

Exhibit No.:
Issue: ACA Adjustment
Witness: George E. Godat
Type of Exhibit: Direct Testimony
Sponsoring Party: Laclede Gas Company
Case No: GR-2004-0273
Date: September 8, 2006

LACLEDE GAS COMPANY

GR-2004-0273

DIRECT TESTIMONY

OF

GEORGE E. GODAT

TABLE OF CONTENTS

	<u>Page</u>
Purpose of Testimony	1
History of Contracting Practice	3
Staff's Proposed Adjustment	5
Failure to Show Imprudence	6
Absence of Harm	10
Inconsistency with Natural Gas Price Volatility Mitigation Rule	12

1 **DIRECT TESTIMONY OF GEORGE E. GODAT**

2 Q. What is your name and address?

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

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

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

8 Q. Please state your qualifications and experience.

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

19 **PURPOSE OF TESTIMONY**

20 Q. What is the purpose of your testimony?

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

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

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

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

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

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

20 Second, I believe Staff's proposed disallowance should be rejected because there
21 is absolutely no evidence that Laclede's practice **of paying demand charges to reserve
22 and lock-in the price of its swing supplies** actually harmed customers. Specifically,
23 while Staff acknowledges that the purchasing practices followed by Laclede have enabled

1 the Company **to make off-system sales**, it fails to offset its proposed disallowance
2 **with the off-system sales revenues that have actually been generated by the Company
3 and flowed through to its ratepayers.** Had Staff done so, such an offset would have
4 totally negated its proposed disallowance and shown that Laclede's customers were
5 actually benefited by this contracting practice during the ACA period in question.

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

18 **HISTORY OF CONTRACTING PRACTICE**

19 Q. What are "swing" supplies?

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

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

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

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

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

22 A. This hedging strategy benefits Laclede's customers because **the payment of demand
23 charges allows the Company to lock in the price for its swing supplies for an entire

1 month. Consumers benefit from this hedge by avoiding intra-month price spikes, caused
2 by cold weather or otherwise, because in such circumstances Laclede can buy needed
3 swing supplies at the lower first-of-month price. Conversely, if warmer weather and
4 conservation practices cause Laclede customers' demand for gas to decline, Laclede is
5 able to forego its purchases of swing gas in favor of storage or other supplies.**

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

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

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

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

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

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

21 **STAFF'S PROPOSED ADJUSTMENT**

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

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

13 **FAILURE TO SHOW IMPRUDENCE**

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

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

1 Q. Why do you say that?

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

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

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

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

21 A. Yes. I think it is important for the Commission to recognize that **all of the demand
22 charges paid by Laclede have been established through a competitive bidding process.
23 As a result, there was every reason to believe that they were reasonably priced and fairly

1 reflected the value of stabilizing prices. Indeed, Laclede had utilized the very
2 competitive bidding process recommended by Staff to confirm the validity of these
3 market prices.**

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

7 A. The Staff's observation **that demand charges for swing supply had increased during the
8 ACA period** says nothing about the prudence of the Company's actions in this case.
9 **The fact is that the commodity cost of gas, as well as demand costs, were rising at this
10 time and the change in the latter represented a relatively miniscule increase of less than
11 two-tenths of one percent when measured against the Company's overall gas costs during
12 that period. And to the extent prices were increasing, those increases were a direct and
13 obvious market response to the greater price volatility that had emerged in the natural gas
14 marketplace -- volatility that, because of its potential cost impact, naturally increased the
15 value of hedging arrangements designed to mitigate it. Under such circumstances, it was
16 entirely prudent for Laclede to pay increased demand charges in order to provide its
17 customers protection from another huge run-up in intra-month prices, as the market was
18 anticipating at that time.** Moreover, as in the past, had weather and pricing conditions
19 turned out differently during the ACA period, **the savings achieved by paying these
20 demand charges could have easily dwarfed their cost. Indeed, had that exact high price
21 scenario occurred, and had Laclede not hedged the price of its swing supplies,** I would
22 not be surprised if Laclede would now be facing a Staff adjustment premised on the
23 Company's failure to protect its customers **from such price increases.** In view of all

1 of these considerations, I do not believe there is any basis for concluding that Laclede
2 acted imprudently by continuing a long-standing strategy that had proved its value over
3 the years. Staff's effort to focus with 20/20 hindsight on a particular ACA period, as
4 opposed to the merits and results of the long-term strategy, should be rejected by the
5 Commission.

6 **ABSENCE OF HARM**

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

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

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

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

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

21 A. Yes. Laclede has **been making these off-system sales since the mid-1990s.** In its
22 2002 rate case (Case No. GR-2002-356), a Stipulation and Agreement ("Stipulation")
23 approved by the Commission (and in effect during the ACA period) provided that

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

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

13 A. **Even though Staff acknowledges that the Company's strategy of paying demand
14 charges to lock in the price of swing supplies facilitates off-system sales, the Staff has
15 completely ignored the revenues imputed to customers from these off-system sales.
16 While the \$3.8 million annual imputation discussed above is not expressly divided
17 between off-system sales and capacity releases, the majority of these revenues were
18 derived from off-system sales. Thus, when the customer benefits from off-system sales
19 are factored into Staff's calculation – as they should be – the result effectively negates
20 Staff's proposed disallowance by eliminating any notion that the Company's ratepayers
21 were somehow harmed by Laclede's payment of demand charges for swing supplies.**

22 On the other hand, the failure to reject Staff's proposed disallowance would deprive
23 Laclede of the value of what it bargained for in the Stipulation – and in the process

1 violate that agreement – by taking away with an ACA adjustment what the Company was
2 entitled to keep under the Stipulation. None of these impermissible results should be
3 permitted by the Commission.

4 **INCONSISTENCY WITH NATURAL GAS**
5 **PRICE VOLATILITY MITIGATION RULE**
6

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

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

14 Q. How does the rule promote that objective?

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

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

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

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

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

18 Q. Does this conclude your direct testimony?

19 A. Yes, it does.

SCHEDULE GEG-1

Timeline of Laclede Issues for 0304 Portfolio

