MGE

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ROBERT J. HACK
Vice President, Pricing & Regulatory Affairs

September 26, 2000

Thomas R. Schwarz, Jr.
Deputy General Counsel
Missouri Public Service Commission
P.O. Box 360
Jefferson City, MO 65102

RE: Case No. GO-2000-705, Missouri Gas Energy

Dear Tim:

I write you with no small amount of dismay upon reflection about our conference call on the afternoon of September 20. MGE initiated the conference call. We had hoped to engage representatives of the Commission Staff and the Office of the Public Counsel in a constructive discussion about possible actions that could be undertaken to mitigate the customer impacts of high gas costs this coming winter within the context of the Fixed Commodity Price PGA agreement approved by the Commission. Our sense of the meeting, is that the Staff prefers not to be involved with decisions on market prices, and this position has essentially repudiated some of the fundamental concepts we believe underlie the collaborative effort that was set up within the Fixed Commodity Price PGA agreement.

Price Stabilization Program

We first discussed the possibility of altering the parameters of the Price Stabilization Program to make it possible for MGE to obtain some level of price protection on this winter's volumes. The terms of the Fixed Commodity Price PGA agreement required MGE to obtain call options, market conditions permitting, prior to September 30, 2000, covering 70% of normal flowing November-March volumes at a strike price not to exceed $4.40/MMBtu and a total cost not to exceed $3.050 million. Prudence review of such purchases was precluded by the agreement.

As the Staff was aware, market conditions between August 1 (the date the Commission approved the agreement) and September 30, 2000, did not permit MGE to purchase any call options meeting those parameters. Our market research as of early September indicated that call options covering 70% of normal flowing November-March volumes at a strike price of approximately $8/MMBtu could be purchased for $3.050 million. It also indicated that for the same overall cost, the strike price could be reduced to about $7.50/MMBtu if we covered 70% of the normal flowing volumes for only the months of December-February. We saw more value in the latter and proposed to modify the Price Stabilization Program to reflect those terms, although we acknowledged that this strike price cap was extremely high and therefore that other alternatives, including a decision not to purchase any price protection, could certainly be deemed reasonable in light of the extreme volatility we continue to see in the wholesale market.

Our perception of the Staff's response is, in a nutshell, "MGE, you should do what you think is best, and we'll review your actions after-the-fact. If we think what you did was reasonable, we'll most likely permit you to recover the associated costs. If we disagree with what you did, however, we'll propose to disallow the associated costs." First, this is contrary to how MGE's Price Stabilization Program operated during the winters of 1997-1998, 1998-1999 and 1999-2000, as well as how it was proposed to operate in the Fixed Commodity Price PGA settlement approved by the Commission. Second, it ignores the fact that MGE currently has no upside earnings potential in its gas commodity transactions; that is, the best MGE can hope for through the ACA process is to be made whole. Given the fact that the Staff has proposed multi-million dollar disallowances in every MGE ACA proceeding to date, willingly agreeing to be exposed to additional after-the-fact prudence review by the Staff is not something that MGE considers advisable.

NYMEX Trigger Price for the Fixed Commodity Price PGA

The next item we discussed was the possibility of adjusting the trigger price contained in the Fixed Commodity Price PGA agreement. The $2.25/MMBtu trigger price contained in the agreement was negotiated over an 18-month period of time and first filed with the Commission in April of 2000. The agreement approved by the Commission calls for re-examination of the trigger price by MGE, the Staff and Public Counsel every two months following Commission approval in light of intervening natural gas market activity.

MGE provided information to the Staff and Public Counsel showing MGE's actual average cost of gas over the most recent twelve months ($2.93/MMBtu), six months ($3.28/MMBtu) and three months ($3.83/MMBtu). We also provided a twelve month forecast based on the NYMEX strip as of September 5, 2000 (using the same volumes as the most recent twelve months history) producing a weighted average forecast cost of $4.50/MMBtu. By averaging the most recent twelve months history and the twelve month forecast, MGE proposed increasing the trigger price to $3.75/MMBtu.

Our perception of the Staff response to this proposal is that the Staff is unwilling to adjust the trigger price upwards unless there is some reasonable likelihood that the adjusted trigger price could actually be implemented and the Staff is able to reach some comfort level that the market price of natural gas is not going to further bottom-out below that adjusted trigger price. Although we appreciate, and to a large extent share, the Staff's desire to minimize gas commodity costs billed to our customers, one of the fundamental concepts underlying the Fixed Commodity Price PGA agreement is that eliminating gas cost volatility within the PGA is a good thing. Now we also understand that eliminating volatility was not the only objective and that that objective must be balanced against overall price levels. A cost of $4/MMBtu looks good today. Will a cost of $5.50/MMBtu look good tomorrow?

We understand that nobody expected the current high prices and nobody can predict for certain whether they will last for three months, six months, twelve months or longer. Thus, the Staff's unwillingness to lock in a trigger price based on today's market for a period of two years is not entirely without justification. To address this concern, MGE offered the possibility of fixing the commodity cost within the PGA, on the basis of current market conditions, only for this winter season. Our perception of the Staff's response is, in a nutshell, "MGE, you should do what you think is best, and we'll review your actions after-the-fact. If we think what you did was reasonable, we'll most likely permit you to recover the associated costs. If we disagree with what you did, however, we'll propose to disallow the associated costs." Again, willingly agreeing to be exposed to additional after-the-fact prudence review by the Staff on decisions regarding market prices for fiinancial instrument contracts is not something that MGE considers advisable.

We had hoped that the signing and approval of the Fixed Commodity Price PGA represented a breakthrough in Missouri regulation, where customer impacts were addressed in a thoughtful, collaborative and creative fashion.

MGE will continue to explore ways to mitigate the customer impact of the current high gas costs. We welcome and invite the Staff's constructive input in advance. In any event, MGE believes it will need to notify the Commission that it has been unable to purchase call options within the parameters set out in the Fixed Commodity Price PGA agreement approved by the Commission. MGE also expects to seek Commission approval of modifications, along the lines of those discussed earlier in this letter, to the Price Stabilization Program set out in the Fixed Commodity Price PGA agreement.

Please call me if you would like to discuss this matter.

Sincerely,

Robert J Hack

CC: Doug Micheel
Mike Langston