

MEMORANDUM

To: The Commission

From: the Staff

Re: Policy Considerations for Actual Cost Adjustment/Purchased Gas Adjustment cases with Affiliate Transactions

Introduction

The PGA has been in effect in Missouri for over 50 years. When the FERC deregulated the price of the natural gas commodity during the mid 1990's, an entire new era of gas procurement strategies began. This changed the PGA and ACA processes and created opportunities for LDCs to sell natural gas and release unused pipeline capacity.

Not only were LDCs able to sell capacity and natural gas, the PGA process became more complex. Because of the need for upstream contracts and various timing provisions and different types of contracts (firm, firm with no-notice provisions, swing etc.), now, instead of one or two transportation contracts larger LDCs may have twenty or more transportation and storage contracts. Instead of the one or two invoices for the purchase of the gas commodity there may be hundreds of invoices.

A number of additional developments added to the complexity of the PGA process: the development of hedging, the opportunity for off-system sales and capacity release, incentive programs, storage arbitrage, transportation imbalances, park-and-loan agreements and affiliated transactions between the LDC and its unregulated marketing affiliate. Also adding to the complexity is the development of gas marketing companies. In Missouri only Laclede Gas Company (LGC or Laclede) and Atmos Energy have gas marketing affiliates which operate in the same service territory as the LDC. The increased complexity of buying and selling natural gas has increased the opportunity for LDCs to benefit the marketing affiliate to the detriment of

the regulated LDCs and their customers.

The Supreme Court recognized the fact that utility companies with affiliates may engage in “a profit-producing scheme among public utilities termed “cross-subsidization,” in which utilities abandon their traditional monopoly structure and expand into non-regulated areas [through affiliates such as Laclede Energy Resources or Atmos Energy Marketing]. This expansion gives utilities the opportunity and incentive to shift their non-regulated costs to their regulated operations with the effect of unnecessarily increasing the rates charged to the utilities' customers. *See United States v. Western Elec. Co.*, 592 F.Supp. 846, 853 (D.D.C.1984) (“As long as a [public utility] is engaged in both monopoly and competitive activities, it will have the **incentive** as well as the **ability** to ‘milk’ the rate-of-return regulated monopoly to subsidize its competitive ventures....”)” *State ex rel. Atmos Energy Corp. v. Public Service Com'n*, 103 S.W.3d 753, 764 (Mo. Banc 2002) (emphasis supplied).

This incentive is demonstrated by review of Laclede’s bonus plan for its corporate officers, which specifically gives bonuses for increasing LER’s profits. It is further demonstrated by Laclede’s press releases touting LER’s profits. *See attached*. Based on review of these documents, Laclede Group’s very business model appears to be set up to subsidize its competitive ventures. The lack of structural separation creates opportunities or incentives to move profits from the regulated business to the competitive venture. This is the reason there may be **no presumption of prudence** in transactions between a regulated monopoly and its affiliates.

Moreover, moving profits from the regulated utility has an effect on economic development in that such development depends on affordable energy costs. If LGC moves

profits from the regulated entity to an unregulated affiliate, it has a negative effect on rates for residential, commercial and industrial consumers.

Before moving to specific policy suggestions, Staff notes Laclede was able to operate for over a hundred years without a marketing affiliate. Missouri Gas Energy and AmerenUE (Gas) are operating sound companies without marketing affiliates.

Specific policy suggestions for the Commission's consideration:

Laclede, or any the local distribution company (LDC), with a gas marketing affiliate, especially an affiliate that markets gas in the same region as the LDC must operate its regulated business separately and distinctly from the affiliate. LGC should be operated solely for the benefit of the Laclede Gas Company and its Missouri consumers consistent with provision of safe and reliable service. Laclede and its employees should never participate in any activities that dilute, diminish, or harm the safe and efficient operations or profitability of the LDC. An affiliate should never be permitted to take profitable business opportunities from the LDC or in any way jeopardize the LDC's ability or opportunity to earn its approved rate of return.

Laclede should have sufficient documented policies, procedures, training and controls in place to implement this policy. For example, the following should be addressed in LGC's policies, procedures and controls:

1. No employees, officers or information shall be shared between Laclede Gas Company (LGC or Company), the local distribution company (LDC), and its affiliate.
2. There shall be an individual at the Laclede Group level responsible for maximizing the benefits to LGC consistent with safe and reliable service. The person signing or approving contracts for LGC may not have any, responsibilities, duties, interests, or pay/bonus incentives related to Laclede Energy Resources, Inc., (LER).

3. LGC should have sufficient controls and sufficiently motivated management to assure the charges to its customers are just and reasonable.
 - a. LGC's compensation including bonuses should be properly structured to encourage its gas buyers to act to assure the LDC's procurement of gas, transportation, and storage is at the lowest cost consistent with reliability and prudent hedging. Cost, compensation and bonus considerations shall include the maximization of the LDC revenues from idle assets through capacity release and off-system sales.
 - b. LGC shall have sufficient policies and procedures regarding secondary employment so there is no conflict of interest for any LDC employee. (For example, an LGC employee should not be allowed to have secondary employment with a marketer or supplier of natural gas. Thus, the policy should not allow a LGC employee to have responsibilities or salary/pay incentives for both the LDC and the affiliate, LER.)
 - c. LGC should maintain sufficient documentation of its rationale for the prudence of its gas supply (natural gas and propane) contract/awards. LGC's controls shall include policies and procedures for documentation requirements for the LDC's gas supply contracts/awards made outside of an impartial and open Request For Proposal (RFP) process.
 - d. LGC should have sufficient controls/procedures and documentation in place to assure transactions conducted using electronic platforms are not unduly limited to favor an affiliate.

- e. LGC should have sufficient controls/procedures and documentation in place to assure in all its activities, the LDC operates solely for the LGC's benefit, not for the benefit of an affiliate.
 - f. LGC should have sufficient controls/procedures and documentation in place to assure the LDC sufficiently evaluates releases of its capacity versus the off-system- sales alternative to maximum benefits to the LDC. (rather than releasing capacity for others such as the LDC's affiliate to maximize natural gas sales)
 - g. LGC should have sufficient controls/procedures and documentation in place to assure the LDC does not link deals for gas supply and transportation only when doing business with its affiliate.
- 4. Any gas supply awards made to an affiliate shall only be awarded through an RFP process.
 - 5. LGC's liquidity resources shall not be used to benefit an affiliate. Any affiliate must be operated separately and distinctly from LGC.