Exhibit No.:	
Issue:	Price Stabilization Plan
Witness:	David M. Sommerer
Sponsoring Party:	MoPSC Staff
Type of Exhibit:	Direct Testimony
Case No.:	GO-2000-394
Date Testimony Prepared:	July 10, 2001

MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

DIRECT TESTIMONY

OF

DAVID M. SOMMERER

FILED
JUL 1 0 2001
Missouri Public Service Commission

LACLEDE GAS COMPANY

CASE NO. GO-2000-394

Jefferson City, Missouri
July, 2001

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Denotes Highly Confidential Information

DIRECT TESTIMONY

OF

DAVID M. SOMMERER

CASE NO. GO-2000-394

LACLEDE GAS COMPANY

Q. Please state your name and business address.

A. David M. Sommerer, P.O. Box 360, Jefferson City, Mo. 65102.

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

A. I am the Manager of the Procurement Analysis Department with the Missouri Public Service Commission.

Q. How long have you been employed with the Commission?

A. Approximately 16 years.

Q. Please describe your educational background and experience.

A. In May 1983, I received a Bachelor of Science degree in Business and Administration with a major in Accounting from Southern Illinois University at Carbondale, Illinois. In May 1984, I received a Master of Accountancy degree from the same university. Also, in May 1984, I sat for and passed the Uniform Certified Public Accountants examination. Upon graduation, I accepted employment with the Commission.

Q. What has been the nature of your duties at the Commission?

A. From 1984 to 1990 I assisted with audits and examinations of the books and records of public utilities operating within the State of Missouri. In 1988 the responsibility for conducting the Actual Cost Adjustment (ACA) audits of natural gas utilities was given to the Accounting Department. I assumed responsibility for planning and implementing these audits and trained available Staff on the requirements and conduct of the audits. I participated in most of the ACA audits from early 1988 to early 1990. On November 1, 1990, I transferred to the Commission's Energy Department. Until November of 1993, my duties consisted of reviews of various tariff proposals by electric and gas utilities, Purchased Gas Adjustment reviews, and tariff reviews as part of a rate case. In November of 1993, I assumed my present duties of managing a newly created department called the Procurement Analysis Department. This Department was created to more fully address the emerging changes in the gas industry especially as they impacted the utilities' recovery of gas costs. My duties have included managing the five member staff, reviewing ACA audits and recommendations, participating in the gas integrated resource planning project, serving on the gas project team, and participating in matters relating to natural gas service in the State of Missouri.

Q. Have you previously testified before this Commission?

A. Yes. A list of cases in which I have filed testimony is included as **Schedule 1** of my testimony.

Q. What is the purpose of your testimony in this case?

A. To provide the Staffs position regarding extension of Laclede Gas Company's (Laclede's, Company's) Price Stabilization Plan (PSP).

Q. Could you provide a general overview of your testimony?

A. Yes. The Staff believes that a comprehensive approach to purchasing natural gas, including hedging of gas costs, is much more appropriate than a piecemeal method. Pre-approval of specific portions should not be necessary for something as dynamic as the diversification of the Company's gas supply portfolio. The Staff believes that formulistic approaches such as the current PSP don't work because they limit the flexibility needed to address an ever-changing natural gas market. It is not appropriate to veil so many of the program's details in secrecy, nor is it appropriate to provide financial incentives to hedge natural gas costs.

Q. Please give the history of price stabilization programs in Missouri.

A. In Union Electric Company's (UE) 1993-1994 and1994-1995 Actual Cost Adjustment filings, the staff supported UE's request to pass-through the cost of call options although the options expired without being exercised. In early 1995, the Staff and Union Electric Company (now AmerenUE) started discussing the use of final instruments such as futures, options, and collars to manage the risk of gas supply costs. These discussions ultimately led to a limited pilot program that initially took effect for the 1995-1996 winter and was subsequently extended for the 1996-1997 winter. This program was limited to only one of AmerenUE's systems, was limited to no more than 50% of the Company's projected gas supply purchases on that system, and contained a sharing grid that required the Company to absorb any losses over $265,000. The purpose of the pilot program was to allow the Company, the Missouri Public Service Commission Staff, and the Office of the Public Counsel (OPC) to gain experience on a trial basis in the use of financial instruments. The pilot program was extremely limited in scope and was designed in a period prior to any significant price run up.

Q. What were the results?

A. Monthly prices were fairly low for the winter of 1995/1996. However, gains were realized in the amount of $177,000, $27,000 of which was retained by the Company. The winter of 1996/1997 did have some substantial monthly price increases; with prices exceeding $4.00/MMBtu in January of 1997. Ultimately, the program incurred a loss of $309,000 with AmerenUE incurring about $90,000 of that amount.

Q. What were the stated goals?

A. AmerenUE's stated purpose was to allow it, the Commission, Staff, and the Office of the Public Counsel, "to gain experience on a trial basis in the use of financial market instruments such as futures, options, collars and derivatives to manage the risk of gas supply costs.

Q. What was the next significant step in the evolution of price stabilization programs in Missouri?

A. The winter of 1996-1997 experienced some large price spikes and significant Purchased Gas Adjustment increases (PGA). At the end of that winter, a natural gas roundtable was held to discuss gas price volatility in the natural gas industry. The Staff cautioned the participants about placing too much reliance on index pricing during this meeting. At about the same time the Commission established dockets for all Local Gas Distribution Companies. In its order in Laclede Case No. GO-97-401, on April 10, 1997, the Commission said the purpose of those cases.

> "On April 1, 1997, the Staff of the Missouri Public Service Commission (Staff) and Laclede Gas Company (Laclede) filed a Joint Motion To Open Docket and a Joint Motion To Establish Procedural Schedule. Staff states that events during the last heating season have raised general policy questions regarding the

> frequency of Purchased Gas Adjustment (PGA) filings and the extent to which changes in various PGA factors should be prorated for billing purposes. Staff and Laclede request that the Commission open a docket to address the general policy issues relating to proration of certain gas costs traditionally flowed through the purchased gas adjustment clause and the frequency of PGA filings. Staff and Laclede request the Commission to address these issues prior to the 1997 winter heating season.

Q. What was the result of that case?

A. As part of the Stipulation and Agreement presented in that case, Laclede established a price stabilization fund was established. In a July 18, 1997 Order the Commission stated:

> "The agreement allows Laclede to use financial instruments in its efforts to reduce the volatility of Laclede's cost of natural gas. To assure recovery by Laclede of the direct costs incurred in connection with procurement of these financial instruments Laclede is authorized under the agreement to implement a Price Stabilization Charge. The agreement provides that the Price Stabilization Charge shall take effect August 1, 1997. The revenues generated from the Price Stabilization Charge and gains from the use of financial instruments shall be accounted for separately and credited to a Price Stabilization Fund on a monthly basis."

As a result of discussions that took place in May through July of 1997 AmerenUE, Laclede, and eventually, Missouri Gas Energy (MGE) all adopted similar programs. The three largest LDCs in the state operated under the program for the winter of 1997-1998. With the exception of November of 1997, prices remained low that winter and hedging gains were minimal.

Q. Please continue.

A. Laclede sought modifications to its program in Case No. GO-98-484. In a May 26, 1998 Order granting modifications, the Commission stated:

> "The Commission originally approved the Program in Case No. GO-97-401. The tariff approved in that case provides that the Program shall be terminated July 31, 1998 unless otherwise ordered by the Commission. In this filing Laclede seeks to extend that fund for another term and modify it in several respects. Laclede proposes to change the parameters within which it uses financial instruments in two respects. First, it proposes a new authorized price range for financial instruments. Second, it proposes a new restriction on the timing of the sale of exchange traded financial instrument. Laclede also proposes to modify the tariff approved in Case No. GO-97-401 in two respects to clarify procedures to be followed at the end of the term of the experiment. First, the tariff provides that the Price Stabilization Charge shall be terminated on the effective date of the 1999 summer PGA filing. Second, the tariff provides that any balance remaining in the fund at the end of the term shall be charged or returned to customers through the ACA factors established in the applicable winter PGA filing."

Q. What did AmerenUE and MGE do?

A. AmerenUE (Case No. GO-98-486) and MGE (Case No. GO-98-364) also received extensions for one additional year, through the winter of 1998-1999. Once again gas prices remained at relatively low levels for the entire winter of 1998-1999 and hedging gains were minimal.

Q. Please describe the next step in the evolution of hedging in Missouri.

A. The largest three LDCs generally proceeded on different paths for the winter of 1999-2000. AmerenUE chose not to extend its program. MGE filed for an extension that generally resembled its existing price stabilization fund. This was approved in a Commission Order in Case No. GO-2000-231 on October 14, 1999.

Q. What was the status of the Laclede program at that time?

A. Still using Case No. GO-98-484, the Company argued for a considerable expansion of its price stabilization fund to start in the winter of 1999-2000. It argued for three main changes. These changes were explained in the Commission's June 15, 1999 Order in Case No. GO-98-484. In describing Laclede position the Commission stated:

> "First, Laclede proposes to eliminate the program's existing restriction on when financial instruments may be sold and adopt an approach that gives Laclede greater flexibility to trade in and out of these instruments when market conditions warrant. This would allow Laclede to more effectively manage the volatility of the market. Laclede alleges that this will create opportunity to reduce the overall cost of acquiring price protection for Laclede and its ratepayers. Second, Laclede proposes to incorporate an "incentive feature" into its PSP. Laclede argues that in exchange for undertaking the risks inherent in guaranteeing price protection, it should have a corresponding opportunity to benefit from it if achieves positive results. Third, Laclede proposes a three-year term for the program. Laclede contends that the longer authorization period would provide the Commission with sufficient experience with the operation of the program under varying conditions and permit a fair assessment of its effectiveness, and that this would reduce the expense of the annual review which is costly to both the Commission and to Laclede."

Q. What was the Staff's position in this case?

A. The Staff argued against authorizing incentives as part of the program. It argued that a general policy of diversification of the gas supply portfolio was a better approach. It further argued that Laclede's program was speculative, its provisions were vague, and offered Laclede "outs" from any real guarantees of price protection. The Commission ultimately approved a version of Laclede's original proposal, submitted in Laclede's surrebuttal testimony. A key provision of the new plan was that it granted approval for the winters of 1999-2000, 2000-2001, and 2001-2002.

Q. What happened in the winter of 1999-2000?

A. As discussed earlier, MGE operated under a more traditional price stabilization fund program, Laclede operated under the first year of its newly authorized incentive PSP and AmerenUE operated with no pre-authorized programs. Once again, the pricing situation during the winter of 1999-2000 was relative stable, with few index prices exceeding $3.00/MMBtu and most the winter well below $3.00/MMBtu. Hedging gains were once again minimal.

Q. What was the status of the price stabilization programs for the largest three utilities for the winter of 2000-2001?

A. AmerenUE continued without any preauthorized program. As part of MGE's Stipulation and Agreement in Case No. GO-2000-705, MGE retained a limited right to continue its traditional program from Case No. GO-2000-231 (the 1999-2000 program). This preauthorized program expired under the terms of the Stipulation on September 30, 2000. On September 27, 2000, MGE sought extension but was denied any further extension of the program by Commission Order in Case No. GO-2001-215. Laclede continued under the second year of its incentive PSP.

Q. Please provide a general discussion regarding the basic provisions of Laclede's PSP.

A. ** ** The highly confidential program description is provided in Schedule 2.

Q. **____
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Q. What are the "outs' that you mentioned earlier?

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Q. What were Laclede's profits opportunities?

A. There were two major components to the incentive part of the plan. First a price protection incentive was developed. Depending upon where price protection was achieved, realized gains would be shared between the customer and the company. **____
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Q. **____
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A. **__________________**

Q. What was the other incentive feature?

A. The other incentive provision was called the "overall cost reduction incentive". **____
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Q. Please explain how the program operated for Laclede for the winter of 2000-2001.

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Q. Please define what call options are?

A. A call option is an option that gives the buyer (holder) the right, but not the obligation, to buy a futures contract (enter into a long futures position) for a specified price within a specified period of time in exchange for a one-time premium payment (New York Mercantile Exchange, NYMEX, Glossary). A strike price or exercise price is the price at which the underlying futures contract is bought or sold in the event an option

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is exercised. (NYMEX Glossary). Call options can be used like insurance. For the payment of a premium, a certain amount of price protection can be achieved. Strike prices determine the price level that the protection will be effective at. Much like deductibles for car insurance, the higher the "strike price" the less costly the premium is. If the "catastrophe" doesn't occur, you lose the premium but have still obtained some intangible value because of the protection received. Similarly with natural gas call options; if prices stay below the strike prices, the premium will be lost. Before the option expires, it trades in its own market and may be bought and sold. One more similarity to insurance is the concept of volatility. The more volatile the market, the costlier the premium. If accidents are happening quite frequently, the cost of car insurance premiums will go up. Price volatility in the futures markets has a similar effect on call option premiums.

Q. Please continue with your discussion of the operation of Laclede's program for 2000-2001.

A. Prices moved up dramatically in the weeks after the TSP and CPL were set in March 2000. In a June 1, 2000 letter to the Commission, Mr. Neises advised the Commission that:

> "...as a result of the Company's decision to declare the Price Protection Incentive component of the Program inoperable this year, the company will retain no gains under that component of the Program or incur any losses resulting from the purchase of price protection above the catastrophic price level established by the program (i.e., $5.20 per MMBtu)."

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Q. What happened next?

A. In June, July and August OPC, Staff and Laclede met to discuss possible actions to protect ratepayers. On September 1, 2000, the parties filed a Unanimous Stipulations and Agreement (Agreement) in Case No. GO-2000-394, which relaxed the PSP's existing requirement that the company procure price protection equal to 70 percent of its flowing supplies. The Agreement stated that by permitting Laclede to obtain price protections for lesser volumes, this revision would help to reduce the price at which such protection would be triggered for those volumes.

Q. Please continue.

A. The winter of 2000-2001 saw the highest NYMEX closing prices ever experienced. NYMEX closing prices for December 2000, January 2001, and February 2001 were 6.02/MMBtu, 9.98/MMBtu, and 6.29/MMBtu, respectively. PGA rates for Laclede were also at record levels. Just looking at January 2001, **____

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________** was nearly $45,000,000 less. **______________________________

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Q. Please explain other Case No. GO-2000-394 proceedings.

A. On December 22, 2000, the Staff filed a Staff Recommendation, requesting that the Commission terminate the third year of the experimental PSP. An on-the-record hearing was held February 2, 2001 to address this issue. On February 13, 2001 the Commission ordered modification to the PSP for year 3. It ordered a reduction in the 90-day window to 60-days and ordered the company to implement its offer to contribute, for the third year of the program, an additional $4 million of its own funds to the $4 million that is currently authorized. Finally, the Company received authorization, over Staff's objections, to reduce the required price protection volume percentages in the company's PSP from 70 percent to 40 percent for the upcoming winter in order to permit a corresponding reduction in the TSP and CPL. Staff noted that call options have been extremely expensive relative to past years coming out of this past winter given the tremendous price volatility and prevailing price levels. **______________________ ____** This can be contrasted to a current market environment where fixed price contracts are available for around $4.00/MMBtu.

Q. What are Staff concerns about the existing PSP?

A. The PSP is not flexible enough to meet the dynamic gas market. It requires continuous regulatory modification. It is a piecemeal way to address hedging that does not take into account other parts of the Company's planning process. The program's sharing percentages for the Company are so great as to divert millions of dollars away from reducing high gas costs. The program description continues to be so vague as to result in uncertainty about the treatment of gains under the program. The program design encourages speculative trading rather than hedging and continues to put the customer at substantial risk for price increases while forwarding all the costs.

Q. Please elaborate on these flaws.

A. The record in Case No. GO-2000-394 from June 1, 2000 forward speaks to the continual need to seek program modification. Indeed, the record indicates that when price protection was needed most, the program's escape clause, removed all risks for the Company dumping them on ratepayers. A review of Laclede's testimony in the recent Gas Supply Incentive Plan (GSIP) Case No. GT-2001-329 indicates that the Company recognizes that fixed price instruments need to be considered as part of a hedging evaluation. Laclede's testimony in that case also clearly demonstrated that Laclede understands that it cannot afford the price risk inherent in purchasing its customer's gas supply - it cannot afford to play in the game on its own money. The Commission needs to consider that Laclede's hedging approach now involves policy issues in the GSIP, various PSP proposals, and gas supply decisions made outside the context of either of these programs. This splintered approach to hedging is not in the customers' best interest.

Q. Can you illustrate your concern about sharing percentages?

A. Consider that even with one of the incentive components held in abeyance and no guaranteed price protection for consumers, **______________________________ __________** It is conceivable that these alleged profits could be dwarfed by profits in other high gas cost scenarios.

Q. What do you mean by vague program descriptions?

A. As an illustration, the program sharing components describe savings achieved **____ ____ ___________________________________** Emphasis added. **_______________ ____ ____

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____** Of course the cost reduction incentive appears to reward such behavior by limiting sharing claims to trades taking place at least several days prior to expiration. So even though the effective price for a certain package of gas supply may have been reduced from $10.00 to $9.00 (because of a $1.00 gain from an early trade), an option with a $6.00 strike could have brought the effective price of the gas down to $6.00 if held until near expiration. (See Schedule 3.)

Q. What is an additional flaw of the program?

A. No matter whether the price goes up or down from the key **__________

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__________** One significant feature of call options is known as "time decay". Options tend to lose value the closer they get to expiration. This is because the probability of them being in the money is less as time goes by, all other things being equal. **____

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Q. What is Staff's recommendation in this case?

A. The Commission should terminate the PSP. Laclede should make a filing in January of each year that analyzes and discusses all the various components of its price stabilization alternatives. This should include storage, and fixed prices contracts, as well as call options and other financial instruments. The Staff believes it is significant that Laclede is the only Company in Missouri with a PSP. This piecemeal and inflexible approach should not continue. This is consistent with the Staff's position in Case No. GT-2001-329, concerning Laclede's request to extend its GSIP.

Q. Has the Staff ever tried to disallow the cost of call options or hedging costs?

A. No, not to my knowledge. The Staff has consistently maintained that prudently incurred natural gas hedging costs qualify as gas costs under the PGA. The Staff also believes that hedging is part of the overall responsibility of a Company's gas supply management. Finally, the Staff believes that diversification of the gas supply portfolio is appropriate but should not be constrained by elaborate-rigid profit formulas and restrictive percentages.

Q. Does this conclude your direct testimony?

A. Yes.

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 OF DAVID M. SOMMERER

STATE OF MISSOURI	)	
	)	ss.
COUNTY OF COLE	)	

David M. Sommerer, of lawful age, on his oath states: that he has participated in the preparation of the foregoing Direct Testimony in question and answer form, consisting of 16 pages to be presented in the above case; that the answers in the foregoing Direct 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.

David M. Sommerer

Subscribed and sworn to before me this 9th day of July 2001.

D SUZIE MANKIN
NOTARY PUBLIC STATE OF MISSOURI
COLE COUNTY
MY COMMISSION EXP. JUNE 21,2004

CASES WHERE TESTIMONY WAS FILED

DAVID M. SOMMERER

COMPANY	CASE NO.
Missouri-American Water Company	WR-85-16
Great River Gas Company	GR-85-136
Grand River Mutual Telephone	TR-85-242
Associated Natural Gas Company	GR-86-86
Empire District Electric Company	WR-86-151
Grand River Mutual Telephone Company	TR-87-25
Great River Gas Company	GM-87-65
KPL Gas Service Company	GR-89-48
KPL Gas Service Company	GR-90-16
KPL Gas Service Company	GR-90-50
Associated Natural Gas Company	GR-90-152
United Cities Gas Company	GR-90-233
United Cities Gas Company	GR-91-249
Laclede Gas Company	GR-92-165
United Cities Gas Company	GR-93-47
Western Resources Inc.	GR-93-240
Union Electric Company	GR-93-106
Missouri Public Service	GA-95-216
Missouri Gas Energy	GO-94-318
Missouri Gas Energy	GO-97-409
United Cities Gas Company	GO-97-410
Missouri Gas Energy	GR-96-450
Missouri Gas Energy	GC-98-335

COMPANY	CASE NO.
Laclede Gas Company	GO-98-484
Laclede Gas Company	GR-98-374
Laclede Gas Company	GC-99-121
Laclede Gas Company	GT-99-303
Laclede Gas Company	GR-98-297
Laclede Gas Company	GT-2001-329

SCHEDULE 2

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SCHEDULE 3

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