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Witness:	**George E. Godat**
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LACLEDE GAS COMPANY

GR-2004-0273

DIRECT TESTIMONY

OF

GEORGE E. GODAT

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DIRECT TESTIMONY OF GEORGE E. GODAT

Q. What is your name and address?

A. My name is George E. Godat, and my business address is 720 Olive Street, St. Louis, Missouri 63101.

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

A. I am employed by Laclede Gas Company ("Laclede" or "Company") in the position of Director of Gas Supply.

Q. Please state your qualifications and experience.

A. I graduated from the University of Missouri Rolla in 1991, where I received a Bachelor of Science degree in Mechanical Engineering. I joined Laclede in January of 1992 as an Engineer in the Distribution/Design department. I was promoted to Distribution Engineer in 1994 where I was responsible for the Engineering Department of Laclede's Missouri Natural Division. I was promoted to the position of Gas Supply Administrator in the Gas Supply Department in 1996 and to Senior Gas Supply Administrator in 1998. I became Manager of Energy Services in October 2001, and was promoted to my current position in October 2003. As Director of Gas supply, I am responsible for directing most of the day to day gas supply purchasing, sales, risk management and accounting functions for Laclede Gas Company.

PURPOSE OF TESTIMONY

Q. What is the purpose of your testimony?

A. The purpose of my testimony is to respond to the Staff's recommendation in this proceeding to disallow approximately $2.4 million **<u>in demand charges that Laclede incurred during the 2003-2004 winter heating season to reserve and lock-in at first-of-the-</u>

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month prices the cost of "swing" gas supplies that it had contracted for to serve its customers.**

Q. Is it your understanding that this is the only remaining issue in this case?

A. Yes. Consistent with the Notice filed by the Staff of the Missouri Public Service Commission on August 24, 2006, it is my understanding that Staff's proposed disallowance **relating to demand charges for swing gas** is the only remaining issue in this case.

Q. Does the Company oppose Staff's proposed disallowance?

A. Yes. As I discuss later in my testimony, the Commission should reject Staff's proposed disallowance for three primary reasons. First, there is absolutely no evidence that Laclede's contracting practice **of paying demand charges for the right to reserve and lock-in the price of its swing supplies** was imprudent. To the contrary, these are the very same hedging practices that Laclede had successfully employed for many years, with Staff's full knowledge. Moreover, they are practices that not only resulted in more stable prices for Laclede's customers, but also created substantial savings for those same customers in the process. Nevertheless, because the Staff mistakenly believes that these practices did not result in savings during the particular ACA period in question, it has proposed to disallow **some of these demand charges** based on what I believe is a fundamentally unfair, erroneous and impermissible hindsight review.

Second, I believe Staff's proposed disallowance should be rejected because there is absolutely no evidence that Laclede's practice **of paying demand charges to reserve and lock-in the price of its swing supplies** actually harmed customers. Specifically, while Staff acknowledges that the purchasing practices followed by Laclede have enabled the Company **<u>to make off-system sales</u>**, it fails to offset its proposed disallowance **<u>with the off-system sales revenues that have actually been generated by the Company and flowed through to its ratepayers</u>.** Had Staff done so, such an offset would have totally negated its proposed disallowance and shown that Laclede's customers were actually benefited by this contracting practice during the ACA period in question.

Finally, Staff's proposed disallowance is fundamentally inconsistent with the Commission's own Natural Gas Price Volatility Mitigation rule. As I discuss later, that rule affirmatively encourages local distribution companies like Laclede to use various contracting practices and financial instruments to achieve greater price stability on behalf of their customers. To that end, the rule explicitly acknowledges and accepts the proposition that prudent efforts aimed at promoting more stable prices may occasionally result in prices that are higher than spot market prices. By seeking to penalize the Company for using a price stabilization practice precisely because it may have resulted in a slightly higher than spot-market price in a particular year, the Staff has proposed an adjustment that eviscerates the core assurances provided by the Commission's Price Volatility Rule. For all of these reasons, I believe that the Commission should reject Staff's proposed disallowance.

HISTORY OF CONTRACTING PRACTICE

Q. What are "swing" supplies?

A. In contracting for gas supplies, Laclede has to take into consideration the extremely variable demands for natural gas that its customers can and do impose during the winter heating season. **<u>Because most of Laclede's customer base consists of temperature sensitive residential and commercial customers, the demand for gas during the winter</u>

heating season can vary significantly from day to day and even hour to hour based on changes in the weather.** Laclede has a variety of tools at its disposal to meet these varying demands, including storage gas, propane peak shaving capabilities and, of course, flowing gas supplies that are purchased and then received on a daily basis from producers and marketers over the interstate and intrastate pipelines that are connected to Laclede. A portion of these gas supplies are "baseload" supplies that Laclede is obligated to take in even increments each day to serve those minimum load requirements that Laclede expects it will experience each day, regardless of weather conditions or other factors. Another component of these supplies are called "swing" supplies. These consist of supplies which Laclede may or may not need on a given day to serve its customers depending on how weather conditions are affecting the demand for gas and the availability of other supply options for meeting that demand.

Q. Why does Laclede **pay demand charges in connection with these swing supplies?**

A. **Laclede pays these charges in connection with the swing supplies it buys because that is what the producers and marketers selling such supplies demand in order to provide Laclede with (a) the flexibility to take the gas on a "swing" basis (i.e. to buy as much or as little gas each day that Laclede needs to meet the variable, temperature-sensitive demands of its customers that I mentioned earlier) and (b) the right to lock-in for the entire month the price that Laclede will be required to pay for such supplies when it does purchase them.**

Q. How does this hedging strategy benefit Laclede's customers?

A. This hedging strategy benefits Laclede's customers because **the payment of demand charges allows the Company to lock in the price for its swing supplies for an entire month. Consumers benefit from this hedge by avoiding intra-month price spikes, caused by cold weather or otherwise, because in such circumstances Laclede can buy needed swing supplies at the lower first-of-month price. Conversely, if warmer weather and conservation practices cause Laclede customers' demand for gas to decline, Laclede is able to forego its purchases of swing gas in favor of storage or other supplies.**

Q. How long has Laclede been paying **demand charges on its swing supplies?**

A. Laclede's practice **of paying demand charges on its swing supplies in order to reserve this flexibility and lock in the price of its gas supplies** is a long-standing one. In fact, Laclede had been following that practice for at least ten years prior to the ACA period under consideration in this case.

Q. Was Staff aware of Laclede's practice **of paying such charges?**

A. Yes. Throughout the entire ten year period preceding the ACA period in this case, Staff was fully aware of Laclede's practice in this regard. In fact, the Staff had reviewed this practice in detail, not only in various ACA proceedings, but in other proceedings as well.

Q. Did Staff ever voice any concerns throughout this period **that Laclede's payment of demand charges on its swing supplies was imprudent or inadvisable?**

A. No. In fact, in case after case over this period, the Staff gave every indication that measures **designed to hedge or stabilize gas prices -- which is precisely what Laclede's payment of demand charges on its swing supplies does** -- were a good thing that should be aggressively pursued by local distribution companies.

STAFF'S PROPOSED ADJUSTMENT

Q. Why then has Staff suddenly proposed to disallow **a portion of these charges in this case**?

A. Since I do not believe there is any valid justification for such an adjustment, all I can do is point to what Staff has stated in its recommendation in support of its proposed disallowance. As I understand it, Staff bases its proposed adjustment on the theory that Laclede did not adequately support, with a formal study that was prepared prior to contracting for gas supplies,** its decision to pay the demand charges that it incurred to reserve and lock in the price of its swing supplies during the ACA period.** According to Staff, the need for such a study was particularly compelling **given the increases that had been experienced in the cost of these demand charges over prior years. In any event, since the savings achieved by locking up the prices on these swing supplies were, according to Staff's calculations, less than the demand charges during this particular ACA period, Staff proposed to disallow that portion of the charges related to locking in the price presumably on the grounds that Laclede was imprudent for incurring them.**

FAILURE TO SHOW IMPRUDENCE

Q. Do you agree with Staff's position that Laclede was imprudent?

A. Absolutely not. Legal counsel has advised me that to make an adjustment based on imprudence, the Staff must show, and the Commission must find, that utility management acted imprudently compared to what a reasonable person would or should have done at the time the transaction took place. I have also been advised that any prudence determination must be based on the facts and circumstances that existed at the time the transaction took place and may not use hindsight to arrive at its conclusion. In view of this standard, I do not believe that the Staff has come anywhere close to establishing that Laclede acted imprudently **by paying demand charges to lock-in the price of its swing gas supplies** during the ACA period.

Q. Why do you say that?

A. As I previously indicated, at the time Laclede made its decision **to pay demand charges on its swing supplies for the winter of 2003-2004,** it had been employing such a practice for at least ten years. Moreover, it had been doing so with Staff's full knowledge and apparent concurrence **that paying demand charges to lock-in the price of swing supplies was a reasonable contracting practice.** Indeed, had Staff believed that this long-standing contracting practice was unreasonable or flawed for some reason, it had numerous opportunities in prior ACA proceedings and other venues to say so. Staff never did, however. To the contrary, as a result of the unprecedented run-up in gas prices that was experienced in December 2000, and the $3.50 per MMBtu increase in intra-month prices that occurred in February 2003 (just months prior to Laclede contracting for gas supplies for this 2003-04 ACA period), the Commission initiated a formal process to evaluate the adequacy of the hedging practices being followed by LDCs to stabilize prices, and promulgated a rule (4 CSR 240-40.018, effective December 30, 2003) in which it strongly urged utilities to utilize price mitigation and other efforts to stabilize gas prices -- **something that locking-in the price of swing supplies unquestionably does.** A timeline summarizing events relevant to this process is set forth in Schedule GEG-1 attached hereto. In view of this background, I do not see how anyone, least of all the Staff, could assert that it was somehow imprudent for Laclede to continue a practice that it had consistently employed for years under Staff's watchful eye.

Q. Isn't Staff correct, however, in claiming that Laclede was imprudent for not conducting a formal study before it decided to continue this practice, **particularly in view of how demand charges had increased?**

A. No. Such an argument is completely fallacious. First, at the time these decisions were made, Laclede had every reason to believe, based on many years of real world experience in the natural gas markets, that such a practice was, and remained, a reasonable one, both in terms of its impact on gas costs and in terms of its usefulness in stabilizing prices. In fact, a study conducted by Laclede in the winter of 1995-1996 **had showed that the benefit of buying gas at first-of-month pricing outweighed the cost of the demand charges.** Since that time, Laclede had continued to monitor this hedging strategy and, prior to the subject ACA period, had seen no evidence to indicate that such hedging strategy had become imprudent or was not cost-effective. To the contrary, as discussed above, as recently as six months before it entered the winter of 2003-2004, Laclede had seen **intra-month price spikes** in the natural gas markets that, given their magnitude, had broadly reconfirmed the wisdom of using such a hedging strategy to mitigate such spikes. In view of this readily available data, there was absolutely no need for a formal "study" to prove what Laclede had observed the natural gas markets prove on a regular basis each month. Moreover, when Laclede did in fact conduct a formal study, as acknowledged by Staff on page 9 of its Recommendation in this case, **that study confirmed that such a hedging strategy had saved its customers nearly $20 million over a five-year period (1998-2003) ending immediately prior to the ACA period under consideration in this case.**

Q. Are there other reasons why a formal study was not needed?

A. Yes. I think it is important for the Commission to recognize that **all of the demand charges paid by Laclede have been established through a competitive bidding process. As a result, there was every reason to believe that they were reasonably priced and fairly reflected the value of stabilizing prices. Indeed, Laclede had utilized the very competitive bidding process recommended by Staff to confirm the validity of these market prices.**

Q. What is your response to Staff's assertion that a formal study was needed **in light of the increases which had been experienced in the magnitude of the demand charges paid by the Company?**

A. The Staff's observation **that demand charges for swing supply had increased during the ACA period** says nothing about the prudence of the Company's actions in this case. **The fact is that the commodity cost of gas, as well as demand costs, were rising at this time and the change in the latter represented a relatively miniscule increase of less than two-tenths of one percent when measured against the Company's overall gas costs during that period. And to the extent prices were increasing, those increases were a direct and obvious market response to the greater price volatility that had emerged in the natural gas marketplace -- volatility that, because of its potential cost impact, naturally increased the value of hedging arrangements designed to mitigate it. Under such circumstances, it was entirely prudent for Laclede to pay increased demand charges in order to provide its customers protection from another huge run-up in intra-month prices, as the market was anticipating at that time.** Moreover, as in the past, had weather and pricing conditions turned out differently during the ACA period, **the savings achieved by paying these demand charges could have easily dwarfed their cost. Indeed, had that exact high price scenario occurred, and had Laclede not hedged the price of its swing supplies,** I would not be surprised if Laclede would now be facing a Staff adjustment premised on the Company's failure to protect its customers **from such price increases.** In view of all of these considerations, I do not believe there is any basis for concluding that Laclede acted imprudently by continuing a long-standing strategy that had proved its value over the years. Staff's effort to focus with 20/20 hindsight on a particular ACA period, as opposed to the merits and results of the long-term strategy, should be rejected by the Commission.

ABSENCE OF HARM

Q. Even if the Commission decides that this long-standing hedging strategy was somehow imprudent, should it nevertheless reject Staff's proposed disallowance?

A. Yes. I have also been advised by legal counsel that a disallowance of gas costs is impermissible without also finding that the allegedly imprudent action resulted in actual harm to ratepayers.

Q. Has Staff shown that ratepayers were harmed **by Laclede's payment of demand charges during the ACA period**?

A. No. In that regard, it should be noted that another benefit from this hedging strategy is that it provides Laclede with an opportunity to **buy swing gas at a lower price than the market rate for a given day. This pricing advantage, in turn, provides Laclede with an opportunity to realize a profit on the sale of gas to customers off of Laclede's system, known as an "off-system sale." These off-system sales involve gas that the Company temporarily does not need to serve its own customers.**

Q. Has Laclede **been making these off-system sales**?

A. Yes. Laclede has **been making these off-system sales since the mid-1990s.** In its 2002 rate case (Case No. GR-2002-356), a Stipulation and Agreement ("Stipulation") approved by the Commission (and in effect during the ACA period) provided that

Laclede's annual revenue requirement included an imputed $3.8 million in off-system sales and capacity release revenues. In exchange for this imputation, the Company was permitted to retain all of the revenues realized from off-system sales and releases of pipeline capacity. In effect this means that regardless of the level of off-system sales or pipeline capacity release achieved by Laclede, its customers were *guaranteed* $3.8 million per year through lower rates. The Stipulation further provided that "no other treatment of such revenues shall be implemented as the result of any action taken in another Commission case..." (Stipulation, p.10). Moreover, as a result of Laclede's success in making off-system sales during this period, Laclede's customers today are benefiting from an even higher imputation.

Q. Why do these factors negate any possible finding that Laclede's customers have been harmed **<u>as a result of its payment of these demand charges</u>**?

A. **<u>Even though Staff acknowledges that the Company's strategy of paying demand charges to lock in the price of swing supplies facilitates off-system sales, the Staff has completely ignored the revenues imputed to customers from these off-system sales. While the $3.8 million annual imputation discussed above is not expressly divided between off-system sales and capacity releases, the majority of these revenues were derived from off-system sales. Thus, when the customer benefits from off-system sales are factored into Staff's calculation – as they should be – the result effectively negates Staff's proposed disallowance by eliminating any notion that the Company's ratepayers were somehow harmed by Laclede's payment of demand charges for swing supplies.</u>** On the other hand, the failure to reject Staff's proposed disallowance would deprive Laclede of the value of what it bargained for in the Stipulation – and in the process violate that agreement – by taking away with an ACA adjustment what the Company was entitled to keep under the Stipulation. None of these impermissible results should be permitted by the Commission.

INCONSISTENCY WITH NATURAL GAS PRICE VOLATILITY MITIGATION RULE

Q. You previously indicated that Staff's proposed disallowance was also inconsistent with the Commission's Natural Gas Price Volatility Mitigation Rule. What do you base that conclusion on?

A. The Commission's Natural Gas Price Volatility Mitigation rule, which is set forth at 4 CSR 240-40.018, was adopted for the express purpose of encouraging local distribution companies, like Laclede, to use various contracting practices and financial instruments to achieve greater price stability on behalf of their customers.

Q. How does the rule promote that objective?

A. It facilitates that objective by explicitly acknowledging and accepting the fact that prudent contracting and hedging practices aimed at promoting more stable prices may occasionally result in prices that are higher than spot market prices. In other words, it recognizes that a more stable price is not always going to be the lowest price given the way market prices can decline as well as increase from what was assumed or prevailing at the time a hedging decision was made. By providing this kind of assurance, the rule effectively tells utilities that they will not be penalized with disallowances simply because their price mitigation practices result in higher rates in a given year than would have been the case had the utility simply relied on the spot market.

Q. How is Staff's proposed disallowance inconsistent with this rule?

A. Staff's proposed disallowance strikes at the heart of the rule and what it was intended to accomplish by disallowing costs precisely because a price mitigation practice allegedly resulted in prices slightly higher than the spot-market prices which prevailed in a particular year. **<u>Indeed, by disallowing any and all demand charges that were paid to lock-in the price of swing gas, Staff's proposed adjustment essentially says that *not one cent* above and beyond the immediate savings achieved through the payment of the demand charges should have been incurred by Laclede to hedge for intra-month price spikes.</u>** As a result, Staff's proposed disallowance is directly contrary to the explicit wording and intent of the Commission's Price Volatility Rule.

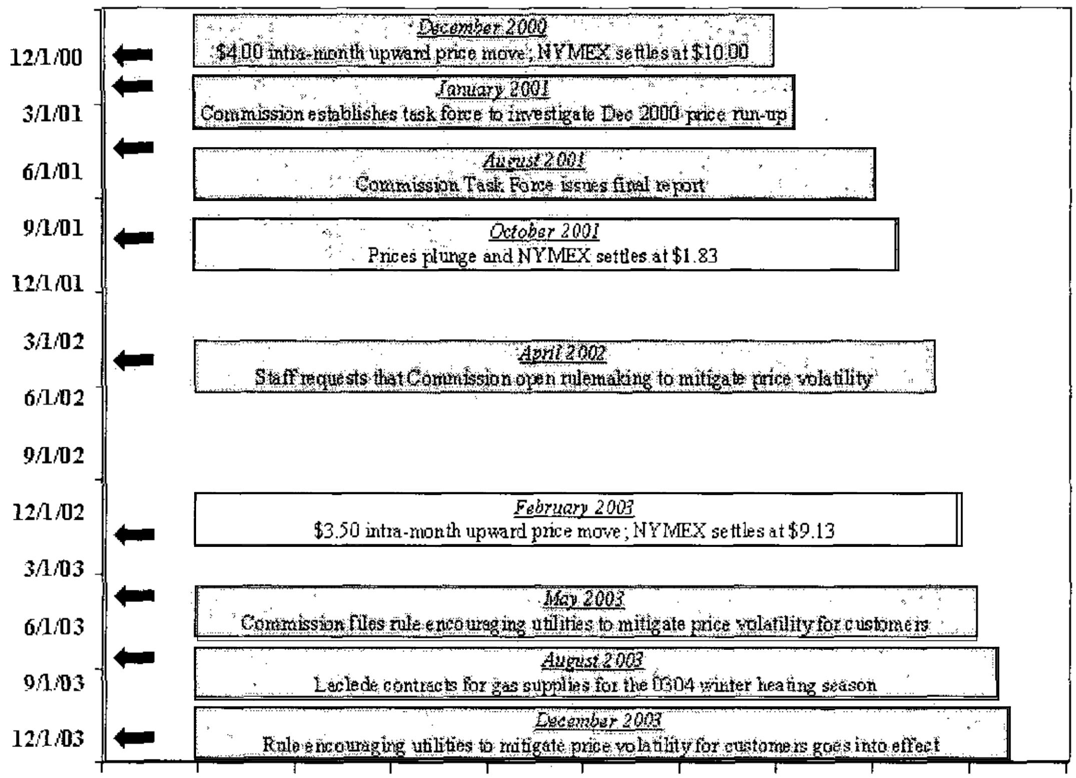
Q. What would this mean for hedging strategies in the future in the event the Commission were to adopt Staff's proposed adjustment?

A. Contrary to the Rule's intent, it would actively discourage hedging by telling utilities that the practice is acceptable only if, and to the extent, it produces a favorable outcome in each and every ACA period. That would send exactly the wrong message at a singularly inappropriate time given the gas price environment faced by local distribution companies and their customers today. For all of these reasons, Staff's proposed adjustment should be rejected by the Commission.

Q. Does this conclude your direct testimony?

A. Yes, it does.

Timeline of Laclede Issues for 0304 Portfolio



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