MEMORANDUM

TO: Missouri Public Service Commission Official Case File, Case No. GR-2009-0268, Missouri Gas Energy, a Division of Southern Union Company

FROM: David M. Sommerer, Manager - Procurement Analysis Department
Anne Allee, Regulatory Auditor - Procurement Analysis Department
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Kwang Choe, PhD, Regulatory Economist - Procurement Analysis Department

/s/ David M. Sommerer 12/13/2010	/s/ Robert S. Berlin 12/13/2010
Project Coordinator / Date	General Counsel's Office / Date

SUBJECT: Staff's Recommendation in Missouri Gas Energy's 2008-2009 Actual Cost Adjustment Filing

DATE: December 13, 2010

I. BACKGROUND

The Commission's Procurement Analysis Department (Staff) has reviewed the Missouri Gas Energy's (MGE or Company) October 15, 2009 Actual Cost Adjustment (ACA) filing for the 2008-2009 period. The filing, in case GR-2009-0268, contains the Company's ACA account balance calculation.

MGE served an average of 511,556 customers in the Kansas City, Joplin and St. Joseph areas during the 2008-2009 ACA. MGE transports its gas supply over Panhandle Eastern Pipe Line (PEPL), Southern Star Central Gas Pipeline (SSC), Kinder Morgan Interstate Gas Transmission (KM), and Quest Pipeline, previously known as Kansas Pipeline Company (KPC).

Staff reviewed and evaluated MGE's billed revenues and actual gas costs for the period of July 1, 2008, to June 30, 2009. The Staff examined MGE's gas purchasing practices to determine the prudence of the Company's purchasing and operating decisions, including (1) a reliability analysis of estimated peak cold day requirements and the capacity levels needed to meet those requirements, (2) the Company's rationale for its reserve margin for a peak cold day, (3) a review of normal, warm and cold weather requirements and the gas supply plans for meeting these requirements, and (4) a review of MGE's hedging for the period to determine the reasonableness of the Company's hedging plans.

This ACA memorandum consists of the following sections for which the Staff makes recommendations:

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Staff has not proposed any dollar adjustments to the Company's filed June 30, 2009 ACA account balances, but provides recommendations to the gas purchasing practices.

II. ACA BALANCE

The ACA factor is based upon the ACA balance and is changed once a year at the same time the Company makes its required Winter PGA filing. In addition to its Winter PGA filing, MGE is permitted to make up to three (3) additional PGA filings each year. Although the ACA balance in this case appears to be reasonable, Staff is concerned with the amount of the ACA balance in MGE's recent Winter PGA filing for the 2009/2010 ACA period. Although the balance Staff is referencing occurs after the ACA period in this case, Staff wants to take the earliest opportunity to recommend the Company monitor its ACA balance throughout the year and make adjustments to its PGA rate to prevent its ACA balance from reaching an unreasonable level.

III. ** ____ ________________ **

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IV. RELIABILITY ANALYSIS AND GAS SUPPLY PLANNING IMPROVEMENT

As a regulated gas corporation and a Local Distribution Company (LDC) providing natural gas service to Missouri customers, assuring reliability of supply is an essential company function. The Company is responsible for conducting reasonable long-range supply planning and for the decisions resulting from that planning. One purpose of the ACA process is to examine the Company's analysis and decisions to assure reliability of its gas supply, transportation, and storage capabilities. For this analysis, Staff reviews: the LDC's plans, methods of calculating, and decisions regarding its estimated peak day requirements and the capacity levels to meet those requirements, the LDC's peak day reserve margin and its rationale for this reserve margin, and the Company's natural gas supply plans for various weather conditions.

MGE's primary service areas are: Kansas City, St. Joseph and Joplin. MGE has approximately 402,500 firm customers in the Kansas City area, 29,000 in St. Joseph, and 80,200 in Joplin, for a total of 511,700 firm customers (MGE Demand/Capacity Analysis, November 2007). For the 2008/2009 ACA MGE reports an average of 445,665 residential customers, 64,479 commercial customers, 299 industrial customers, and 1,113 transport customers, for an average total of 511,556 customers. To assure that each area has sufficient transportation capacity, MGE must consider the capacity available for each area. In its Demand/Capacity Analyses dated November 2007, MGE plans its capacity by service area.

Staff has no proposed financial adjustments to the 2008/2009 ACA period related to Reliability Analysis and Gas Supply Planning section.

The following is a list of comments and concerns by Staff as they pertain to Reliability Analysis and Gas Supply Planning:

A. CAPACITY PLANNING

1. Demand/Capacity Analysis for MGE's Three Service Areas

   For its short term and long-term monthly gas requirements and peak day requirements planning, the Company refers to MGE's report, Demand/Capacity Analysis dated November 30, 2007 (November 2007 Analysis) provided 1/31/2008. This is the same analysis MGE relied on for the 2007/2008 ACA, GR-2008-0367. Staff's concerns with the November 2007 Analysis are the same as those documented in the Staff recommendation in GR-2008-0367.

   MGE also provided a copy of its Demand/Capacity Analysis dated November 30, 2009 (November 2009 Analysis), received 12/14/2009. However, it would not have been available for the 2008/2009 ACA capacity planning. It will be applicable in the subsequent 2009/2010 ACA period.

   MGE should continue to evaluate whether its peak day methodology is reasonable and revise its planning as necessary to adequately prepare for peak day requirements.

2. Other MGE Capacity Studies

In addition to the peak day studies and capacity available to meet those requirements for each of its three service areas, MGE conducts studies in other areas of its service area that are potentially constrained or to evaluate requirements related to a specific pipeline.

a. Panhandle Eastern Pipeline (PEPL) Capacity
MGE conducted a separate analysis of peak day capacity needs served off the Panhandle Eastern Pipeline in the 2006/2007 ACA, GR-2007-0256. Staff expressed a concern in the 2006/2007 ACA regarding the reserve beginning in 2008/2009. MGE provided additional information on 5/29/09 in that case, including a conference call on 6/3/2009, to address Staff's concerns. MGE noted that the MGE PEPL Study is being updated and the results were being reviewed in June 2009. The updated PEPL study should be included with MGE's capacity plans for the 2009/2010 ACA.

b. Warrensburg Capacity Study
During a 5/8/2008 call for the 2006/2007 ACA, MGE noted that it is examining a study for the Warrensburg area because of growth in that area. In a separate 6/11/08 conference call MGE explained it will review the two feeds off of PEPL to Warrensburg prior to the contract expiration in 2010. The updated Warrensburg study should be included with MGE's capacity plans for the 2009/2010 ACA. The MGE capacity review for Warrensburg may be tied to the updated PEPL study.

c. MGE provided its 2009 North Kansas City study and provided work papers for the 2008 and 2009 North Kansas City studies in the 2007/2008 ACA, GR-2008-0367. Staff's concerns with the peak day estimates and the documentation of its capacity planning for North Kansas City are the same as those documented in the Staff recommendation in GR-2008-0367.

B. SUPPLY PLANNING

1. Supply for Peak Day

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____ ** Additionally, it was part of the winter purchases based on results from an RFP process. There were no similar deals for the

other supply contract, but it was part of the winter purchases based on results from an RFP process.

MGE plans did not include any "Virtual Call", a recall of capacity release volumes, for its peak day requirements as it had in the prior ACA. Staff previously expressed concerns regarding reliance on Virtual Calls for cold day supply.

2. Monthly Supply Planning

For its monthly supply planning, MGE refers to its Demand/Capacity Analysis dated November 2007 (November 2007 Analysis), the same as that provided in the prior ACA, the Monthly Supply/Demand Summaries and the MGE Dealsheets.

The November 2007 Analysis contains estimates of monthly requirements for normal and cold or "design" winter weather and for average warm and average cold winters (normal plus or minus one standard deviation) for November 2007 through October 2008. No estimates are provided for future years. Because MGE only updates its Demand/Capacity Analysis about every two years, it should include monthly estimates for more than a one-year period for its warm, normal, and cold weather supply requirement estimates, the weather normal and extreme estimates MGE considers in its Monthly Supply/Demand Summaries.

Base load for monthly planning is the same as that for peak day planning, and the concerns are documented in prior cases.

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_____ ** A warm weather analysis allows MGE to consider the flexibility of its daily supply plans when the daily weather is warm. Staff is concerned with the reasonableness of these warm estimates. MGE's estimates of warm winter weather requirements do not adequately consider the heating degree day extremes, especially for the months of November and December. Staff expressed a similar concern for the 2007/2008 ACA, GR-2008-0367.

The early winter months are of great concern because if the weather is warm and storage is full or nearly full, MGE may have to sell natural gas into the market at a price lower than it paid for the gas. ** ____________________________________
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Staff recommends that MGE review its warm weather supply plans and assess the possible cost to customers for excess gas for warmer days in those months. ** ________ ** For the 2008/2009 ACA, MGE had no ** ____ ** in place in November. For December through February, it had ** ________ **

V. HEDGING

In its review of MGE's purchasing practices, the Staff reviewed the Company's hedging transactions. The Staff also reviewed the Company's natural gas hedging policy, natural gas trading procedures, and 2008 – 2009 hedging strategy.

Weather was near normal in November, colder than normal in December 2008 and January 2009, and warmer than normal in February, and March 2009. The Company executed the hedging transactions for the 2008-2009 ACA period based on the ** ________ ** plan. MGE combined storage, and financial instruments to hedge portions of the volumes needed for the winter heating season November 2008 through March 2009. MGE utilized ** _____ ** for its financial instruments and the Company started placing the financial hedges from spring 2007 and continued purchasing them through fall 2008. MGE hedged ** ____ ** of normal winter requirements with storage, and ** ______ ** The Company employed both time-based as well as discretionary approaches to execute its financial hedging transactions. ** ________ **

The natural gas market prices were highly volatile during the 2008-2009 ACA period. Market prices continued to spike in the first half of 2008 followed by precipitous drops between the second half of 2008 and the early part of 2009. Market prices went from above $13/MMBtu in July 2008 to below $4/MMBtu in March 2009. ** ________ ** Although Staff is not suggesting that the Company should or could design its hedging strategy in order to beat the market, the Company's hedging plan should be flexible enough to incorporate changing market circumstances. The Company should continually evaluate its hedging strategy in response to changing market dynamics to balance the cost of hedging against the goal of price stabilization. For example, a part of the Company's hedging strategy was based on price view where the Company executed some of its hedging transactions when the Company viewed the prices were relatively low. Staff recommends the Company be aware of any fundamental shifts in the market dynamics while being cautious on the market views. The Staff also recommends the Company continue to update its price risk management planning in order to be able to make informed hedging decisions. The Staff further recommends the Company continue to document its hedging decisions and provide the documentation to the Staff during each ACA review. This documentation should include an overall hedging plan that addresses hedging goals, objectives, and strategies for each month of each ACA review. The hedging plan should be updated, documented and completed well in advance of each approaching winter season.

Although the Company used a diversified portfolio approach to hedge against market risks for the winter heating season November 2008 through March 2009, Staff recommends the Company analyze its hedging risk for each winter month under normal conditions and cold weather conditions, including cold weather that may occur late in the winter season. This analysis should include a review of the volumes hedged and the associated cost. In addition, MGE should analyze each month where price exposure exists, to evaluate the costs and risks of not covering, or minimally covering, the unhedged price volatility for that particular month. The Company should also continue to carefully evaluate longer-term time horizons for placing hedges as it extended the forward purchasing window. Finally, the Staff recommends the Company continue to assess and document the effectiveness of its hedges for the 2009-2010 ACA and beyond. The analysis should include but not be limited to whether the hedging implementation was consistent with the hedging plan, testing in detail for hedge effectiveness for any financial instruments that attempt to hedge the physical price risk exposure, identifying the benefits/costs based on the outcomes from the hedging strategy, and thus evaluating any potential improvements on the future hedging plan and its implementation.

VI. RECOMMENDATIONS

It is Staff's opinion the Company should do the following:

1. Establish the following ACA and Refund account balances shown in the table below to reflect the (over)/under-recovery balances as of June 30, 2009. An over-recovery reflects the amount that is owed to the customer by the Company and is shown in the table below as a negative number. An under-recovery is an amount that is owed to the Company by the customers and is shown in the table below as a positive number.

Account	6-30-09 Ending Balances per MGE Filing	Current ACA Staff Adjustments	6-30-09 Staff Recommended Ending Balances
ACA Balance	$ 4,726,867.50	$ 0	4,726,867.50
Large Volume Refund	$ (527,232.53)	$ 0	$ (527,232.53)

2. Monitor its ACA balance throughout the year and make adjustments to its PGA rate as appropriate.

3. Respond to the concerns expressed by Staff in the Reliability Analysis and Gas Supply Planning Improvement section related to capacity planning and supply planning.

4. Respond to the concerns / comments expressed by Staff in the Hedging Section.

5. Respond to all recommendations included herein within 30 days.

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of Missouri Gas Energy's	)	
2008-2009 Actual Cost Adjustment	)	Case No. GR-2009-0268

AFFIDAVIT OF DAVID M. SOMMERER

STATE OF MISSOURI	)	
	)	ss.
COUNTY OF COLE	)	

David M. Sommerer, being of lawful age, on his oath states: that as a Utility Regulatory Manager in the Procurement Analysis Department of the Utility Services Division, he has participated in the preparation of the foregoing report, consisting of 7 pages to be presented in the above case; that he has verified that the following Staff Memorandum was prepared by himself and Staff of the Commission that have knowledge of the matters set forth as described below; that he has verified with each of the Staff members listed below that the matters set forth in the Staff Memorandum are true and correct to the best of his knowledge and belief,

Anne Allee, Regulatory Auditor:	Billed Revenues and Actual Gas Costs
Lesa A. Jenkins, P.E., Regulatory Engineer:	Reliability Analysis and Gas Supply Planning
Kwang Choe, PhD, Regulatory Economist:	Hedging

that he has knowledge of the matters set forth in such report and that such matters are true to the best of his knowledge and belief.

David M. Sommerer

David M. Sommerer

Subscribed and sworn to before me this 13th day of December 2010.

D. SUZIE MANKIN
Notary Public - Notary Seal
State of Missouri
Commissioned for Cole County
My Commission Expires: December 08, 2012
Commission Number: 08412071

D Suzie Mankin

Notary Public