Exhibit No.:	
Issue:	*Price Stabilization Program*
Witness:	*David M. Sommerer*
Sponsoring Party:	*MoPSC Staff*
Type of Exhibit:	*Surrebuttal Testimony*
Case No.:	*GR-2001-387*
Date Testimony Prepared:	*January 10, 2003*

MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

SURREBUTTAL TESTIMONY

OF

DAVID M. SOMMERER

LACLEDE GAS COMPANY

CASE NO. GR-2001-387

Jefferson City, Missouri
January 2003

****Denotes Highly Confidential Information****

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BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of Laclede Gas Company's Purchased	)	
Gas Adjustment Tariff Revisions To Be Reviewed	)	Case No. GR-2001-387
In Its 2000-2001 Actual Cost Adjustment	)	

AFFIDAVIT OF DAVID M. SOMMERER

STATE OF MISSOURI	)	
	)	ss.
COUNTY OF COLE	)	

David M. Sommerer, being of lawful age, on his oath states: that he has participated in the preparation of the following Surrebuttal Testimony in question and answer form, consisting of 15 pages to be presented in the above case; that the answers in the following Surrebuttal Testimony were given by him; that he has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of his knowledge and belief.

David M. Sommerer

David M. Sommerer

Subscribed and sworn to before me this 9th day of January 2003.

Toni Charlton

TONI M. CHARLTON NOTARY SEAL NOTARY PUBLIC STATE OF MISSOURI

TONI M. CHARLTON
NOTARY PUBLIC STATE OF MISSOURI
COUNTY OF COLE
My Commission Expires December 28, 2004

SURREBUTAL TESTIMONY

OF

DAVID M. SOMMERER

LACLEDE GAS COMPANY

CASE NO. GR-2001-387

Q. Please state your name and business address.

A. David M. Sommerer, P.O. Box 360, Jefferson City, Mo. 65102.

Q. Are you the same David M. Sommerer that filed direct testimony in this case?

A. Yes.

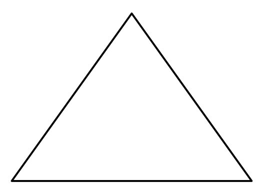
Q. What is the purpose of your surrebuttal testimony?

A. The purpose of my testimony is to address the rebuttal testimony of Laclede Gas Company (Laclede or Company) witnesses Steven F. Mathews and Michael T. Cline.

Q. On page 1 of Mr. Mathews' rebuttal testimony, he refers to the Price Stabilization Program (PSP) Tariff and Program Description that were in effect at the time these transactions took place. Do you agree with Mr. Mathews' statement on page 1, line 20, through page 2, line 2, that Staff "…either ignores the clear and unambiguous meaning of these approved provisions or attempts to define them out of existence by suggesting an entirely new method for determining what constitutes "savings" under the Overall Cost reduction Incentive Component of the PSP."?

A. No. The Staff believes that a fundamental "triad" was altered after the Company declared the Price Protection Incentive Component inoperable on June 2, 2000. The triad reflected three fundamental price protection features that helped define the meaning of the term "net cost of price stabilization." Those three elements were: (1) a specific price level guarantee, (2) a provision to cover a certain level of volumes, and (3) a specified funding level to obtain the level of protection and price guarantee from the first parts of the triad. The first element of the triad, the specific price level guarantee, was lost when the Company opted out of the Price Protection Incentive on June 2, 2000. The provision to cover a certain level of volumes, the second element of the triad, was rendered inactive with the September 2000 Stipulation And Agreement. The only element left of the three fundamental price protection features was the $4 million authorized funding level. The concept of the three related elements is illustrated below:

(1) Guaranteed Price Cap (lost June 2, 2000)



(3) Funding Level

(2) Volumes Protected (no requirement after September 2000)

Q. How does the breaking of the above triad create problems with the Company's definition of "net cost of price stabilization?"

A. As previously discussed in Staff's direct testimony, call options are similar to insurance. By paying a premium a company can obtain a certain level of coverage. There is typically a deductible which can lower the price of the insurance but increase the exposure to the insurable loss. In the case of natural gas call options, the insurable loss was the possibility of high natural gas prices, the deductible was the level of strike price (price cap) obtained and the premiums represented the funding level the customers provided so that a certain level of coverage could be obtained. In year 1 of the program (1999-2000) there was a specific level of coverage required (generally ** HC ____________________________ **). There was a specific price cap level determined based upon price protection available at the $4 million funding level. In year 2 of the program (the winter of 2000-2001) two of the critical constraints were removed, two fundamental elements of the price protection triad, resulting in ambiguity over the meaning of the terms "savings" and "net cost of price stabilization."

Q. Do you have a comment with regard to Mr. Mathews' rebuttal testimony on page 2 where he discusses the financial gains flowed through to the Company's customers?

A. Yes. When the various numbers Mr. Mathews cites are summarized in a table, the level of actual flowed through "gains" are far less than the gross proceeds. See the following table:

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HC		

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Q. Do you believe the Staff's criticisms are both unfair and inappropriate as discussed in Mr. Mathews' rebuttal testimony page 3, lines 7 through 9?

A. No. The Company's claims of savings rest upon a faulty concept that any proceeds that exceed costs should constitute savings. This ignores the fundamental problem that occurred when the benchmark of having price protection at a certain funding level was made inactive for year 2 of the program. It also does not address something that is at the root of an effective hedge. Increases in gas costs of the physical commodity side of the business must be offset by corresponding financial gains on the financial hedge side of the gas procurement function. This is illustrated by the large arrows below:

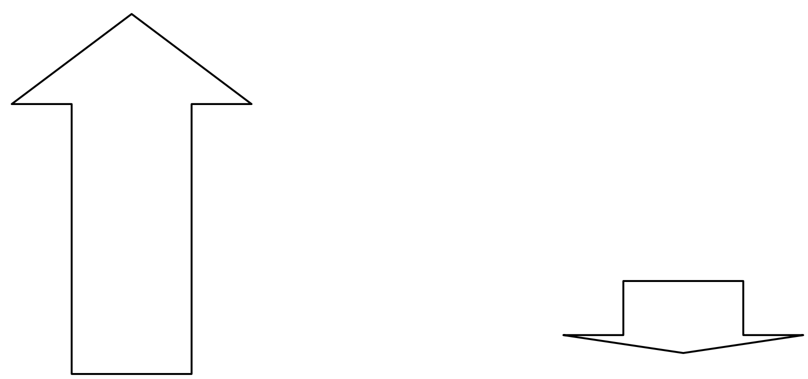
Effective Hedge

Large price increases gas invoices   Offset by Option Gains

The Staff believes Laclede's concept of "savings" and price stabilization has focused on some fraction of the second arrow. That concept (considering a savings to be anytime a proceed from an option sale exceeds the cost of the option) is illogical and ignores the insurable loss occurring from increased gas costs illustrated by the first arrow. The relationship between high gas costs and option gains cannot be over-emphasized. If Laclede would not have experienced massive cost increases from the increase in gas market prices, there would have been no option proceeds. The option proceeds that the Company repeatedly points to were NOT isolated results from a profitable trading operation but were, in fact, only possible because natural gas prices were extremely high.

Q. Can the relationship between increasing gas costs and offsets from option gains be illustrated for Laclede's system for the winter of 2000-2001?

A. In a general way, yes. Schedule 1 attached shows a 10-year history of natural gas expense and sales volumes (Source, Laclede's 2002 Annual Report to Stockholders). It is clear that gas cost more than doubled from historical levels to the fiscal year ended September 2001. If it is conservatively assumed that $150 million represents the increase of gas expense because of winter gas price increases, the following relationship can be shown:



$150 million increased gas costs ** HC ____________________ **

Q. Is the Staff's proposed adjustment a "disallowance of gas costs?"

A. No. The Staff's position is that the $4.9 million that Laclede seeks to keep is the result of an inappropriate analysis of savings. The Staff has not proposed to disallow $1 of actual gas costs in this case. In reality, Laclede is suggesting that the actual gas costs of customers should be increased over and above the invoiced amounts so that Laclede can declare the $4.9 million as income.

Q. What is the significance of Staff's recommendation that the revised program description and tariff sheets were in compliance with the Commission's June 15, 1999 Order as discussed on page 4, lines 17 through page 5, line 8, of Mr. Mathews' rebuttal testimony?

A. A compliance filing contains little room for discretion for either the filing party or the reviewing party. If the majority of the Commission has approved the Company's proposal, as it did in 1999, the Staff is limited to ensuring that the tariffs accurately reflect the Commission's Order. As a matter of record, the Staff and the Office of the Public Counsel were opposed to the Company's proposal in that case (*In the Matter of Laclede Gas Company's Tariff Sheets Designed to Extend for an Additional Period the Experimental Price Stabilization Fund, Case No. GO-98-484*).

Q. On pages 8 and 9 of his rebuttal testimony, Mr. Mathews criticizes the Staff's analysis (Staff's analysis is found in my direct testimony, Schedule 9). What is your response to these criticisms?

A. One of Mr. Mathews' concerns is illustrated by his statement on page 8, lines 4 though 7, of his rebuttal testimony. He states, "[it] is abundantly clear that had Laclede ***not*** engaged in any intermediate trading activity during the Actual Cost Adjustment (ACA) period, but instead simply spent the $4 million in Program funding on call options that it then held until expiration, it would have achieved millions of dollars less in savings than it actually did." Again on page 8 of his rebuttal, Mr. Mathews goes on to say on lines 19 through 23 that "[i]ndeed, rather than attempt to replicate the results that would have been achieved had the Company stopped all trading activity once it had spent the $4 million authorized under the Program, the Staff's analysis simply assumes that the Company had nearly $9 million to spend on call options."

In these instances Mr. Mathews criticizes the Staff for not developing an analysis that he himself fails to provide. Mr. Mathews has not provided a calculation to show gains resulting from simply investing the initial $4 million ratepayer provided funds and calculating the gain from holding the options. In fact, Mr. Mathews' rebuttal testimony, Schedule 2 is merely a replication of Staff's direct testimony Schedule 9 with the cost of call options highlighted. The only thing that this additional highlighting provides is an emphasis that the Company spent more than the initial $4 million funding levels.

Q. Have you provided a calculation similar to what the Company has suggested?

A. Yes. The calculation is contained in a series of schedules attached to this testimony. Schedule 2 provides a summary of the call option activity related to the 2000-2001 ACA period. It is sorted by date of purchase. The purpose of this schedule is to track the experience of the Company if it would have only spent the initial $4 million and held the positions until maturity (** HC ____ **). From this master schedule, the Staff developed Schedule 3 which provides an inventory of the call option activity as it actually occurred. Schedule 4 provides the inventory of the various contract months based upon a tracking of the $4 million of initial funding expenditure. Therefore, Schedule 4 represents the portfolio of options that would have been held assuming the interplay between Laclede's reinvestment of previously held option positions and expenditures for new option purchases using the initial $4 million funding level.

Q. What do you mean by "the interplay between Laclede's reinvestment of previously held option positions and expenditures for new option purchases?"

A. In attempting to recreate the options that would have been obtained with only the expenditure of the initial $4 million, a decision must be made regarding how to allocate the dollars spent to acquire additional options subsequent to an option sale. At the time of an additional option purchase, Laclede would have a choice between reinstating the original option position or procuring additional options with the program funds. The Staff's calculation first reinstates a previously reduced option position for any option purchase that was preceded by a sales event that reduced the initial option position. Any additional purchase beyond the level necessary to reinstate the initial option position is assigned as an expenditure specifically related to the $4 million program funding. Therefore, reinstatements of prior option positions are funded by interim proceeds from early option sales, while primary option purchases are acquired by the initial $4 million funding level. This analysis shows that Laclede would have spent its initial $4 million funding level by October 30, 2000.

Q. Could you provide an example of this process?

A. Yes. Transactions related to the November 2000 call options will be illustrated. Starting with the date purchased from Schedule 2, the first significant purchase of November call options will be traced through to show how an expenditure can be related to a reinstatement of an original option position or related to an additional purchase of options.

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Q. Why would Laclede make an early sale such as the one just described?

A. Laclede could view the that gas prices are headed down on a permanent basis and thus want to cash in on the options value before the option's value decreases to zero. In that case, Laclede would not reinstate its original position. Alternatively, Laclede could have the view that gas prices are temporarily going down but eventually are headed back up. Under that market view, Laclede would be seeking to sell the option while it has value, wait until gas prices dip, re-establish its position when gas prices are lower (and therefore the cost of options are lower), and finally sell the option when gas prices once again rise. It must be recognized that selling out of the initial option position exposes the customer to unprotected increases in the price of gas. If Laclede is wrong, based on its market view, the customers would either have no protection (assuming Laclede did not re-establish the original protection) or the customers would have less protection (assuming Laclede reinstated a position at a higher strike price than the original options). In addition, early or intermediate trading is not always favorable, as Laclede's calculation implies. Early trades can result in massive exposure. This was well evident for January 2001.

Q. Please continue with your November 2000 call option example.

A. ** HC

HC

HC

HC

HC ** The funds used for this purpose are assumed to be funds derived from the prior early sale of options, NOT

NP

FROM THE INITIAL MRA. The last column in Schedule 2 tracks the expenditure of initial MRA funds. It can be seen from this column that certain option purchases by Laclede, reinstatements, do not result in a reduction of the original $4 million MRA fund. ** HC

HC

HC

HC **

This process results in the development of Staff's Schedule 4, which shows the positions established for each contract month until the initial MRA fund of $4 million is exhausted. ** HC

HC **

Q. Please continue with your discussion.

A. In summary, the resulting allocation of funds between option reinstatements and options purchased with initial funding levels results in a specific assignment of costs to each contract in the inventory of options procured with the $4 million initial funds. Once the costs are assigned, proceeds can be calculated assuming that the options would have been held to maturity which is done on Schedule 2.

Q. Please provide further explanation about Schedule 2.

A. Schedule 2 takes the MRA costs that were allocated in Schedule 4 and associates those initial MRA costs (the last column in Schedule 2) with the options that were acquired with MRA funds. Then a calculation is made (the next to last column in Schedule 2) that derives the proceeds associated with holding those initial MRA options until maturity.

The total proceeds from holding the initial MRA options to maturity are $33,134,960. When netted against the cost of those initial MRA options ($4 million), a net proceed of $29,134,960 results.

Q. What is the next step in this process?

A. An overall assessment is made by comparing Laclede's early trading approach with Staff's evaluation of the ultimate outcome if the options purchased with the MRA funds would have been held until maturity.

Q. What was the overall result of this analysis?

A. The results are summarized on Schedule 5. A comparison is made between the net proceeds (gross proceeds minus option costs) that were achieved by all of Laclede's trading ($24,576,550) versus the net proceeds had options been procured up to the initial funding level and held to maturity ($29,134,960). The net cost of price stabilization $4,558,410 is then compared to the MRA, resulting in a net cost of $558,410. This is summarized in the following table:

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HC		

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Q. Is Staff suggesting that an additional contribution is needed from Laclede because actual costs exceed the MRA?

A. No. Although a strict reading of the tariffs require this result, the Staff has limited its recommendation to the request that the Commission order the Company to flow back the $4,873,000 that is the subject of the case to customers since no real savings were achieved.

Q. Do you agree with Mr. Mathews' conclusion on page 11 of his rebuttal testimony that "…the fact remains that those benefits far exceeded anything that would have been produced for customers in either 2000-2001 or 2001-2002, if the Company had adopted Staff's approach toward hedging?"

A. No. Mr. Mathews' assumptions are flawed. He rests his conclusions on a strike price that was not applicable to Missouri Gas Energy's (MGE's) program. He implies that MGE had no price protection at all, but it did. He ignores the fact that the Staff has recommended an approximately $8 million adjustment against MGE for this period. The suggestion that Staff only considered historical call option programs as reasonable is also invalid since the Staff supported AmerenUE's decision to hedge without a pre-authorized program the winter of 2000-2001. AmerenUE was one of the three original LDCs adopting the initial price stabilization programs back in 1997.

Q. Do you agree with Mr. Mathews' comments on page 12 of his rebuttal testimony regarding the Company's efforts for the winter of 2001-2002?

A. No. The Staff has already addressed Mr. Mathews' claim of savings through the use of call options for year 3 of the program. The results of that year will be reviewed in the 2001-2002 ACA.

Q. Do you have any comments to make regarding Mr. Mathews' discussion of actions Laclede took during the spring and summer of 2000, as discussed on page 13 through 15 of his rebuttal testimony?

A. Yes. Had the Staff and Public Counsel been unwilling to enter into the September 1, 2000 Stipulation And Agreement, it is very possible gains would not have resulted to the extent they did. Prior to that Stipulation And Agreement, the Company was still responsible for ** HC ______________________ **. One possible outcome would have been for the Company to procure very high strike prices (perhaps exceeding $10/MMBtu) in order to satisfy this condition. The relaxing of that condition allowed at least some additional protection to be procured at more reasonable strike prices.

Q. Would you explain why the Staff did not support increasing the funding level for options in the September 1, 2000 Stipulation And Agreement?

A. Yes. The Staff's belief was and continues to be that the Company's management needs to have the flexibility to act quickly in a changing market. Pre-approved programs are subject to continual amendment and do not react quickly enough to the current market environment.

Q. Please describe Schedule 6.

A. Schedule 6 simply shows that cash that was provided from the initial MRA or from early sales activity was always enough to cover option purchases. No separate funding mechanisms were necessary, except for the time value of money, for which carrying costs were allowed.

Q. Do you have comments regarding Mr. Cline's rebuttal testimony?

A. Yes. Mr. Cline's rebuttal testimony simply quantifies the Company's view of how savings should be calculated and shared. On page 2 of Mr. Cline's rebuttal testimony he states, "[t]he net cost of price stabilization is nothing more than the Company's actual cost to procure financial instruments less whatever amounts the Company received from the sale of any such instruments prior to the last three days of (NYMEX) option trading, exclusive of the gains and costs covered by the Company's Price Protection Incentive component." The meaning of the term "net cost of price stabilization" is not as clear as Mr. Cline argues. As discussed earlier in my rebuttal testimony, this term had a specific meaning when the Company was obligated to ensure a certain cap and amount of coverage. Mr. Cline's result of applying his definition results in the inescapable conclusion that any time an option sale brought in proceeds prior to the last 3 trading days, the Company would achieve "savings." This result does not lend any real meaning to the concept of price stabilization.

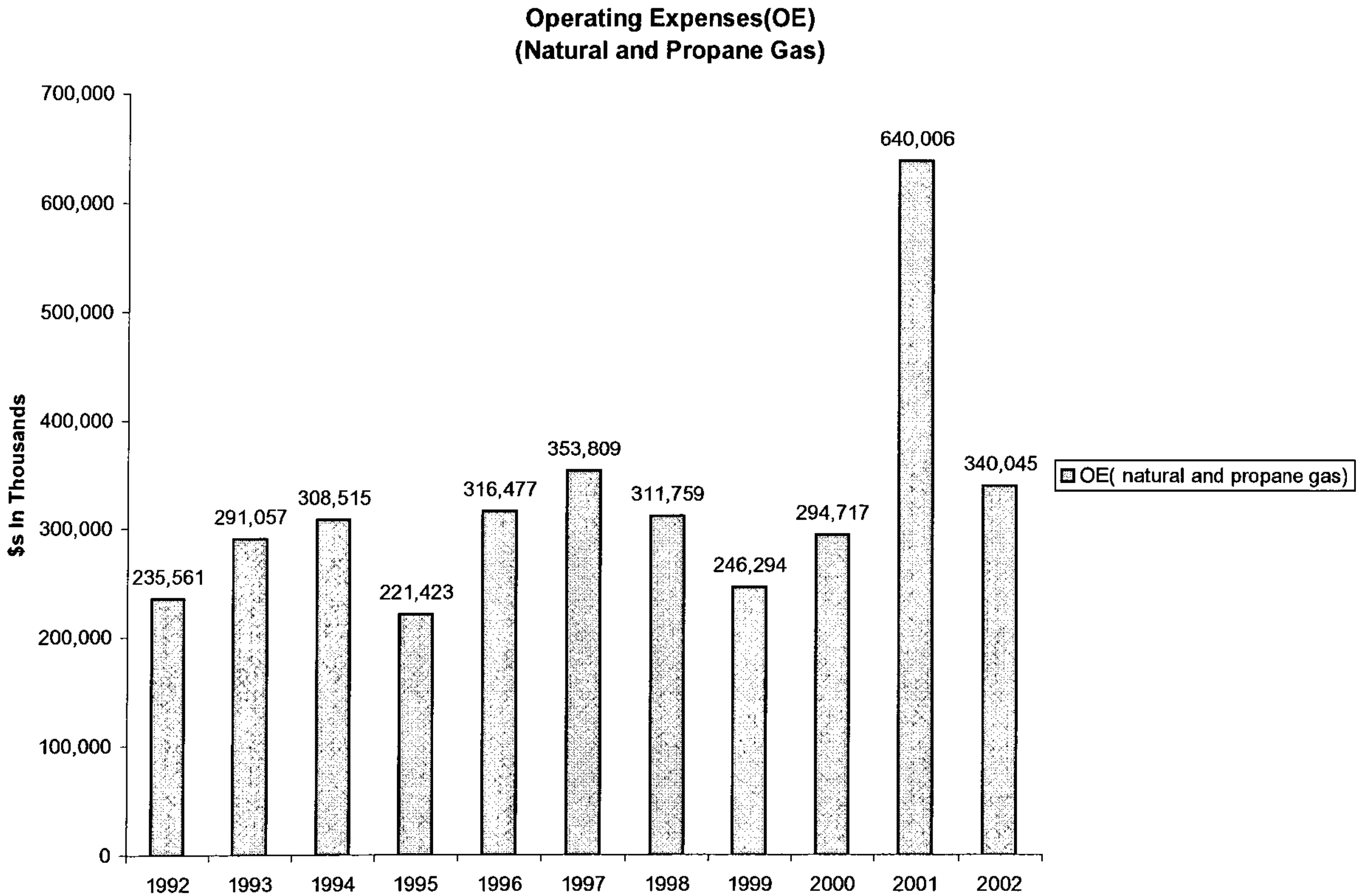
A. Do you have any corrections to make to your rebuttal testimony?

A. Yes. The statement on page 4, lines 8 through 10, of my rebuttal testimony inadvertently indicated that "Staff used the simple arithmetic means of closing prices, which represents a fair trading range to use for making a comparison as the (sic) whether true savings where achieved." In actuality the Staff used the lowest closing price for the last three trading days, a number that is lower than the average.

Q. Does this conclude your surrebuttal testimony?

A. Yes, it does.

Schedule 1-1



Operating Expenses(OE)
(Natural and Propane Gas)
$s In Thousands
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600,000
500,000
400,000
300,000
200,000
100,000
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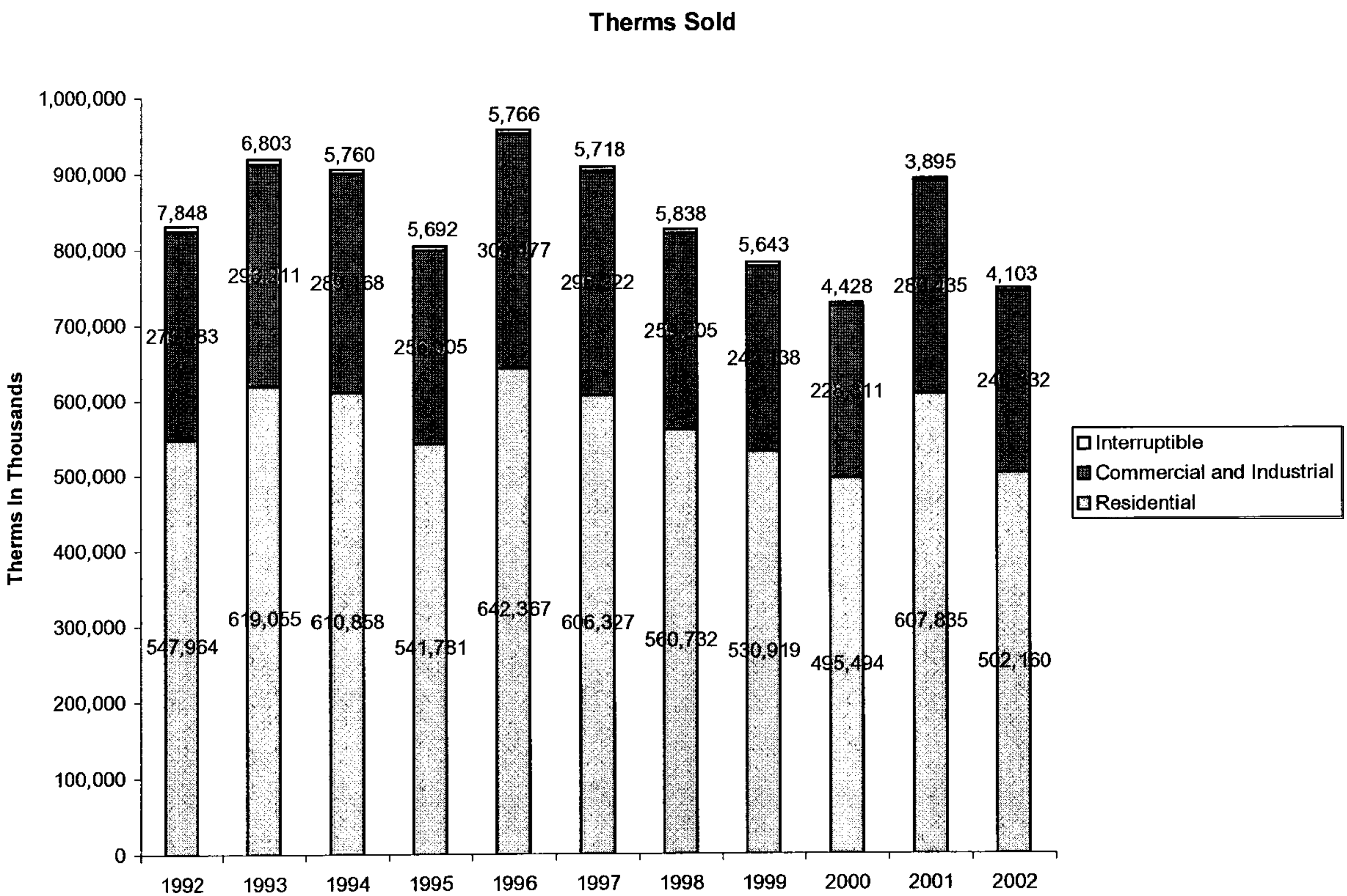
235,561
291,057
308,515
221,423
316,477
353,809
311,759
246,294
294,717
640,006
340,045
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
OE(natural and propane gas)



Therms Sold
Therms In Thousands
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800,000
700,000
600,000
500,000
400,000
300,000
200,000
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1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
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5,718
5,838
5,643
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4,103
547,964
619,055
610,858
541,781
642,367
606,327
560,732
530,919
495,494
607,835
502,160
Interruptible
Commercial and Industrial
Residential

Schedule 1-2

SCHEDULES 2 THROUGH 6

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DEEMED

HIGHLY CONFIDENTIAL