BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Southern Missouri Gas Company, L.P.'s Purchased Gas Adjustment Factors to be Reviewed in its 1999-2000 and 2000-2001 Actual Cost Adjustment	)))))	Case No. GR-2001-388

REPLY BRIEF OF

SOUTHERN MISSOURI GAS COMPANY, L.P.

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NON-PROPRIETARY (NP) VERSION

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COMES NOW Southern Missouri Gas Company, L.P. ("SMGC" or "Company") for its Reply Brief in this matter and states as follows:

INTRODUCTION

As Public Counsel noted in its Initial Brief, the parties in this case are in agreement as to the basic facts of the case. (Public Counsel Br. at 1). For example, the parties agree on the following fundamental points:

1) SMGC entered into Gas Supply and Gas Transportation Agreements with two large industrial customers who were on the verge of leaving the SMGC natural gas system during the winter of 2000-2001 in favor of a lower-priced propane alternative source of energy; (Public Counsel Br. at 2-3).

2) The large industrial customers who were about to leave the SMGC system were unwilling to obtain gas supplies from a third party marketer, but they were willing to purchase gas supplies from SMGC (because they were comfortable with SMGC and not with gas marketers) to be transported using SMGC's transportation service; (Public Counsel Br. at 2-3).

3) The two industrial customers met the volumetric thresholds to be Transportation Service customers; (Staff Br. at 8, 13; Public Counsel Br. at 2).

4) SMGC used all of the profits (nearly $40,000) from the sales of gas to the two industrial customers to lower the costs that would otherwise have been borne by SMGC's other ratepayers. (Staff Br. at 25; Public Counsel Br. at 12).

5) SMGC's ratepayers benefited from the fact that the large industrial customers remained on the natural gas system and the ACA balance was reduced by the gas sale profits. (Staff Br. at 25; Public Counsel Br. at 12).

6) The Company may not have acted imprudently from a business standpoint. (Staff Br. at 4).

The fundamental disagreement among the parties in this case is whether SMGC may lawfully sell gas supplies that may be transported utilizing the Company's transportation tariff without having a specific provision in its intrastate tariff authorizing it to do so. As explained in SMGC's Initial Brief, the Company believes that it may lawfully sell gas supplies to transportation customers under FERC's "blanket marketing certificate" program that was established when the FERC restructured the natural gas markets in the 1980s, and created an unregulated market for the supply of natural gas for transporters.

Staff has argued that there must be a provision in SMGC's Missouri tariff authorizing it to sell gas in this unregulated market. Since no such provision exists in SMGC's Missouri tariff, Staff (and Public Counsel) believe it would be unlawful and a "violation" of the tariffs for SMGC to participate in this activity for the benefit of SMGC's consumers. These parties have proposed an ACA adjustment (an apparent penalty to "remedy" this infraction) that would impute $99,199 of theoretical revenues from these industrial customers that would be used to lower the ACA balance.

For the reasons stated in SMGC's Initial Brief and herein, the Commission should find that SMGC has not violated its tariffs and reject the proposed adjustment of Staff and Public Counsel in this proceeding. However, without conceding the legitimacy of Staff's or Public Counsel's arguments on this issue, in light of the adverse reaction from Staff and Public Counsel to SMGC's efforts to keep the industrials on the natural gas system and benefit other SMGC ratepayers, and the regulatory costs associated with litigating this issue in this case and in the pending Complaint case, SMGC is willing to allow its existing Gas Supply Agreements with its large industrial customers to expire at the end of the contract terms. It is simply not worth the regulatory ill-will that this effort has engendered, and the costs of litigating this issue, for SMGC to continue to attempt to use this approach to keep its industrial customers on its natural gas system if SMGC must continue to litigate with the Staff and Public Counsel.

In the future, SMGC will refuse to enter into such Gas Supply Agreements, unless the Commission has approved a tariff provision that specifically authorizes SMGC to do so. However, SMGC sincerely hopes that both Staff and "Public Counsel remain[s] ready, willing and able to work as expeditiously as possible with SMGC to put in place tariff provisions that will allow it to serve its customers in the future in the most beneficial manner." (Public Counsel Br. at 14). These discussions among the parties should focus upon the tariff proposal contained in Mr. Klemm's Rebuttal Testimony, Ex No. 6, Schedule No. 4 which is intended to provide explicit tariff language authorizing SMGC to enter into gas supply and transportation agreements such as those contracts at issue in this case. Although this proposal was included in SMGC's rebuttal testimony in this case, Staff and Public Counsel chose not to address it in their surrebuttal testimony or initial briefs.

With the hope of resolving this problem for the future, SMGC has decided to file the tariff sheet with a 30-day effective date concurrently with this Reply Brief. (Attachment No. 1) Unfortunately, SMGC does not believe that it will have the luxury of the sixty (60) days that Staff witness Russo estimated it would take "if things went smoothly" to find an acceptable solution to this problem since these large industrial customers' gas supply agreements expire on **_____** (Ex No. 15HC, Schedule 2-15, 2-1). These customers are expected to go to alternative sources of energy when their gas supply agreements expire, if an acceptable, competitively priced natural gas alternative is not provided by SMGC. If these customers (which make up a substantial portion of SMGC's total throughput) leave the SMGC system, the remaining SMGC customers will be responsible for paying the higher fixed transportation costs that will remain after the industrial customers leave the SMGC natural gas system. This would be an unfortunate consequence for SMGC and its remaining customers if an acceptable solution cannot be found expeditiously.

While SMGC hopes that this approach will resolve all future issues related to the Gas Supply Agreements, given the extreme remedy and positions advocated by Staff and Public Counsel in this proceeding, SMGC must respond to some of the arguments and statements contained in their Initial Briefs.

I. THE PROPOSED ADJUSTMENT SHOULD BE REJECTED SINCE SMGC HAS AUTHORITY TO PARTICIPATE IN SALES OF GAS PURSUANT TO FEDERAL LAW.

In Staff's Initial Brief, Staff criticized SMGC for "fail[ing] to explain how FERC Orders that deregulated and restructured the natural gas industry authorize it to violate its Transportation Tariffs on file with the Commission." (Staff Br. at 23). While SMGC has never contended that FERC has authorized it to "violate its Transportation Tariffs," SMGC had erroneously assumed

Staff was familiar with the seminal orders that established the current regulatory framework for the natural gas industry in this country. However, this is apparently not the case. During the evidentiary hearing, it became apparent that the technical Staff was not particularly familiar with the fundamental FERC orders that restructured the natural gas industry and required the establishment of interstate transportation services. (Tr. 233-34) Nor was the primary Staff witness that alleged that SMGC was "violating its transportation tariff" familiar with the Missouri Public Service Commission's seminal order in ***Re Investigation of Developments In The Transportation of Natural Gas And Their Relevance To Regulation Of Natural Gas Corporations in Missouri,*** Case No. GO-85-264, 28 Mo.P.S.C. (N.S.) 619 (September 18, 1986), that first authorized intrastate transportation services in Missouri. (Tr. 233-34).

Although FERC Order Nos. 436 and 636 were hugely important decisions for those regulators and other stakeholders that lived through the massive restructuring of the natural gas industry, it may be understandable that more recent participants in the regulatory process would not be as familiar with this "ancient" history. However, this restructuring of the natural gas industry is important background for the issues in this case.

A. Transition to Competition in the Natural Gas Industry

In 1938, Congress enacted the Natural Gas Act to regulate the sale for resale in interstate commerce of natural gas.[1] Congress enacted the NGA because it "considered that the natural gas industry was relatively concentrated and that monopolistic forces were distorting the market price for natural gas."[2] Under the NGA, Congress regulated the interstate chain of distribution of natural gas from the wellhead to the market under a traditional public utility model. The heart of

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[1] 15 U.S.C. 717-717w (1938).

[2] FPC v. Texaco, Inc., 417 U.S. 380, 397-398 (1974).

the NGA regulatory system was the fixing of "just and reasonable rates" for natural gas companies (both producers and pipelines) engaging in the sale for resale and interstate commerce of natural gas. The structure of the natural gas industry regulated by the NGA was simple. The producers would sell their natural gas in the production area to the interstate pipelines at the rates determined by the Federal Power Commission (FPC) (later called Federal Energy Regulatory Commission) to be "just and reasonable." The pipelines would transport their purchased gas and their own production to the city gate for sale to local distribution companies (LDCs) at FPC-determined just and reasonable rates which recovered both the pipeline's cost of gas and cost of transmission. The primary features of the NGA-regulated natural gas industry were FPC-determined just and reasonable prices and interstate pipeline sales of gas for resale to LDCs at the city gate at those prices and transactions that combined or bundled into one package the pipeline's gas supply and transmission costs.

In the energy crisis of the 1970's, significant shortages of natural gas occurred. The interstate natural gas shortages during the 1970's were the catalyst for reform of the regulation of the natural gas industry. Simply put, the FPC's regulation under the NGA did not prove adequate to the task of ensuring an adequate supply of interstate gas. As a result, Congress responded to the natural gas shortages by enacting the Natural Gas Policy Act of 1978 (NGPA) (codified as amended at 15 U.S.C. §§ 3301-3432 (1994)) to increase the flow of gas into the interstate market.

Under the NGPA, the process of decontrolling wellhead prices of natural gas began. Congress also took action to promote gas transportation by interstate and intrastate pipelines by authorizing the FERC to approve certain transportation arrangements outside the NGA's certification's requirements. The NGPA permitted the FERC to approve the transportation of gas

by interstate pipelines on behalf of any intrastate pipeline and any LDC. The NGPA's primary aim was to permit a competitive wellhead market where market forces play a "more significant role in determining the supply, the demand, and the price of natural gas."[3]

The NGPA radically changed the key aspect of the natural gas industry by eliminating FERC-determined prices for wellhead and first sales of natural gas. In so doing, the NGPA was designed to create a workably competitive market for the production of natural gas.

In 1985, the FERC adopted Order No. 436 in response to the NGPA's aim to permit a more competitive wellhead market and to the economic changes in the natural gas industry. Order No. 436 instituted open-access, nondiscriminatory transportation to permit downstream gas users, such as LDCs and industrials, to buy gas directly from gas merchants in the production area and to ship that gas via the interstate pipelines. As a result of the adoption of Order No. 436, the interstate pipeline system was largely transformed from a system in which most natural gas was sold on a merchant basis to a system where approximately 79% of total annual interstate pipeline throughput was transportation. This reversed the historical function of pipelines, which prior to Order No. 436 had primarily acted as gas merchants.

Summarizing, the NGPA and Order No. 436 fundamentally changed two key components of the natural gas industry. First, the price of natural gas as a commodity was no longer subject to FERC-determined rates. Second, the transportation and sale of natural gas became distinct economic and commercial services. Pipelines and other gas merchants became direct competitors in the sale of gas to LDCs and to end users, such as industrials and gas-fired electric generators.

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[3] Transcontinental Gas Pipeline Corp. v. State Oil and Gas Board of Mississippi, 474 U.S. 409, 422 (1986).

In 1989, Congress adopted the Decontrol Act.[4] This legislation amended the NGPA to repeal all remaining price controls on wellhead gas in order to obtain additional production of natural gas at lower prices by creating competition among the various producers. In effect, in the evolution of the natural gas industry from the passage of the NGPA in 1938 to the passage of the Decontrol Act in 1989, the natural gas industry was transformed from a "traditional" structure where pipelines purchased gas from producers at regulated prices and transported that gas to consuming markets where it was resold to LDCs at regulated prices and other end users, to a structure where LDCs and industrial end users increasingly utilized pipelines only to transport (at FERC regulated prices) the gas they purchased at decontrolled prices directly from producers and marketers.

In 1992, the FERC adopted Order No. 636 which completed the restructuring process for the natural gas pipeline industry to make it more competitive. According to the FERC, Order No. 636 was designed to "reflect and finally complete the evolution to competition in the natural gas industry."[5] Under Order No. 636, the FERC required pipelines to unbundle (*i.e.,* separate) their sale service from their transportation services at an upstream point near the production area and to provide all transportation services on a basis that is equal in quality to all gas supplies where the purchase from the pipeline or from any other gas purchaser. The pipelines were also required to provide a variety of transportation services to their shippers, including unbundled storage services and interruptible transportation services.

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[4] Pub.L. No. 101-60, 103 Stat. 157 (1989).

[5] Final Order No. 636, p.2 (April 8, 1992).

In Order No. 636,[6] the FERC concluded its massive natural gas industry restructuring. In Order No. 636, the FERC mandated unbundling and authorized sales customers to reduce their pipeline gas purchases.[7] As a part of the restructuring effort, the FERC adopted a "blanket marketing certificate program." Under FERC's blanket marketing certificate program, any entity, except an interstate pipeline, is authorized by the FERC without making any formal application to make sales of gas at negotiated rates in interstate commerce.[8] SMGC believes that it had the authority to participate in this program when it entered into the Gas Supply Agreements with the large industrials in this proceeding.

Fundamentally, the FERC's efforts to restructured natural gas industry were designed to decontrol the price of natural gas and leave the market to determine at what prices gas supplies would be sold to LDCs and end users. Gas supplies are provided to transportation customers on a virtually unregulated basis by entities, pursuant to the FERC's blanket marketing certificate program. SMGC does not believe that it must seek prior approval from the Commission to participate in such sales of gas to transportation customers. For this reason, the Commission should reject Staff and Public Counsel position that SMGC did not have "authority" to sell gas supplies to these transportation customers. (Staff Br. at 9; Public Counsel Br. at 6). However, if

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[6] Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation Under Part 284 of the Commission's Regulations; and Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, Order No. 636, 57 Fed. Reg. 13,267 (Apr. 16, 1992), III FERC Stats. & Regs. (CCH) Paragraph 30,939 (Apr. 8, 1992), order on reh'g; Order No. 636-A, 57 Fed. Reg. 36,128 (Aug. 12, 1992), III FERC Stats. & Regs. (CCH) Paragraph 30,950 (Aug. 3, 1992), reh'g denied; Order No. 636-B, 57 Fed. Reg. 57,911 (Dec. 8, 1992), 61 FERC (CCH) Paragraph 61,272 (1992), aff'd in part and remanded in part; United Distribution Companies v. FERC, 88 F.3d 1105 (D.C. Cir. 1996) [known as, "AGD III"].

[7] The various FERC orders that restructured the natural gas industry are also discussed at length by the Missouri Court of Appeals in ***Midwest Gas Users' Association v. Public Service Commission***, 976 S.W.2d 470 (Mo. App. 1998).

[8] *See also* Regulations Governing Blanket Marketer Sales Certificates, 61 FERC P 61,281, 1992 WL 409181, Util. L. Rep. P 5803 9 (F.E.R.C., Nov. 30, 1992).

the Commission disagrees with SMGC on this jurisdictional matter, and finds that SMGC needs intrastate approval to make such gas sales, SMGC is willing to file a tariff that explicitly authorizes SMGC to make such sales.

II. STAFF'S AND PUBLIC COUNSEL'S CONTENTION THAT SMGC'S TARIFF SHEET NO. 15 PROHIBITS SMGC FROM SELLING GAS TO TRANSPORTATION CUSTOMERS SHOULD BE REJECTED.

In the Initial Briefs of Staff and Public Counsel, these parties argue that SMGC's Tariff Sheet No. 15 contains a provision that prohibits SMGC from selling gas to its transportation customers. This contention was raised for the first time when Public Counsel announced in his opening statement that he believed that a provision in SMGC's Tariff Sheet No. 15 prohibits SMGC from selling gas to its transportation customers. (Tr. 36) This was a complete surprise to SMGC personnel since no one, including counsel for the Office of the Public Counsel or the Staff, had previously identified any specific tariff provision that these parties alleged was being violated. (Tr. 167). In fact, Staff witness James Russo testified that "Staff cannot identify a specific tariff section that is being violated by SMGC. . . " (Ex No. 16, p. 3).

In addition, while Position Statements are generally designed to afford the parties the opportunity to understand the basis for an adverse party's contentions in Commission proceedings, the late-filed Position Statement of Public Counsel in this case failed to include any reference to Tariff Sheet No. 15 or any other specific provision that allegedly was being violated. Public Counsel cryptically answered the question in the Public Counsel's late-filed Position Statement without any other explanation for its position. (Public Counsel's Statement of Positions, p. 1).

Staff's Position Statement also made no reference to Tariff Sheet No. 15 or any other specific tariff provision that Staff alleged was being violated. (Staff Position Statement, p. 1).

Staff witness Jim Russo also admitted that he had only become aware of this theory regarding Tariff Sheet No. 15 on the Friday before the hearings were held on Tuesday, March 11, 2003. (Tr. 219):

[Mr. Russo] . . . But when you look at that one section of nominations, I believe it's on Sheet 15 that one sentence, I believe that in itself would not allow this type of service.

[Fischer]: And, Mr. Russo, you didn't point that out in your direct, rebuttal or surrebuttal testimony either, did you?

[Mr. Russo]: That is correct, sir.

[Fischer]: Is the first time you heard that this morning in the opening statement by Public Counsel?

[Mr. Russo]: No, it is not.

[Fischer]: Okay. That's the first time I heard it.

[Mr. Russo]: **Well, last Friday is when I realized that section was there, sir.** (emphasis added).

While Public Counsel's Brief leads the reader to believe that Public Counsel fully informed SMGC of its position at the "first meeting between SMGC and Public Counsel," (Public Counsel Br. at 11), Public Counsel fails to mention that there was never any discussion of provisions on Tariff Sheet No. 15 at that meeting. (Obviously, if there had been such a discussion, Staff witness Russo (who also attended the meeting with Public Counsel) would have been aware of this tariff provision before "last Friday when I realized that section was there.")[9]

[9] On Friday, March 7, 2003, Staff also filed its formal Complaint in Case No. GC-2003-0314 which also alleged that SMGC violated its tariffs. However, in the Complaint filed by Staff on March 7, and in its Amended Complaint filed after the hearings in this matter on April 18, 2003, Staff did not make any reference or allegation that SMGC had violated Tariff Sheet No. 15 of its tariffs. If Staff really believed that the provisions of Tariff Sheet No. 15

In addition, Public Counsel's brief also fails to mention that the Office of the Public Counsel did not even take an active role until late in this proceeding.

Notwithstanding the unfortunate trial procedures used by Public Counsel and Staff in presenting their cases, the Commission should nevertheless reject the positions of Staff and Public Counsel on the merits. SMGC explained at length in its Initial Brief the reasons that the provisions of Tariff Sheet No. 15 are inapplicable to the situation at hand. (SMGC Initial Br. at 27-28)

As Mr. Klemm explained during questioning by Commissioner Forbis at the evidentiary hearings (Tr. 137-39), the provisions of Tariff Sheet No. 15 apply in the very limited situation of a traditional third-party transportation service where the LDC has agreed in writing to be the transportation customers' agent in the nomination process:

[Commissioner Forbis]: Mr. Micheel raised in his opening statement this morning on Sheet 15 of the transportation service tariff, under the nominations section, which is Schedule 1-29.

Do you find that?

[Mr. Klemm]: Yes, I'm there, Commissioner Forbis.

[Commissioner Forbis]: Could you comment on his point that says in no event will the company in its role as agent purchase transportation volumes on behalf of a customer?

[Mr. Klemm]: Yes. The first thing that I would say is that this language, I think is relatively standard, and it's, I think, under the premise, under traditional transportation service.

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applied to the facts of this case, then SMGC would have expected that Staff would have clearly made this allegation in its Complaint or its Amended Complaint.

[Commissioner Forbis]: Okay.

[Mr. Klemm]: And under traditional transportation service, the company, that being Southern Missouri or another LDC. . . may have an agency agreement with the . . transport customer for nomination purposes, but what this—how I interpret this is, for instance, if, say, it's colder than normal and there's an operational flow order, and while we might be—have an agency agreement with that third-party transporter, if we ask them to say that, you know, you need to put additional gas onto the system because your takes are high, you know, we tell them, and then they have to go out and do that.

We would not be able to go and try to contract gas on their behalf to buy it on their behalf and put it into our system.

[Commissioner Forbis]: Okay.

[Mr. Klemm]: And so I would view that as, again, as I indicated, language for an agent as it relates to a third-party transport customer, and not necessarily acting as an . . . agent with respect to the gas supply contract that Southern Missouri, in fact, contracted with these three particular customers in question through these proceedings.

[Commissioner Forbis]: Okay. So SMGC's interpretation is that this is a very specific paragraph dealing with a certain instance in a certain case. Is that fair to say it that way?

* * *

[Mr. Klemm]: In my opinion, . . . I would just phrase it under these particular being traditional transport, which is the vast majority of the situation, I'm sure, in Missouri, as well as throughout the entire country, yes, I would agree with your statement, Commissioner Forbis.

The nomination provisions of Sheet No. 15 do not apply to the contractual arrangements between SMGC and the large industrial customers in this case since SMGC has not agreed in writing or otherwise to serve as the agent for these transportation customers for nominating transportation volumes. (Tr. 167) Staff and Public Counsel, however, suggest in their briefs that Mr. Klemm's statement that SMGC is not an "agent" for the industrial customers is not "credible." (Staff Br. at 11; Public Counsel Br. at 8). Instead of analyzing the legal relationship created by the Gas Supply and Gas Transportation Agreements themselves, Staff and Public Counsel rely on a single statement in the hand-written notes of SMGC's Gas Control Manager when he wrote an informal memo to the file. (Staff Br. at 11; Public Counsel Br. at 7) The Commission should decline to accept the analysis of Staff and Public Counsel on this point since this informal memo did not create a legal relationship between SMGC and its transportation customers.

Based upon the legal relationship of the parties created by the Gas Supply Agreements and the Gas Transportation Agreements, it is clear that SMGC **sold the gas at a profit** to the

transportation customers at the **_____**

The legal relationship between SMGC and its transportation customers is not an "agency" relationship, whereby SMGC would have merely arranged the gas supplies for a fee. SMGC had the title to the gas as it was transported to the point of delivery, and in turn, sold the gas to the transportation customers at the point of delivery. SMGC had not agreed to be the industrial customers' agent, but was the seller of the gas supplies to willing buyers. There is no mention of an "agency" relationship in any of the contracts between SMGC and these transportation customers. (Tr. 172, 176)

Staff cites the following definition of an agent: "An agent is a business representative who handles contractual arrangements between the principal and third persons." (Staff Br. at 11) Staff's definition does not apply to SMGC and its transportation customers since SMGC was not a business representative for the industrial customers making contractual arrangements between the industrial customers and third persons. SMGC was acting on its own behalf when it sold gas supplies at a profit to these industrial customers at the delivery point designated in the gas supply agreements. The Gas Supply Agreements and Gas Transportation Agreements do not reference any other third person which would be the case if SMGC was acting as an agent between the industrial customers and a third person in making contractual arrangements for gas supplies.

The following statement of black letter law contained in 2A C.J.S Agency §§10, pp. 565-66 clarifies the difference between an "agent" and a "buyer-seller" relationship:

> Whether the relation is one of agency or of buyer and seller depends on the intention of the parties. One who buys goods on behalf of another or to whom goods are delivered to sell for the benefit of another is an agent, ***but one who purchases on his own behalf to sell to another is not.***
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> * * *
>
> Where a person purchases goods for and on behalf of another and not for himself, the relationship between the parties is one of agency rather than that of

> buyer and seller, as where one buys and ships to another, for a commission, goods ordered by the other, and if goods are delivered to another to sell for the party delivering them, the relation is one of agency; ***but if one is to purchase goods on his own behalf, and to sell them to another, the contract is one of sale, and not agency, although so designated by the parties.*** *(emphasis added)(citations omitted).*

SMGC purchased the gas on its own behalf, and then SMGC marked-up the cost of the gas supplies, and made a $40,000 profit on the sales. As SMGC has already mentioned, this profit was used to benefit SMGC's other ratepayers. (SMGC Initial Br. at 12, 32) Simply put, SMGC is not the "agent" for the industrials. SMGC was the seller, and the industrials were the buyers of the gas supplies. As a result, the nominations provisions of Sheet No. 15 are inapplicable to these contractual arrangements at issue in this case since SMGC never acted as an agent for the industrial customers in the nomination process.

Tariff Sheet No. 15 does not prohibit SMGC from selling gas to a transportation customer, pursuant to a Gas Supply Agreement. As Mr. Klemm testified, there is no SMGC tariff provision that prohibits SMGC from selling gas to a transportation customer. (Tr. 139) The Commission should therefore reject the suggestion of Staff and Public Counsel that Tariff Sheet No. 15 would in restrict SMGC from entering into the Gas Supply Agreements with its transportation customers.

Public Counsel also argued in its Initial Brief that, when SMGC's Tariff Sheet Nos. 15-16 states that "Title to the gas shall remain vested in the transporter at all times during transportation," it is inconsistent with the contractual arrangements between SMGC and its transportation customers. This contention is incorrect. Under SMGC's Gas Supply Agreements, title to the gas supplies is vested in SMGC until it is sold to the industrials at the delivery point at the **_____**. (Ex No. 15HC, Schedule 2-1, 2-8, 2-15, 2-22) At this delivery point, the title to the gas is vested in the industrial customer, and the

customer becomes the "transporter" and the title to the gas remains "vested in the transporter at all times during transportation" on SMGC's system. Under traditional, third-party marketer arrangements, SMGC would not be involved in the process until the gas reached its interconnection point with the SMGC system. However, when SMGC provides the gas supplies to the transportation customer, then SMGC controls the gas supplies and transports it on the interstate pipeline until it reaches the point of sale, the point of delivery where it is sold to the industrial customer. At this point, the industrial customer becomes a "transporter" which "shall be deemed to be in control and possession of the gas transported at the point of delivery and thereafter." (SMGC Tariff Sheet No. 16, Ex No. 14, Schedule 1-30). There is no inconsistency between SMGC's tariffs and the contractual arrangements in this case. Public Counsel's attempt to find an "inconsistency" with SMGC's tariff should therefore be rejected.

III. STAFF'S CONTENTION THAT SMGC MAY NOT PARTICIPATE IN UNREGULATED ACTIVITIES UNLESS THE UNREGULATED ACTIVITIES ARE KEPT SEPARATE AND APART FROM THE OTHER REGULATED OPERATIONS OF SMGC IS INCORRECT.

Citing Section 393.140(12), RSMo Supp. 2002, Staff made the unabashed allegation that "if SMGC wants to own and operate an unregulated business, then it must be kept separate and apart from the other regulated operations of SMGC." (Staff Br. at 16) This is simply incorrect and untrue.

Section 393.140(12) specifically **precludes** regulation of a utility's unregulated operations by the Commission if they are "substantially kept separate and apart from the business of the utility." ***State ex rel. Atmos Energy Corporation v. Public Service Commission,*** Case No. SC84344 (Slip Opinion April 22, 2003). However, Section 393.140(12) does not **require** a utility to keep its unregulated activities separate and apart from the other regulated operations, as Staff asserts.

The Missouri Supreme Court recently interpreted Section 393.140(12) in its decision involving the Commission's affiliated transactions rules in the ***Atmos*** slip opinion at 8 of 9:

> Section 393.140(12) precludes regulation of a utility's affiliate where the affiliate is "substantially kept separate and apart" from the business of the utility. However, that section also sates that the PSC shall have the "right to inquire as to, and prescribe the apportionment of, capitalization, debts and expenses fairly and justly to be awarded to or borne by the ownership, operation, management or control of such gas plant". . . Thus, where the affiliate is not one substantially kept separate" from the utility, the PSC is authorized to "inquire" into certain aspects of requiring affiliate's operations as they relate to the capitalization, debts, expenses, etc., of the utility. (*emphasis added*)(*citations omitted*).

Clearly, the Missouri Supreme Court recognizes that there are times where unregulated activities are not "substantially kept separate and apart" from the regulated business of the utility.

Similarly, Staff erroneously asserted that "SMGC specifically violated the Commission Affiliate Transaction Rules" since "SMGC is not maintaining its books of accounts and records completely separate and apart from the activities related to third party marketing affiliate." (Staff Br. at 17). Apparently, Staff is operating under the incorrect assumption that the Affiliated Transactions Rule contains a requirement that a public utility create unregulated affiliates if the public utility intends to participate in unregulated activities. This is not the case, and Staff cites no provision of the Affiliated Transaction Rule that contains such a requirement.

The Commission's Affiliated Transactions Rules "set forth financial standards, evidentiary standards and record keeping requirements applicable to any Missouri Public Service Commission (commission) regulated gas corporations whenever such corporation participates in transactions with any affiliated entity . . ." [or any gas marketing affiliate]. *See* Purpose Sections of 4 CSR 240-40.015 and 4 CSR 240-40.016. **However, the Affiliate Transaction Rules do not apply if the gas corporation does not transact business with an affiliate.** As Staff recognizes in its Brief (at 16), SMGC does not have a gas marketing affiliate (Ex No. 26;

Tr. 245-46), and as a result, there were no transactions between SMGC and a gas marketing affiliate. There is no requirement in the Affiliated Transactions Rule that requires that SMGC create an unregulated gas marketing affiliate to make unregulated sales of gas supplies to transportation customers.

Staff also cited Mr. Russo's testimony where he suggested that SMGC was not complying with the following provision of 4 CSR 240-40.015(4)(A): "A regulated gas corporation shall maintain books, accounts and records separate from those of its affiliates." (Staff Br. at 17). Contrary to Mr. Russo's suggestion, SMGC does maintain separate books, accounts and records separate from those of its only affiliates—DTE Enterprises, Inc., Citizens Gas Fuel Company and Tartan Management Company of Missouri, L.C. (Ex No. 26). However, since SMGC does not have a gas marketing affiliate, this provision is inapplicable to gas sales to transportation customers made by SMGC itself. Again, 4 CSR 240-40.015(4)(A) does not prohibit a regulated utility from participating in unregulated activities such as the sales of gas supplies to transportation customers.

Typically, when a regulated public utility participates in unregulated activities, the regulated public utility will account for the revenues and expenses associated with the unregulated activity "below-the-line" so that the ratepayers are not affected by the activity. In SMGC's case, however, the revenues from the gas sales to the industrial were not taken "below-the-line" because SMGC wanted to provide the profit (i.e. revenues minus costs= profit) from these gas sales to its regulated ratepayers. In other words, the revenues and the costs associated with the gas sales were kept "above-the-line" so that SMGC's other ratepayers would receive the benefit of the profits from the gas sales. Staff is being myopic when it criticizes SMGC personnel for using the "phone, office space, personnel, etc." to provide the gas supplies to the

industrial customers, suggesting that "SMGC's residential and other industrial customers are paying for non-regulated activities related to these two industrial customers via paying SMGC's rates." (Staff Br. at 17). Staff fails to recognize that while those minimal resources were used to make the gas sales to these industrial customers, it is equally true that all of the revenues associated with these contracts were accounted for in a manner that directly benefited SMGC's ratepayers. This is not a case where a regulated utility leaves the costs to be paid for by the ratepayers, but moves the revenues from the transaction below-the-line to benefit the regulated utility's shareholders.

Certainly, in the past, there have been numerous examples of public utilities in Missouri engaging in various forms of unregulated activities, including real estate transactions, off-system sales of gas, gas appliance sales, and other heating, ventilation and air-conditioning (HVAC) activities, without creating separate affiliates. *See e.g.*, ***Re Missouri Cities Water Company,*** Case No. SM-87-8, 29 Mo.P.S.C. (N.S.) 178 (July 28, 1987); ***Re Laclede Gas Company,*** Case No. GR-83-233, 26 Mo.P.S.C.(N.S.) 411 (Dec. 15, 1983); ***Re Laclede Gas Company***, Case No. GR-96-181, 8 Mo. P.S.C.3d 120, 194 P.U.R.4th 284 (1999); ***Re Associated Natural Gas Co.***, 26 Mo. P.S.C. (N.S.) 237 (1983).

For the reasons stated herein, the Commission should reject Staff's position that SMGC violated Section 393.140(12) or the Affiliated Transaction Rule since SMGC has not kept the activities associated with the gas sales to the industrial customers separate and apart from its other regulated activities.

IV. STAFF'S AND PUBLIC COUNSEL'S CONTENTION THAT SMGC CREATED A NEW CLASS OF CUSTOMERS IS MISPLACED.

SMGC has already addressed at length in its Initial Brief the allegation that that SMGC created a new class of customers, "Internal Transport Customers" in violation of its tariffs. (Staff

Position Statement, p. 1). It is therefore unnecessary to reiterate those points herein. As explained in SMGC's Initial Brief, these customers qualified for transportation service under SMGC's tariffs, and theses customers were taking transportation service, pursuant to the terms of the Gas Transportation Agreements.

Based upon the competent and substantial evidence on the whole record, there can be little question that the industrial customers received transportation service under the Company's transportation tariff, and should therefore be classified as "transportation customers." Merely because the company, rather than a third-party marketer, provided the gas supplies, does not transform these transportation customers into a "new class of customers." The argument of Staff and Public Counsel on this point should therefore be rejected.

V. STAFF'S SUGGESTION THAT SMGC MUST REGISTER AS AN ENERGY SELLER UNDER SECTION 393.299 RSMO SHOULD BE REJECTED SINCE LOCAL DISTRIBUTION COMPANIES LIKE SMGC ARE EXEMPTED BY STATUTE FROM THIS REGISTRATION REQUIREMENT.

Staff recognizes that "SMGC is a distributor under the statute," and that as a distributor, "SMGC is not required to register as a seller under this section" [i.e. Section 393.299]. (Staff Br. at 15). Staff nevertheless argues that SMGC must register as a third party marketer under Section 393.299 RSMo Supp. 2002 when "SMGC stepped into the role as a 'seller' under Section 393.299 RSMo Supp 2002." (*Id.* at 15). For the reasons stated in SMGC's Initial Brief and elaborated upon below, the Commission should reject this assertion.

Although Staff clearly recognizes that "[i]t is possible that the transportation customer and the third party marketer roles could be combined into one, that is the customer itself performing both roles" (Staff Br. at 7), Staff fails to recognize that SMGC, as a local distribution company, may also lawfully provide energy services similar to those provided by a gas marketer.

As SMGC explained in its Initial Brief (at 24-25), Section 393.299 specifically exempts a "distributor" (defined as a "gas corporation") from the requirement to be certified by the Commission as a "seller", pursuant to Section 393.299. Since SMGC is a "gas corporation" and a "distributor" under 393.298(3), it is not necessary to be certified as a "seller" under Section 393.299(1), even though it may provide energy services similar to a third-party gas marketer. In summary, Staff is simply incorrect that SMGC must register as an "energy seller" under Section 393.299 since the statute specifically exempts distributors from the requirement to do so.

VI. THE PROPOSED ADJUSTMENT OF STAFF AND PUBLIC COUNSEL SHOULD BE REJECTED SINCE THESE PARTIES HAVE NOT ALLEGED THAT THE COMPANY ACTED IMPRUDENTLY IN THIS ACA PERIOD, AND AS A CONSEQUENCE, DOES NOT SATISFY THE FIRST PREREQUISITE FOR AN ACA ADJUSTMENT.

As explained in SMGC's Initial Brief at 30, Staff witness Annell Bailey agreed that the purpose of the ACA audit process is to determine if the company acted prudently in incurring the costs that it is seeking to recover. And, in this case, Staff found no evidence of imprudence on the part of SMGC:

[Commissioner Murray]: Q. Okay. And is it your understanding that the audit is designed to or should be looking at whether the company acted prudently in incurring the costs that it's seeking to recover?

[Ms. Bailey]: That is one of our major goals, yes.

[Commissioner Murray]: Do you think that the company acted imprudently?

[Ms. Bailey]: No. (Tr. 200)

In its Initial Brief, Staff discussed the legal precedent, ***Re Western Resources***, 3 Mo.P.S.C. 488-89 (1995) and ***State ex rel. Associated Natural Gas Company v. Public Service Commission***, 954 520, 528-29 (Mo.App. W.D. 1997), that clearly holds that in an ACA case "the proponent of a gas cost adjustment must raise a serious doubt with the Commission as to the prudence of the decision (or failure to make a decision) that caused what the proponent views as excessive gas costs." (Staff Br. at 4) Having discussed this legal requirement for an ACA adjustment, Staff apparently recognizes an inconsistency in its position, and therefore attempts to explain what Ms. Bailey meant to say: "Ms. Bailey meant that the Company may not have acted imprudently *from a business standpoint.*" (Staff Br. at 4)(emphasis added). However, this clarification by counsel does not change the fact that the Staff presented no evidence in this proceeding that SMGC acted imprudently from a business standpoint or any other standpoint.

While Staff agrees that SMGC did not act imprudently from a business standpoint, Staff attempts to elevate its allegations of a "tariff violation" to the level necessary to support a prudence disallowance in an ACA case when Staff asserts: "Staff believes that illegal actions are imprudent." (Staff Br. at 5) Staff should not be permitted to equate its allegation related to SMGC's tariffs with the competent and substantial evidence of imprudence required by the Commission and the courts to support an ACA adjustment. Even if the Commission found a technical inconsistency between some provision of SMGC's tariffs and its contractual arrangements in this case, that finding is not the equivalent of finding "imprudence" on behalf of SMGC personnel. Since there is agreement that SMGC did not act imprudently "from a business standpoint" during this ACA period, the first essential prerequisite for making an ACA adjustment has not been met. Therefore, the Commission should reject Staff and Public Counsel's proposed adjustment in this ACA case.

VII. THE PROPOSED ADJUSTMENT OF STAFF AND PUBLIC COUNSEL SHOULD BE REJECTED BECAUSE THESE PARTIES HAVE FAILED TO SHOW THAT RATEPAYERS WERE FINANCIALLY HARMED BY SMGC'S EFFORTS TO KEEP ITS INDUSTRIAL CUSTOMERS ON THE SMGC NATURAL GAS SYSTEM, AND AS A CONSEQUENCE, DOES NOT SATISFY THE SECOND PREREQUISITE FOR AN ACA ADJUSTMENT.

As explained in SMGC's Initial Brief (at 31-33), the Staff and Public Counsel have failed to meet the second prerequisite for making an ACA adjustment. These parties have not produced competent and substantial evidence to show that ratepayers were harmed financially by the actions of SMGC during this ACA period. Quite to the contrary, the competent and substantial evidence shows that, if the Company had not acted to keep the industrial customers on its natural gas system, the Company's remaining ratepayers would have been financially harmed. (Ex No. 3, p. 10; Ex No. 6, pp. 11-12; Tr. 192).

Recognizing that SMGC's other ratepayers received the benefit of SMGC's actions to keep the industrial customers on the natural gas system, Public Counsel nevertheless states that: "This alleged 'defense' misses the point." (Public Counsel Br. at 12) According Public Counsel, "Staff adjustment is aimed at restoring the ACA balance and the Company's other customers to where they would have been if no tariff violation had occurred, ***other facts remaining the same.***" (Public Counsel Br. at 12)(emphasis added).

Staff witness Annell Bailey also testified that Staff's adjustment is based upon the premise that the proposed adjustment would ". . . restore the customers and the ACA balance to where they would have been if this violation had not taken place and ***if the gas had been sold.***"(emphasis added)(Tr. 202).

However, Public Counsel and Staff fail to acknowledge in their respective briefs that, if SMGC not entered into the gas supply agreements with the industrial customers, then the ***other***

facts would not have remained the same, and the gas would not have been sold, as assumed by Public Counsel and Staff. The critical fact that would have changed if SMGC had not entered into the gas supply agreements with the industrial customers, is the industrial customers would have left SMGC's natural gas system, or substantially reduced their throughput. Staff and Public Counsel may not support their proposed adjustment by merely assuming that all other facts would have remained the same, or that the same level of natural gas would have been sold at substantially higher rates.

The position of Staff and Public Counsel is clearly is based upon the unsupported assumption that, absent the measures taken by the Company to retain two industrial customers on the system, there would have been an increase of revenues of $105,809 [subsequently modified by Staff to $99,199], "if the gas had been sold at the authorized PGA-adjusted rate." (Staff Recommendation, App. A, page 6 of 8). However, Staff and Public Counsel have not produced competent and substantial evidence that shows that these customers would have purchased the same volume of gas at a substantially higher tariffed rate for large volume service, or that these customers would have stayed on the SMGC system at all.

Since Staff and Public Counsel have not produced competent and substantial evidence to support its assumption that the industrial customers would have purchased gas in the same volumes at the tariff-authorized rate if SMGC had not entered into the Gas Supply Agreements, these parties have failed meet their burden to show that ratepayers were harmed financially by the Company's actions in this case. As a result, the second essential element necessary to support an ACA adjustment has not been established, and the Commission should therefore reject the proposed adjustment. ***State ex rel. Associated Natural Gas Company v. PSC,*** 954 S.W.2d 520 (Mo.App. 1997).

CONCLUSION

In conclusion, the Commission should not adopt the proposed ACA adjustment of Staff and Public Counsel in this case since neither of the two-pronged tests required for such ACA adjustments has been met. In the instant proceeding, no party has challenged the prudence of SMGC's gas purchases or other activities during the ACA period, and no party has demonstrated with competent and substantial evidence that SMGC's ratepayers were financially harmed by SMGC's decisions. Since the Staff and Public Counsel have failed to meet the requirements of Missouri law for supporting an ACA adjustment, the Commission should reject the proposed adjustment. In addition, it would be unfair to adopt the proposed adjustment since the unrefuted evidence demonstrates that SMGC's provisioning of transportation service and gas supplies to these large customers benefited the Company's ratepayers, even if the Commission finds some "inconsistency" or "tariff violation" related to SMGC's gas supply agreements and transportation service agreements with the industrials in this procceeding.

However, in an effort to move constructively beyond this issue for the future, SMGC is filing a tariff for approval by the Commission which would give the Company specific authority to enter into special contracts to keep fuel-switching industrial customers on its natural gas system. SMGC hopes that the Commission will approve this tariff provision expeditiously to clarify, if necessary, SMGC's authority to enter into contracts with its transportation customers that will result in "win-win" solutions to difficult market problems.

Respectfully submitted,

/s/ James M. Fischer
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ATTORNEYS FOR
SOUTHERN MISSOURI GAS COMPANY, L.P.

CERTIFICATE OF SERVICE

I do hereby certify that a true and correct copy of the foregoing document has been hand-delivered, emailed or mailed, First Class, postage prepaid, this 6th day of May, 2003, to:

Doug Micheel
Office of the Public Counsel
P.O. Box 360
Jefferson City, MO 65102

Robert Franson
Missouri Public Service Commission
P.O. Box 360
Jefferson City, MO 65102

/s/ James M. Fischer

James M. Fischer

FORM NO. 13 P.S.C. No. 1 (original) Sheet No. 4
1st (revised)
Cancelling P.S.C. MO No. 1 (original) Sheet No. 4
(~~revised~~)
All Communities and Rural Areas

Southern Missouri Gas Company, L.P. For Receiving Natural Gas Service
Name of IssuingCorporation Community, Town or City

SPECIAL CONTRACT SERVICE (SCS)
(Experimental Tariff)

Availability

Service under this rate schedule is available to any customer whose average monthly natural gas requirements in a twelve-month period exceed 2,000 MMBtu at a single address or location and who have entered into a written contract on such terms and conditions as agreed upon by the parties and which, in Southern Missouri Gas Company's sole discretion, are deemed necessary to retain an alternate fuel customer, to reestablish service to a previous customer, to acquire a new customer, or to be competitive with alternate suppliers of natural gas.

Special Contract Service Rates

The Company will charge the customer qualifying for this schedule the Large Volume Service rates pursuant to the following:

- The rates agreed upon by the Company and the customer shall be on a Ccf basis and shall: (a) not exceed the maximum commodity charges nor be less than the minimum charges, and (b) not exceed the total PGA rate as shown on Sheet No. 27 nor be less than the sum of the actual cost of the gas secured by the Company to fulfill such special contract, the actual variable transportation costs incurred, plus a reasonable contribution to its fixed transportation costs.
- The monthly customer charge shall be the same as the Large Volume Service.
- The Customer shall supply supporting documents to the Company certifying that the cost of available alternative energy supply is less than the Large Volume Service rates.

DATE OF ISSUE May 6, 2003 (month day year) DATE EFFECTIVE June 5, 2003 (month day year)

ISSUE BY Scott Klemm (name of officer) Vice President (title) 301 East 17th Street Mountain Grove, Mo 65711 (address)

Attachment No. 1

All such contracts shall be furnished to the Commission Staff and the Office of Public Counsel and will be reviewed in any subsequent rate case or PGA/ACA proceeding to determine whether the contract meets the above standards. For ratemaking purposes, the Company shall have the burden to prove that their negotiated rate was prudent.

Billing of License, Occupation, or Other Similar Charges or Taxes

See Sheet No. 19.

Late Payment Charge

Unless otherwise required by law or other regulation, 1.5% will be added to the outstanding balance of all bills not paid by the delinquent date stated on the bill.

Experimental Tariffs

These tariffs shall expire on October 31, 2004 unless extended by an Order of the Commission.