settlement provided for two alternative methods of stabilizing
13 prices for customers: 1) a Fixed Commodity Price PGA that would lock-
14 in prices on 100% of volumes upon the market reaching a prescribed
15 "trigger" price, and which "trigger" price was to be subject to periodic re-
16 negotiation in the event the market did not reach that level; and 2)
17 continuation of the Price Stabilization Fund concept used for the previous
18 three winters;
- 19 • In June of 2000, MGE advised the Commission of, among other things,
20 concerns that MGE would not be able to purchase call options within the
21 parameters of the Price Stabilization Fund contained in the FCP
22 Settlement;
- 23 • In August of 2000, the Commission approved the FCP Settlement;
- 24 • In September of 2000, MGE initiated discussions with Staff and OPC to
25 modify the trigger price of the Fixed Commodity Price PGA to reflect
26 then-current prices and/or modify the term so that price protection could
27 be provided for the winter of 2000/2001;
- 28 • In early-September 2000, Staff signed a settlement with Laclede for a
29 hedging mechanism for the winter of 2000/2001 that was similar to
30 MGE's Price Stabilization Fund. In addition, the settlement permitted
31 Laclede to hedge a variable level of volumes for the winter of 2000/2001;
- 32 • In late-September of 2000, MGE submitted a proposal to the Commission
33 to modify the Price Stabilization Fund included as part of the FCP
34 Settlement because market conditions did not allow for purchases within
35 the parameters approved in the August order;
- 36 • In mid-October 2000, Staff recommended that the Commission not
37 approve modifications to the Price Stabilization Fund, but that the
38 Commission include additional language in MGE's tariff providing MGE
39 with hedging authorization;
- 40 • In late-October 2000, the Commission rejected MGE's proposed
41 modifications to the Price Stabilization Fund, and did not address Staff's

1 proposed tariff language which would have provided MGE with the
2 authority to hedge and recover the associated hedging costs.
3

4 Based on these facts, I can only conclude that MGE made significant efforts to address
5 the issue of potential price volatility well in advance of the winter of 2000-2001. MGE
6 reasonably and justifiably acted in accordance with the regulatory practices that had been
7 in place for the previous three winters and that had just recently been approved for the
8 winter of 2000-2001. To argue, as the Staff does in this proceeding, that MGE should
9 have ignored these regulatory practices is representative of after-the-fact or 20/20
10 hindsight review in violation of the Commission's long-standing prudence standard.
11

12 **Q. DO YOU HAVE ANY ADDITIONAL COMMENTS WITH REGARD TO**
13 **STAFF'S REBUTTAL TESTIMONY ON THE ISSUE OF HEDGING?**

14 A. Yes. Mr. Herbert states on page 21 of his rebuttal testimony that he does not agree with
15 the statement in my direct testimony that price stability necessarily carries a financial
16 premium. Mr. Herbert then proceeds to provide an example in which a customer could
17 acquire a costless collar, thereby putting a ceiling and a floor on the cost of natural gas
18 that the customer would have to pay in the future. Mr. Herbert claims that since it is a
19 costless collar, there is no cost to the customers.
20

21 However, as stated on page 49 of my direct testimony, there are customers who prefer
22 price stability and there are those customers that prefer the lowest price of natural gas.
23 Hedging, or purchasing insurance on the cost of natural gas, does not generally result in
24 the lowest cost of natural gas. In fact, Mr. Herbert appears to agree with this conclusion,

1 as he states on page 20 of his rebuttal testimony that "[i]f an index price can be shown to
2 be a product of a truly competitive market then in the long run of perhaps ten years index
3 pricing may well yield the lowest price for a company." In addition, while there may be
4 no cost to the LDC for purchasing a costless collar, that surely does not mean that there is
5 not necessarily a cost to the customers for that costless collar. While a costless collar
6 limits the customers' exposure to high prices, it also limits their ability to participate in
7 falling natural gas prices. Thus, if a costless collar is purchased, just as if a fixed price
8 contract were purchased, the customers are locked-in to the price range of the collar (or
9 specific price with the fixed price contract), and are unable to benefit from any fall in
10 natural gas prices below the collar's floor price. Therefore, for customers who want to
11 pay the market price for natural gas, and generally a lower price in the long-term than
12 hedged volumes, there is clearly a cost to a "costless" collar.

13
14 **Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?**

15 **A.** Yes, it does.

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

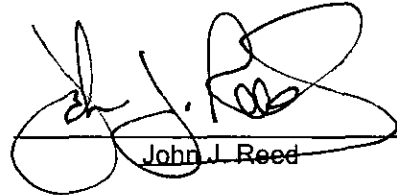
In the Matter of Missouri Gas Energy's
Purchased Gas Cost Adjustment tariff
Revisions to be reviewed in its 2000-
2001 Actual Cost Adjustment.

)
)
)
)
Case No. GR-2001-382

AFFIDAVIT OF JOHN J. REED
COMMONWEALTH OF MASSACHUSETTS)
COUNTY OF MIDDLESEX)

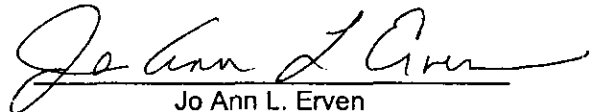
ss.

John J. Reed, of lawful age, on his oath states: that he has participated in the preparation of the foregoing Rebuttal Testimony in question and answer form, to be presented in the above case; that the answers in the foregoing Rebuttal 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.



John J. Reed

Subscribed and sworn to before me this 17th day of April, 2003.



Jo Ann L. Erven

My Commission Expires: March 31, 2004