Exhibit No.:	
Issue:	PSP Overview
Witness:	Kenneth J. Neises
Type of Exhibit:	Direct Testimony
Sponsoring Party:	Laclede Gas Company
Case No.:	GO-2000-394

FILED

JUL 10 2001

Missouri Public Service Commission

LACLEDE GAS COMPANY

DIRECT TESTIMONY

OF

KENNETH J. NEISES

July 2001

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Laclede Gas Company's	)
Experimental Price Stabilization Fund.	) Case No. GO-2000-394

AFFIDAVIT

STATE OF MISSOURI	)
	)
CITY OF ST. LOUIS	)

Kenneth J. Neises, of lawful age, being first duly sworn, deposes and states:

1. My name is Kenneth J. Neises. My business address is 720 Olive Street, St. Louis, Missouri 63101; and I am Senior Vice President – Energy and Administrative Services of Laclede Gas Company.

2. Attached hereto and made a part hereof for all purposes is my direct testimony, consisting of pages 1 to 13, inclusive.

3. I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded are true and correct to the best of my knowledge and belief.

K J Neises

Kenneth J. Neises

Subscribed and sworn to before me this 10th day of July, 2001.

Patricia P. Hicks

Notary Public

PATRICIA P. HICKS
Notary Public — Notary Seal
STATE OF MISSOURI
City of St. Louis
My Commission Expires: June 27, 2002

DIRECT TESTIMONY OF KENNETH J. NEISES

Q. What is your name and address?

A. My name is Kenneth J. Neises, 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 Senior Vice President-Energy & Administrative Services.

Q. Please state your qualifications and experience.

A. I graduated from Creighton University in 1967, where I received a Juris Doctorate degree. In 1970, I received a L.L.M. degree from Georgetown University Law Center. From 1967 to 1973, I was employed as a litigation and trial attorney for the Federal Power Commission (now the Federal Energy Regulatory Commission). I left the Commission in 1973 to accept an appointment by the U.S. Postal Rate Commission to represent the interests of the general public in proceedings before that Commission. I then served as a partner in the law firm of Debevoise and Liberman in Washington, D.C. until joining Laclede in 1983 as an Associate General Counsel. I was elected to the position of Vice President in January 1987 and Senior Vice President in January 1994. Prior to assuming my current position, I was Senior Vice President-Gas Supply and Regulatory Affairs. In that position I had overall management responsibility for the Company's gas procurement activities, its participation in proceedings before the Federal Energy Regulatory Commission ("FERC") on matters affecting Laclede and its customers, and Laclede's participation in various regulatory proceedings before this Commission. My current duties include these responsibilities, as well as overall responsibility for labor, community relations and corporate communications.

PURPOSE OF TESTIMONY

Q. What is the purpose of your direct testimony?

A. The purpose of my testimony is to provide an overview of the Company's Price Stabilization Program ("PSP") and explain why we believe it should be continued, with certain modifications, beyond the initial three-year term of the Program.

Q. Are the Company's recommendations being addressed by any other witness?

A. Yes. Mr. George Godat will provide additional details and analysis in support of the Company's recommendations in this case.

HISTORY AND STRUCTURE OF PSP

Q. When was the PSP initially approved by the Commission?

A. The PSP, in its earliest form, was approved by the Commission in 1997 as part of a Stipulation and Agreement that had been submitted by the Company and Staff in Case No. GO-97-401. The purpose of the PSP was to provide the Company with a means to procure financial instruments, in the form of call options, that could then be used to provide the Company and its customers with some level of protection from spikes in the wholesale price of gas during the winter heating season.

Q. What are call options?

A. Call options are a form of financial instrument that can be purchased on the New York Mercantile Exchange ("NYMEX"). In exchange for a specific, up-front payment, the option entitles the buyer to a financial gain in the event the market price of gas rises above a specific "strike price" during the month for which the option was purchased. These financial gains can, in turn, be used to offset any increase in the price of the physical gas supplies purchased by the Company, thereby providing the Company and its customers with a level of protection from such price increases.

Q. Does the cost of these instruments vary depending on their strike price or other factors?

A. Yes. Generally speaking, an option with a higher strike price will require a lower up front payment, while an option with a lower strike price will require a higher up front payment. In addition, the cost of an option reflecting a particular strike price will vary over time depending on current futures prices, market volatility and other factors. For example, on June 1, 1999, it would have cost $0.05 cents per MMBtu to purchase a January 2000 call option with a strike price of $4.00 per MMBtu. Exactly one year later, however, the cost to purchase a January 2001 call option with the same strike price had risen to $0.847 cents per MMBtu – an increase of over 1600% in the cost of the option.

Q. Are there any particular advantages to using call options versus other forms of financial instruments?

A. The primary advantage of call options is that they permit the buyer to place a ceiling on its upward exposure to gas prices while still enabling the buyer to take advantage of any significant declines in the market price of gas should prices fall rather than increase. In contrast, futures or fixed price contracts obligate the buyer to pay a set price that may ultimately be above or below the market price of gas for the month or months for which contracts are purchased. Moreover, call options are particularly useful for obtaining price protection on those variable gas volumes that the Company may or may not have to purchase due to the effects of weather on its overall gas requirements for a particular heating season.

Q. When the PSP was first approved in 1997, were there any general parameters established to govern the Company's purchase of such instruments?

A. Yes. As originally designed, the PSP authorized the Company to spend $4 million to obtain such protection on 70% of its projected normal winter flowing supplies. In its first year, the Program also specified that such options could be purchased at strike prices ranging from $2.80 per MMBtu to $3.20 per MMBtu, as adjusted based on subsequent increases or decreases in the market price for such instruments. During the second year of the Program, however, these parameters were changed, at the suggestion of the Commission Staff, to place a hard strike price ceiling of $4.00 per MMBtu, above which the Company would not be permitted to purchase such instruments.

Q. What factors went into the establishment of these various parameters?

A. As Staff has previously testified, these initial parameters for the Program, many of which were suggested by Staff, were based primarily on judgment and experience, rather than any quantitative analysis of various pricing and weather scenarios. In other words, the initial determinations regarding the overall level of funding for the Program, the amount of winter volumes to be covered, and Staff's recommended ceiling price of $4.00 per MMBtu were based, as they ultimately must be, on informed judgment derived from years of observing the market and a general sense of what was reasonable given the potential cost and need for such protection.

Q. Were additional modifications eventually made to the PSP?

A. Yes. As a result of a litigated proceeding in 1999, in Case No. GO-98-484, the Commission approved a number of modifications to the PSP. Most significantly, the Commission rejected the rigid $4.00 ceiling price on the purchase of call options that Staff had proposed be retained in that proceeding, together with Staff's recommendation that the Company be required to hold such instruments until their expiration once it had purchased them. In their place, the Commission adopted a more flexible and incentive-based framework for the Program that had been proposed by the Company – a framework which, with several modifications, remains in effect today and can remain in place in the future.

Q. What are the major features of the Program, as approved by the Commission in Case No. GO-98-484?

A. As shown by Schedule 1 to the direct testimony of Laclede witness Godat, which reproduces the Plan Description approved by the Commission in Case No. GO-98-484, the PSP was reauthorized for a three-year term, with an annual opportunity for the Commission to make modifications to the Program under certain conditions. The Program also includes two separate incentive features, namely a Price Protection Incentive and an Overall Cost Reduction Incentive.

Q. How does the Price Protection Incentive feature work?

A. As shown by Schedule 1 to Mr. Godat's testimony, the Price Protection Incentive provides a market-oriented procedure for determining both a target strike price and a catastrophic price level at which the Company will seek to obtain price protection for 70% of its normal winter flowing volumes. It also includes a sharing grid which permits the Company to retain a portion of any gain achieved if it can procure financial instruments at strike prices below these levels. Finally, it included a 90 day window under which the Company could opt out of the Price Protection Incentive in the event there was a radical change in market conditions for natural gas during the first 90 days immediately following the establishment of these target prices. This 90 day window was subsequently reduced by the Commission to a 60 day window in an effort to address concerns that had been raised by Staff and Public Counsel following the Commission's reexamination of the Program in February, 2001.

Q. How does the Overall Cost Reduction Incentive Work?

A. This component of the Program permits the Company to retain a share of any savings it achieves in the overall cost of the Program. Such savings can be achieved by either not spending the full amount of funding authorized under the Program or by achieving financial gains on the purchase and sale of options prior to their expiration.

Q. Have any other changes been made to the Program during its three year term?

A. Yes. In addition to the reduction of the 60 day window which I previously mentioned, the required price protection volumes under the Program were eliminated during the second year of the Program and reduced from 70% to 40%

for the third year of the Program. The funding for the Program was also increased from $4 million to $8 million for the third year of the Program. These modifications were made to reflect conditions prevalent in the gas acquisition market.

WHY THE PSP SHOULD BE CONTINUED

Q. Why do you believe the PSP should be continued?

A. First and foremost, I believe it should be continued because it has proven to be an effective and resilient tool for accomplishing the goals for which it was designed, namely, obtaining some level of price protection for the Company's customers. As the Commission knows, beginning last spring and continuing throughout the past winter heating season, wholesale natural gas prices rose to unprecedented levels across the country. Although these radical changes in market conditions required the Company to opt out of the Price Protection Incentive feature of the Program in June of last year, the very existence of the Program prompted the Company to focus on this developing market situation early on and propose remedial measures to address them well in advance of the 2000/2001 heating season. These measures included, among others, a proposed increase in funding for the Program to respond to these market conditions, a proposed elimination of the minimum price protection volume requirement, and proposals to expand the type of financial instruments the Company could use to obtain price protection. While the Company was only able to achieve agreement on one of these measures – specifically, the elimination of the volume requirement – Laclede still managed to achieve significant success under the Program during the course of the winter.

Q. Please describe the results the Company ultimately achieved under the Program last winter.

A. With only $4 million dollars in funding, the Company nevertheless managed to achieve some $28.6 million in savings and gains under the Program. This includes $11.6 million in gains from options that were purchased by the Company and held until their expiration. Pursuant to the terms of the PSP, all of these gains have been accounted for under the Price Protection Incentive component of the Program and flowed through in their entirety to the Company's customers. The $28.6 million also includes $17.0 million in financial benefits achieved by the Company under the Overall Cost Reduction Incentive as a result of its successful purchase and sale of options prior to their expiration. A significant portion of the benefits achieved under this component of the Program have also been flowed through to the Company's customers. Moreover, the Company also agreed to contribute $4.0 million of its $8.9 million share of the benefits it is entitled to retain under this component of the Program to purchase additional price protection for its customers for next winter. All told, I believe that any program that produces financial benefits for customers that are some five times greater than its initial costs while also affording additional funding for obtaining future price protection can only be deemed a success.

Q. Are there any other reasons why the PSP should be continued?

A. Yes. Given the experience of last winter, there has been a growing consensus that LDCs should use a more diverse portfolio of gas supply contracts and financial instruments in order to better balance the goal of acquiring economically priced gas supplies with the goal of reducing the impact of price volatility on the LDC's customers. The PSP is an integral part of the Company's comprehensive strategy in that regard.

Q. Please explain what you mean.

A. The Company has a three pronged strategy for balancing these dual and sometimes conflicting goals. The first involves the continued use of the Company's extensive storage capabilities as a tool that can provide a natural, physical hedge against rising wholesale prices during the winter heating season. The manner in which the Company uses these capabilities is, of course, dictated primarily by reliability considerations. However, the ability to meet up to 30% to 35% of the Company's winter requirements with storage gas purchased during the summer can nevertheless enable the Company to significantly moderate the impact of any run-up in winter gas prices. In fact, the Company's decision to maintain its normal storage injection rates last summer, while others did not, was one of the main reasons that the gas commodity charge of our PGA rates was significantly below – indeed at one point nearly $5.00 below – the market price for natural gas during much of the winter heating season.

Q. What is the second prong of the Company's strategy?

A. The second prong of our strategy involves the procurement of fixed price instruments or contracts. Under its fixed price proposal as part of its Gas Supply Incentive Plan ("GSIP") in Case No. GT-2001-329, the Company would be authorized to obtain such instruments for 10 to 25 Bcf of its winter requirements. The specific level of fixed price instruments procured within this range would be determined by Laclede based on its assessment of market conditions -- determinations that, following next winter, would subject Laclede to certain financial penalties and rewards depending on how well the Company did in obtaining such instruments at a favorable price.

Q. How does continuation of the PSP fit into this strategy?

A. The acquisition of call options under the PSP is, of course, the third and, in my view an extremely critical, prong of this strategy. As I previously indicated, continuation of the PSP will provide the Company with the means to obtain price ceiling protection -- in essence, an insurance policy -- on a significant portion of the Company's winter gas requirements that will not be met with either storage withdrawals or fixed price instruments. At the same time, it will also permit Laclede's customers to participate in any significant declines in wholesale market prices that may occur -- declines that have, in fact, already been experienced.

Q. Has the Company prepared an analysis showing how these various elements of its strategy work together to produce a reasonable, overall balance of price and stability?

A. Yes. Laclede witness Godat has provided such an analysis as a part of his direct testimony. As his analysis shows, implementation of the Company's comprehensive strategy would provide some form of price protection, either through the natural hedge provided by the Company's storage capabilities, the use of call options, or the use of fixed price financial instruments, for approximately 76% to 96% of the Company's normal winter gas requirements, depending on the specific level of fixed price instruments purchased by the Company. At the upper percentage of volumes covered, the price protection would produce an average commodity price of $4.69 per MMBtu, assuming a repeat of the price movements experienced last winter. I should note that this average price is significantly below the average price paid by Laclede last winter. Because approximately 75% of these hedged gas requirements are met by storage gas withdrawals and call options, however, Laclede's customers would be able to benefit from any declines in the market price of gas that might occur in connection with these volumes. Indeed, based on current NYMEX prices, implementation of the strategy would produce a blended average price of approximately $3.81 per MMBtu this winter for the Company's normal winter gas requirements. This price could, of course, go even lower if the market price for gas declines further. Based on this analysis, Laclede believes that continuation of the PSP, as part of the Company's overall procurement and risk management strategy, is absolutely essential if the goal of properly balancing price and stability through diversity are to be achieved.

MODIFICATIONS TO THE PSP

Q. Does that mean that the Company does not believe any further adjustments to the PSP are necessary?

A. No. Given its fixed price proposal in Case No. GT-2001-329, Laclede does not believe that it is necessary or appropriate to maintain the 70% minimum volume requirement for the volumes that are to be protected under the Program. That requirement was established at a time when the PSP was the only effective mechanism for obtaining price protection. In the event the alternative mechanism proposed by the Company in its GSIP case is approved, Laclede believes that it would be appropriate to permanently reduce this level to the 40% of normal flowing winter volumes that is currently in effect for the third year of the Program. In addition to providing a better fit with the other elements of the Company's procurement and risk management strategy, such a reduction in the minimum volume requirement will also permit the Company to obtain call option protection at more favorable strike prices. Schedule 2 to the direct testimony of Mr. Godat shows the specific revisions that would need to be made to the PSP to effectuate this change.

Q. Are there any other changes that the Company believes should be made to the PSP?

A. Yes. Another change relates to how the funding level for the program is determined. There have been concerns raised in the past that the parameters of the PSP may be too rigid to permit the Company to effectively respond to changing market conditions. In large measure, these concerns have arisen because market-related increases in the cost of such instruments have made it impractical to acquire such instruments on reasonable terms and the Company is then required to request changes in the Program in response to these developments. As shown in Schedule 2 to Mr. Godat's testimony, the changes in the PSP designed to address this problem and, in the process, provide the kind of flexibility that will reduce the need to seek such relief, involve the establishment of a funding grid under which the amount spent on procuring such instruments would increase or decrease in proportion to increases and decreases in the

NYMEX strip price. Finally, I would recommend that the 60 day window which was incorporated in the Program for its third year be lengthened to 120 days. Experience under the Program this year indicates that the additional flexibility provided by a longer window can be useful in obtaining financial instruments on more favorable terms. I would accordingly recommend that these changes, together with the other modifications I previously discussed, be approved by the Commission as part of an order continuing the PSP.

Q. Does this conclude your direct testimony?

A. Yes, it does.