

Exhibit No.: _____
Issues: Transportation Tariffs
Capacity Release/Off-
System Sales Revenue
Sharing Grid
Witness: David N. Kirkland
Sponsoring Party: Missouri Gas Energy
Case No.: GR-2009-0355
Date Testimony Prepared: September 28, 2009

MISSOURI PUBLIC SERVICE COMMISSION

MISSOURI GAS ENERGY

CASE NO. GR-2009-0355

REBUTTAL TESTIMONY OF

DAVID N. KIRKLAND

Jefferson City, Missouri

September 2009

Denotes Highly Confidential Information

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REBUTTAL TESTIMONY OF

DAVID N. KIRKLAND

CASE NO. GR-2009-0355

September 2009

1 **Q. WOULD YOU PLEASE STATE YOUR NAME AND BUSINESS ADDRESS?**

2 A. My name is David N. Kirkland, and my business address is 3420 Broadway, Kansas City,
3 Missouri 64111.

4

5 **Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?**

6 A. I am the Director of Gas Supply of Missouri Gas Energy ("MGE" or "Company"), a
7 division of Southern Union Company.

8

9 **Q. PLEASE DESCRIBE YOUR EDUCATIONAL AND EMPLOYMENT**
10 **BACKGROUND.**

11 A. My formal education includes a Bachelor of Science degree in Civil Engineering from
12 New Mexico State University and professional development programs at the University
13 of Colorado and the University of Michigan. My industry experience and employment
14 history includes:

15 • 1973 – 1982: Southern Union Gas Company; The City of Las Cruces, New
16 Mexico; Northwest Pipeline Corporation; Gas Company of New Mexico -
17 Engineer and Senior Engineer positions.

18

19 • 1982 – 1986: Gas Company of New Mexico - Operations Manager, San Juan
20 District; Responsible for all technical operations of a natural gas gathering and

transmission system comprised of 2700 wells, 900 miles of gathering line, 750 miles of transmission pipeline and compression operations.

- 1986 – 1988: Public Service Company of New Mexico - District Manager, San Juan District; Responsible for all operations of the San Juan District natural gas gathering and transmission systems.
- 1988 – 1991: Public Service Company of New Mexico - Director Volume Control; Responsible for gathering systems production control, gas purchase contract obligations, gas transportation functions and negotiating contract settlements.
- 1991 – 1997: Public Service Company of New Mexico - Director Transmission Engineering; Responsible for transmission facility planning, storage operations, reservoir engineering, transmission systems engineering, and business case development for new market opportunities.
- 1997 – 2002: Public Service Company of New Mexico - Director Gas Systems Operations and Engineering; Responsible for supply planning, interstate transportation agreements, FERC regulatory activities, transmission facility planning, storage development, facility engineering and compressor operations.
- 2002 - Present - Missouri Gas Energy - Director of Gas Supply

Q. WHAT ARE YOUR DUTIES AND RESPONSIBILITIES AS MGE'S DIRECTOR OF GAS SUPPLY?

A. The primary responsibilities of this position are threefold: the planning and acquisition of a supply and capacity portfolio to provide reliable gas service to MGE's customers; the management of that supply and capacity portfolio to minimize cost to customers; and regulatory responsibilities associated with these supply/capacity acquisition and management responsibilities.

1 Q. WHAT IS THE PURPOSE OF THIS TESTIMONY?

2 A. I will address Staff witness Anne Allee's proposal to modify the Company's revenue
3 sharing grid for off-system sales and capacity release transactions. I will also address
4 Constellation NewEnergy witness Richard Haubensak's proposal to lower the threshold
5 to provide transportation service in the Company's service territory.
6

7 **REVENUE-SHARING GRID**

8 Q. BEFORE YOU DISCUSS STAFF'S POSITION ON THE COMPANY'S
9 REVENUE-SHARING GRID, PLEASE DESCRIBE THE DEFINITIONS OF
10 "CAPACITY RELEASE TRANSACTIONS" AND "OFF-SYSTEM SALES"

11 A. MGE can sell pipeline capacity rights it holds under interstate pipeline firm service
12 agreements. The sale of pipeline capacity is subject to FERC regulation. A "capacity
13 release transaction" occurs when pipeline capacity is sold to third parties for specific
14 periods of time and at a cost established either by negotiation with a third party or
15 through a competitive bidding process.
16

17 "Off-system sales" typically occur when MGE purchases supply and resells this supply at
18 an alternate location. In these transactions, MGE's goal is to gain an increase in value
19 over the purchase price and any transaction costs for transporting the supply to the
20 alternate location. Off-system sales are driven by the price differential or price spreads
21 that can exist from time to time within pipeline transportation networks. MGE takes
22 advantage of pricing spreads between points of receipt and points of delivery within
23 pipeline systems on which MGE has firm transportation capacity rights.

1
2 **Q. WHAT IS YOUR UNDERSTANDING OF THE STAFF'S POSITION ON MGE'S**
3 **REVENUE SHARING GRID?**

4 A. Staff has proposed an almost seven-fold increase in the sharing percentage thresholds for
5 capacity release and off-system sales revenues, originally approved in Commission Case
6 No. GR-2004-0209. In the approved tariff, the sharing arrangement is:

Annual CR Credits and OSS Margins	MGE Retention Percentage	Firm Sales Customer Retention Percentage
First \$300,000	15%	85%
Second \$300,000	20%	80%
Third \$300,000	25%	75%
Amounts over \$900,000	30%	70%

14
15 Staff accurately states that "MGE is permitted to keep increasing amounts of profit up to
16 a maximum of 30% of the off systems sales and capacity release credits, with higher sales
17 resulting in greater profits for the company." Staff Report, Class Cost of Service and
18 Rate Design, at p. 32.

19 Staff proposes to change the sharing arrangement as follows:

Annual CR Credits and OSS Margins	MGE Retention Percentage	Firm Sales Customer Retention Percentage
First \$2,000,000	15%	85%
Second \$2,000,000	20%	80%
Third \$2,000,000	25%	75%
Amounts over \$6,000,000	30%	70%

1 The change in the sharing thresholds represent an almost seven-fold increase in the first
2 three levels of revenue sharing by increasing the thresholds from \$300,000 to \$2,000,000.

3
4 **Q. ON WHAT BASIS DOES THE STAFF ARGUE FOR THE CHANGE IN THE**
5 **SHARING GRID?**

6 A. Staff states that the sharing grid established in case GR-2004-0209 was based on
7 “roughly **_____** in annual capacity release credits and very little, if any, off-
8 system sales margins.” Staff also shows a table reflecting Capacity Release and Off-
9 System sales revenues for four years starting in 2005. The information in the table
10 reflects the revenues MGE gained by successfully marketing Capacity Release and Off
11 System sales.

12 Staff proposes to change the sharing grid “to reflect the more recent level of activity.”

13
14 **Q. IS MGE’S PAST PERFORMANCE IN GENERATING OFF-SYSTEM SALES**
15 **REVENUE A REASONABLY ACCURATE INDICATOR OF FUTURE**
16 **PERFORMANCE?**

17 A. No. The Staff is relying on performance levels achieved by MGE during a period in
18 which the market was demonstrably anomalous. As a result, MGE’s recent off-system
19 sales revenue performance is not at all likely to continue in the future.

20 MGE obtains the bulk of its off-system sales revenues from transactions on the Kinder
21 Morgan pipeline. The ability to generate revenue on the Kinder Morgan pipeline is
22 driven principally by the difference in the purchase price of gas at the Cheyenne Hub
23 (Rockies price) and the selling price in the Midcontinent markets. The chart below

1 clearly shows the revenue MGE was able to generate during six years of activity which
2 include the top three years of marketing capacity and creating off-system sales on the
3 Kinder Morgan Pipeline. The chart below also shows that revenue varies widely from
4 year to year and cannot be relied upon as a stable source of revenue. The revenues clearly
5 correlate with the price differential or price spreads (shown in the green dots). The price
6 spread is the difference between the gas purchased at Rockies prices (adjusted for
7 pipeline transportation fuel) and the pricing of gas sold in the Midcontinent.

**

**

8

9

10 The difference or spread in gas prices between purchase and sale points is a constant and
11 changing relationship depending on gas production in the Rockies and pipeline export
12 capacity out of the Rockies.

13

1 MGE and its firm customers have enjoyed these price spreads during fiscal years 2006-
2 2007 through 2008-2009, the access to lower priced supplies and the revenues resulting
3 from capacity release and off system sales. However MGE does not anticipate the large
4 revenues it has experienced will return. The pricing spreads between the Rockies and the
5 Midcontinent have historically been driven by the abundance of new gas production
6 coupled with a shortage of pipeline carry-away capacity out of the Rockies. When
7 Rockies production exceeds pipeline export capacity, gas-on-gas competition begins to
8 reduce prices at the wellhead and all points exporting gas from the Rockies. As either
9 new pipeline capacity is placed in service or wellhead production declines, the wellhead
10 competition for pipeline capacity declines and prices rise. This relationship is well
11 established as new pipelines and additions to pipeline capacity have been built out of the
12 Rockies.

13
14 The supply vs. export pipeline capacity relationship in the Rockies is easily seen in the
15 pricing and revenue graph above. As pipeline capacity became scarce relative to the
16 levels of production, wellhead prices declined in the Rockies. MGE was able to purchase
17 these supplies and resell gas into the Midcontinent pipelines at a premium.

18
19
20 **Q. WHAT IS DRIVING THE CHANGE IN THE MARKET?**

21 A. In 2009, the pricing relationship between the Rockies and Midcontinent has collapsed
22 due to the newly installed Rockies Express (REX) pipeline. The REX pipeline began
23 service into the Midcontinent in May 2008 with a capacity of 1.5 bcf/d, which represents

1 an approximate 30% increase in export capacity from the Rocky Mountain supply basin.
2 As seen on the graph for 2009 / 2010, the presence of this new pipe has clearly reduced
3 the revenue opportunity MGE will have in the near term as shown on the forecast
4 revenue for 2009/10.

5
6 Another example of the pricing impact of the newly installed REX capacity can be
7 observed when it became unavailable to the market in September 2008. In September
8 2008, the REX line was shut down for testing, which removed 1.5 bcfd/d from service. In
9 that month, MGE earned ** _____ ** of the ** _____ ** it earned that year in
10 Kinder Morgan off-system sales revenue. Absent this windfall, the revenue chart below
11 shows the adjustment.

**

**

1 **Q. WHAT OTHER MARKET CHANGES ARE ANTICIPATED?**

2 **A.** In addition to this new REX pipeline, additional pipelines are planned, which would add
3 to the export capacity from the Rockies region, as shown below

4

	FERC Approved Bcf/d	Proposed Bcf/d	Estimated Completion
5 Bison	.410	.690	2010
6 Kern	.411		2011
7 Rockies Express	1.8		2009
8 Ruby	1.2		2011
9 Alliance		1.2	2013
10	<hr/>		
11	3.82	1.89	

12
13
14

15 The FERC-approved pipelines will provide a 62% increase in export capacity which will
16 continue to provide for higher wellhead pricing for the Rockies gas producers and
17 continued reduced opportunity for MGE to maintain the revenue recently gained from
18 system sales and capacity release on the Kinder Morgan pipeline.

19

20 The MGE forecast for revenues in this area in 2009/2010 shows very limited earnings
21 based on a forecast negative margin. The relationship between wellhead production and
22 the timing of increased export capacity is well understood by the gas exploration and
23 production community (gas producers). As the major benefactor of increased wellhead
24 prices, the gas producers are also the major investors in additional pipeline capacity. The
25 timing of pipeline expansion will continue to track gas production such that the gas
26 producers in the Rockies will not suffer extended periods, if any, of depressed pricing at
27 the well head.

28

1 As the Rockies producers participate in the development and improvements to the
2 transportation infrastructure, the large pricing differentials MGE has experienced
3 between the Rockies and Midcontinent pipelines will continue to diminish the
4 opportunity for MGE and its firm customers to see the benefits of low gas prices and to
5 see the large capacity release and off system sales revenues as experienced in the 2004 -
6 2008 period.

7
8 **Q. IS MGE'S PAST PERFORMANCE IN GENERATING CAPACITY RELEASE**
9 **REVENUE A REASONABLY ACCURATE INDICATOR OF FUTURE**
10 **PERFORMANCE?**

11 A. No. The capacity release revenue opportunity is different for different pipelines. MGE
12 has successfully grown the capacity release sales on the Southern Star Central Pipeline
13 ("SSCP"). This represents the most stable of MGE's capacity release opportunities at
14 about **_____** of annual revenue, but they are still made into a competitive
15 market subject to the pricing or income needs of competitors and the needs of customers;
16 all of which are difficult to predict. The success MGE has experienced with increased
17 revenue on SSCP does not guarantee continued success or a stable source of revenue.
18 For example, MGE has sold capacity at maximum rates to **_____** in the years
19 2007 – 2009, representing **_____** of the **_____** in market area
20 capacity release. MGE has no way to determine if these sales will continue as the
21 **_____** market changes and responds to **_____**, gas
22 pricing, competing gas pipelines and **_____** transmission infrastructure changes.

1 As described above, the market for capacity release on the Kinder Morgan pipeline is
2 highly variable and tied to the pricing relationship between the Rockies and the
3 Midcontinent.

4
5 The capacity release market on the Panhandle Eastern Pipeline (“PEPL”) system is also
6 variable and now affected by the REX pipeline. MGE has seen dramatic variability in the
7 PEPL revenue ranging from **_____** in 2003 to **_____** in 2007. We believe
8 that the capacity release market on PEPL is affected by the REX pipeline competing for
9 eastern and upper Midwest markets. The Midcontinent continues to see variability in
10 pricing as gas traders and marketers gain experience with newly constructed pipelines
11 exporting gas not only from the Rockies but also exporting gas from the Midcontinent
12 into the Gulf Coast. Recently MGE has seen the **_____** players for capacity
13 release on PEPL **_____**, again indicating a dramatic change in interest for
14 this capacity.

**

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1
2
3 **Q. DID MGE'S CUSTOMERS DERIVE SUBSTANTIAL FINANCIAL BENEFITS**
4 **FROM MGE'S ACTIVE MANAGEMENT OF ITS CAPACITY PORTFOLIO?**

5 A. Yes. MGE's management of the capacity release and off system sales portfolio for the
6 ACA years 2004 – 2008 has yielded in excess of ** _____ ** in revenue of which
7 the firm customer has retained in excess of ** _____ **. It is important to note that
8 during this period, MGE developed the off-system sales market yielding ** _____ **
9 of the ** _____ ** or ** _____ ** of the increase in revenue. A clear illustration of the
10 benefit due to the development of the off system market is the comparison of the revenue
11 generated from off-system sales when compared to the revenue generated from capacity
12 release rates. Had MGE released the capacity on the Kinder Morgan pipeline at
13 prevailing capacity releases rates, MGE would have earned only ** _____ ** during
14 this period or ** _____ ** less than the ** _____ ** MGE did earn. In addition,

1 MGE's firm customers have benefited substantially from the purchase of lower cost
2 supplies in the Rockies. MGE's aggressive management of this market has provided
3 substantial benefit to its customers.

4
5 **Q. ARE THERE ANY OTHER FACTORS REGARDING THIS ISSUE THAT ARE**
6 **IMPORTANT FOR THE COMMISSION TO CONSIDER?**

7 A. Yes, MGE continues to explore creative methods in managing the capacity portfolio. Not
8 only has the management of off system sales and capacity release provided benefits
9 exceeding ** _____ **, MGE has recently changed the capacity portfolio on the
10 ** _____ ** pipeline. MGE has reduced capacity portfolio
11 by approximately ** _____ **, with a savings of ** _____ ** annually. The
12 reduction of this capacity also reduces the opportunity for MGE to provide revenue from
13 capacity release or off system sales transactions.

14 Supporting MGE's forecast of limited revenue opportunity for the Kinder Morgan
15 pipeline, MGE checked the price spreads for April to October of 2010 and sees a 13 cent
16 spread between Kinder Morgan at the Cheyenne Hub and the Midcontinent pipelines.
17 The largest transaction cost, the fuel rate on Kinder Morgan is 3.3% which will consume
18 all of the 13 cent revenue at \$4.00 gas prices. Essentially, MGE does not see much future
19 revenue opportunity on the Kinder Morgan pipe.

1 **Q. BASED ON YOUR REVIEW OF STAFF'S ANALYSIS, WHAT CONCLUSIONS**
2 **HAVE YOU DRAWN?**

3 A. The Staff is only looking at the highest years of capacity release and off-system sales
4 revenues and is making a recommendation on what appears only to be the increased
5 revenues. My testimony provides a broader view of the capacity release and off- system
6 sales markets. The Staff recommendation to increase the sharing thresholds from
7 \$300,000 to \$2,000,000 is based on incomplete information and does not consider the
8 future revenue opportunities in a dynamic market. MGE's recent success through
9 managing the capacity portfolio does not guarantee any repeat of this success in the
10 future.

11
12 **Q. PLEASE SUMMARIZE YOUR TESTIMONY RELATED TO OFF-SYSTEM**
13 **SALES AND CAPACITY RELEASE TRANSACTIONS.**

14 A. My testimony illustrates that the capacity release and off systems sales annual revenues
15 are not uniform, are price competitive and respond to market forces including price
16 signals, transportation costs, well head production capacity and pipeline export capacity.
17 The graphical information displayed in my testimony shows the variability in the price
18 signals and the fluctuation on annual revenue.

19
20 The revenue associated with off system sales and capacity release on the Kinder Morgan
21 pipeline and the Panhandle pipeline is not an indicator of any future revenue potential.
22 The continued expansion of pipeline capacity out of the Rockies will continue to

diminish or eliminate any significant earnings potential on the Kinder Morgan pipeline. The effect of the REX line on PEPL revenues is suspect as MGE has lost most of the customer interest on that pipeline.

The recent increase in capacity release revenue on SSC is the result primarily of max rate sales to power plants served by the SSC system. This revenue is not guaranteed by any means and should not be considered as a continuing source.

Staff notes that MGE has experienced increased revenues from **_____** at the time the current sharing grid was established. If MGE is to forecast a stable source of revenue from these sources in question, the annual volume would be in the **_____** range, which would suggest that if any changes are to be made in the capacity release/off-system sales revenue sharing grid, they should be significantly more moderate than the nearly seven-fold increase proposed by the Staff. If the Commission believes changes in the grid are warranted, MGE suggests the following:

Annual CR Credits and OSS Margins	MGE Retention Percentage	Firm Sales Customer Retention Percentage
First \$600,000	15%	85%
Second \$600,000	20%	80%
Third \$600,000	25%	75%
Amounts over \$1.8million	30%	70%

TRANSPORTATION THRESHOLDS

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. I will respond to Constellation NewEnergy-Gas Division LLC witness Richard Haubensak proposal to lower the threshold to provide transportation service in the Company's service territory.

Q. DO YOU SUPPORT MR. HAUBENSAK'S PROPOSAL?

A. No. While the Company is not opposed to exploring lowering the threshold to provide transportation service in its service area, MGE cannot support this change at the present time.

Q. WHY NOT?

A. MGE has three major concerns related to the proposal to expand the eligibility of customers who qualify for transportation service: stranded interstate transportation capacity, the balancing provisions in MGE's tariff, and providing a transition period for the installation of telemetry equipment.

Stranded Interstate Transportation Capacity

MGE has transportation and storage capacity contracts for firm sales customers. The expiration dates for the majority of the capacity under contract have expiration dates in 2013 and 2017. Firm service customers who change to transportation service will no longer require service under the interstate pipeline contracts. Under MGE's tariff provisions, MGE's remaining customers would pay for the cost of interstate transportation capacity for those customers who change to transportation service.

1 **LV Customer Balancing Provisions and Equipment Changes**

2 If the threshold for transportation capacity is changed to increase the number of
3 customers transporting supplies on MGE's system, MGE would have to propose a change
4 in the balancing provisions to include a daily balancing provision. MGE is not prepared
5 at this time to make such changes, which will require internal system programming
6 changes and a transition period for the installation of measurement and telemetry
7 equipment on customer premises.

8 Mr. Haubensak has not proposed a method for the recovery of this cost from customers
9 migrating to transportation service or how to address the other issues noted above. As a
10 result, MGE cannot support his proposal.

11
12 **Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?**

13 **A. Yes, at this time.**