Exhibit No.:	
Issue:	*Price Stabilization Program*
Witness:	*David M. Sommerer*
Sponsoring Party:	*MoPSC Staff*
Type of Exhibit:	*Direct Testimony*
Case No.:	*GR-2001-387*
Date Testimony Prepared:	*September 27, 2002*

MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

DIRECT TESTIMONY

OF

DAVID M. SOMMERER

LACLEDE GAS COMPANY

CASE NO. GR-2001-387

Jefferson City, Missouri
September 2002

****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 Factors To Be	)
Reviewed In Its 200-2001 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 Direct Testimony in question and answer form, consisting of 13 pages to be presented in the above case; that the answers in the following Direct 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 26th day of September 2002.

Toni M 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

DIRECT 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. By whom are you employed and in what capacity?

A. I am the Manager of the Procurement Analysis Department with the Missouri Public Service Commission (Commission).

Q. How long have you been employed with the Commission?

A. Approximately 18 years.

Q. Please describe your educational background and experience.

A. In May 1983, I received a Bachelor of Science degree in Business and Administration with a major in Accounting from Southern Illinois University at Carbondale, Illinois. In May 1984, I received a Master of Accountancy degree from the same university. Also, in May 1984, I sat for and passed the Uniform Certified Public Accountants examination. Upon graduation, I accepted employment with the Commission.

Q. What has been the nature of your duties at the Commission?

A. From 1984 to 1990 I assisted with audits and examinations of the books and records of public utilities operating within the State of Missouri. In 1988 the responsibility for conducting the Actual Cost Adjustment (ACA) audits of natural gas utilities was given to the Accounting Department. I assumed responsibility for planning and implementing these audits and trained available Commission Staff (Staff) on the requirements and conduct of the audits. I participated in most of the ACA audits from early 1988 to early 1990. On November 1, 1990, I transferred to the Commission's Energy Department. Until November of 1993, my duties consisted of reviews of various tariff proposals by electric and gas utilities, Purchased Gas Adjustment reviews, and tariff reviews as part of a rate case. In November of 1993, I assumed my present duties of managing a newly created department called the Procurement Analysis Department. This Department was created to more fully address the emerging changes in the gas industry especially as they impacted the utilities' recovery of gas costs. My duties have included managing the five member staff, reviewing ACA audits and recommendations, participating in the gas integrated resource planning project, serving on the gas project team, and participating in matters relating to natural gas service in the State of Missouri.

Q. Have you previously testified before this Commission?

A. Yes. A list of cases in which I have filed testimony is included as **Schedule 1** of my testimony.

Q. What is the purpose of your testimony in this case?

A. To provide the Staff's position on how approximately $4,873,000 in undistributed proceeds should be treated under the terms of Laclede Gas Company's (Laclede's or Company's) Price Stabilization Program (PSP). This issue is the only remaining disagreement between the Company and Staff in this case. Case No. GR-2001-387 was created to address the Company's Actual Cost Adjustment (ACA) filing for the twelve months ending September 30, 2001.

Q. Could you provide a general overview of your testimony?

A. Yes. Based upon a review of 10Q documents filed with the Security and Exchange Commission (SEC) it is apparent that Laclede views these funds as income. The Staff disagrees and believes that gas costs should be reduced by the approximately $4.9 million that was being held in an account at the end of September 2001. My direct testimony in Case No GO-2000-394 provided much of the history of the PSP process in Missouri and is repeated in part in this testimony to provide sufficient context.

Q. Please provide a simplified overview on the nature of the dispute.

A. The PSP can be compared to a customer-funded insurance policy where Laclede guaranteed to indemnify the customer from catastrophic gas price increases. In exchange for this guarantee, Laclede was allowed to participate in the sharing of savings related to the program. The fact that a guarantee was made by Laclede and was done so in exchange for the hope of sharing in potential savings is readily apparent based upon a review of the Commission's Report And Order approving the PSP, dated June 15, 1999 in Case No. GO-98-484. Here the majority summarized,

> Second, Laclede proposes to incorporate an "incentive feature" into its PSP. Laclede argues that in exchange for undertaking the risks inherent in guaranteeing price protection, it should have a corresponding opportunity to benefit from it if achieves positive results." (**Schedule 2**, Case No. GO-98-484 Report And Order)

On June 1, 2000, Laclede opted out of the "guarantee part" of the PSP as it watched prices continue to escalate in the late spring of 2000. (**Schedule 3**, June 1, 2000 letter) With no "insurance policy" coverage, the customer was left exposed to price fly-ups. Laclede subsequently negotiated a Stipulation And Agreement with the Staff and Office of the Public Counsel (OPC) (**Schedule 4**) that allowed the Company to use its own discretion in obtaining levels of coverage, including zero coverage. This was to recognize that obtaining the required level of coverage (originally a significant percentage of natural gas purchases) made no sense if the deductible ** HC ** was absurdly high. Ultimately, Laclede was able to sell and resell smaller amounts of the insurance coverage, ending up with levels of coverage that were mere fractions of the original guarantees. Although the $24,000,000 of gain that resulted from the program seems significant, it pales in comparison to the $63,000,000 that would have been generated had Laclede maintained its guarantee. (**Schedule 5**)

Q. Please provide the historical context for Laclede's PSP.

A. A price stabilization fund was established in Laclede Case No. GO-97-401. The underlying concept for establishing the fund in that case was that given the high gas price volatility seen in the winter of 1996-1997, and the relatively new techniques in use at that time to reduce gas price volatility, it was appropriate to develop a fund for the procurement of financial instruments. In its July 18, 1997 Order the Commission stated:

> The agreement allows Laclede to use financial instruments in its efforts to reduce the volatility of Laclede's cost of natural gas. To assure recovery by Laclede of the direct costs incurred in connection with procurement of these financial instruments Laclede is authorized under the agreement to implement a Price Stabilization Charge. The agreement provides that the Price Stabilization Charge shall take effect August 1, 1997. The revenues generated from the Price Stabilization Charge and gains from the use of financial instruments shall be accounted for separately and credited to a Price Stabilization Fund on a monthly basis.

Q. Please continue.

A. Laclede sought modifications to its program in Case No. GO-98-484. In a May 26, 1998 Order granting modifications, the Commission stated:

> The Commission originally approved the Program in Case No. GO-97-401. The tariff approved in that case provides that the Program shall be terminated July 31, 1998 unless otherwise ordered by the Commission. In this filing Laclede seeks to extend that fund for another term and modify it in several respects. Laclede proposes to change the parameters within which it uses financial instruments in two respects. First, it proposes a new authorized price range for financial instruments. Second, it proposes a new restriction on the timing of the sale of exchange traded financial instrument. Laclede also proposes to modify the tariff

> approved in Case No. GO-97-401 in two respects to clarify procedures to be followed at the end of the term of the experiment. First, the tariff provides that the Price Stabilization Charge shall be terminated on the effective date of the 1999 summer PGA filing. Second, the tariff provides that any balance remaining in the fund at the end of the term shall be charged or returned to customers through the ACA factors established in the applicable winter PGA filing.

Q. When did the incentive aspects of the program start?

A. Still using Case No. GO-98-484, the Company argued for a considerable expansion of its price stabilization fund to start in the winter of 1999-2000. It argued for three main changes. These changes were explained in the Commission's June 15, 1999 Order in Case No. GO-98-484. In describing Laclede position the Commission stated:

> First**,** Laclede proposes to eliminate the program's existing restriction on when financial instruments may be sold and adopt an approach that gives Laclede greater flexibility to trade in and out of these instruments when market conditions warrant. This would allow Laclede to more effectively manage the volatility of the market. Laclede alleges that this will create opportunity to reduce the overall cost of acquiring price protection for Laclede and its ratepayers. Second, Laclede proposes to incorporate an "incentive feature" into its PSP. Laclede argues that in exchange for undertaking the risks inherent in guaranteeing price protection, it should have a corresponding opportunity to benefit from it if achieves positive results. Third, Laclede proposes a three-year term for the program. Laclede contends that the longer authorization period would provide the Commission with sufficient experience with the operation of the program under varying conditions and permit a fair assessment of its effectiveness, and that this would reduce the expense of the annual review which is costly to both the Commission and to Laclede.

Q. What was the Staff's position in Case No. GO-98-484?

A. The Staff argued against authorizing incentives as part of the program. It argued that a general policy of diversification of the gas supply portfolio was a better approach. It further argued that Laclede's program was speculative, its provisions were vague, and offered Laclede "outs" from any real guarantees of price protection. The Commission ultimately approved a version of Laclede's original proposal, submitted in Laclede's surrebuttal testimony. A key provision of the new plan was that it granted approval for the winters of 1999-2000, 2000-2001, and 2001-2002.

Q. Please provide a general discussion regarding the basic provisions of Laclede's PSP.

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HC ** The highly confidential program description is provided in **Schedule 6** and tariffs in **Schedule 7.**

Q. ** HC **

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Q. What are the "outs" that you mentioned earlier?

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Q. What were Laclede's profits opportunities?

A. There were two major components to the incentive part of the plan. First a price protection incentive was developed. Depending upon where price protection was achieved, realized gains would be shared between the customer and the company. ** HC
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Q. ** HC
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A. ** HC **

Q. What was the other incentive feature?

A. The other incentive provision was called the "overall cost reduction incentive." ** HC
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Q. Please explain how the program operated for Laclede for the winter of 2000-2001.

A. ** HC
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Q. Please define what call options are?

A. A call option is an option that gives the buyer (holder) the right, but not the obligation, to buy a futures contract (enter into a long futures position) for a specified price within a specified period of time in exchange for a one-time premium payment (New York Mercantile Exchange, NYMEX, Glossary). A strike price or exercise price is the price at which the underlying futures contract is bought or sold in the event an option is exercised. (NYMEX Glossary). Call options can be used like insurance. For the payment of a premium, a certain amount of price protection can be achieved. Strike prices determine the price level that the protection will be effective at. Much like deductibles for car insurance, the higher the "strike price" the less costly the premium is. If the "catastrophe" doesn't occur, you lose the premium but have still obtained some intangible value because of the protection received. Similarly with natural gas call options; if prices stay below the strike prices, the premium will be lost. Before the option expires, it trades in its own market and may be bought and sold. One more similarity to insurance is the concept of volatility. The more volatile the market, the costlier the premium. If accidents are happening quite frequently, the cost of car insurance premiums will go up. Price volatility in the futures markets has a similar effect on call option premiums.

Q. Please continue with your discussion of the operation of Laclede's program for 2000-2001.

A. Prices moved up dramatically in the weeks after the TSP and CPL were set in March 2000. In a June 1, 2000 letter to the Commission, Mr. Kenneth J. Neises, Senior Vice President, Laclede, advised the Commission that:

> …as a result of the Company's decision to declare the Price Protection Incentive component of the Program inoperable this year, the company will retain no gains under that component of the Program or incur any losses resulting from the purchase of price protection above the catastrophic price level established by the program (i.e., $5.20 per MMBtu).

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Q. What happened next?

A. In June, July and August OPC, Staff and Laclede met to discuss possible actions to protect ratepayers. On September 1, 2000, the parties filed a Unanimous Stipulations And Agreement (Agreement) in Case No. GO-2000-394 (**Schedule 4**), which relaxed the PSP's existing requirement that the company procure price protection equal to 70% of its flowing supplies. The Agreement stated that by permitting Laclede to obtain price protections for lesser volumes, this revision would help to reduce the price at which such protection would be triggered for those volumes.

Q. Please continue.

A. The winter of 2000-2001 saw the highest NYMEX closing prices ever experienced. NYMEX closing prices for December 2000, January 2001, and February 2001 were $6.02/MMBtu, $9.98/MMBtu, and $6.29/MMBtu, respectively. PGA rates for Laclede were also at record levels. Just looking at January 2001, ** HC

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HC ** was nearly $41,000,000 less. ** HC HC HC **

Q. Please explain other Case No. GO-2000-394 proceedings.

A. On December 22, 2000, the Staff filed a Staff Recommendation, requesting that the Commission terminate the third year of the experimental PSP. An on-the-record hearing was held February 2, 2001 to address this issue. On February 13, 2001 the Commission ordered modification to the PSP for Year 3. It ordered a reduction in the 90-day window to 60 days and ordered the Company to implement its offer to contribute, for the third year of the program, an additional $4 million of its own funds to the $4 million that is currently authorized. Finally, the Company received authorization, over Staff's objections, to reduce the required price protection volume percentages in the company's PSP from 70% to 40% for the upcoming winter in order to permit a corresponding reduction in the TSP and CPL. (**Schedule 8**) Staff noted that call options have been extremely expensive relative to past years coming out of the 2000-2001 winter given the tremendous price volatility and prevailing price levels.

Q. Does the program description contain vague terminology?

A. As an illustration, the program sharing components describe savings achieved ** HC HC HC ** Emphasis added. **HC HC HC

HC ** Of course the cost reduction incentive appears to reward such behavior by limiting sharing claims to trades taking place at least several days prior to expiration. So even though the effective price for a certain package of gas supply may have been reduced from $10.00 to $9.00 (because of a $1.00 gain from an early trade), an option with a $6.00 strike could have brought the effective price of the gas down to $6.00 if held until near expiration. (See **Schedule 9**.)

Q. What is an additional flaw of the program?

A. No matter whether the price goes up or down from the key ** HC HC HC HC HC . ** One significant feature of call options is known as "time-decay." Options tend to lose value the closer they get to expiration. This is because the probability of them being in the money is less as time goes by, all other things being equal. ** HC HC **

Q. Please indicate why the Staff does not believe Laclede should share in any of the alleged savings.

A. The Staff believes that there was a link between the price guarantees that were part of the "Price Protection Incentive" and the "Overall Cost Reduction Incentive." Once Laclede opted out of the "Price Protection Incentive" feature, the "Overall Cost Reduction Incentive" (Cost Reduction) feature made no sense. According to Tariff Sheet 28-f, the Cost Reduction feature was meant to compare the Maximum Recovery Amount (MRA) of ** HC ** to

the "net cost of price stabilization" (Actual Cost) exclusive of the gains and costs covered by Section G.3 (the Price Protection Incentive). Further elaboration of the Cost Reduction feature is contained on page 4 of the program description where ** HC
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Q. Please explain why savings under the Cost Reduction feature "made no sense" after the commitment for price protection was removed?

A. There was a real and measurable value to an absolute guarantee of price protection. Obviously, obtaining this value required the expenditure of funds. Price insurance is not free. The MRA ** HC ** represents a benchmark that implicitly assumes a certain amount of price protection (volumes covered) at a specific price level. If the Company no longer has an obligation to cover any volumes, and no longer has an obligation to guarantee any price level, then what is the Company buying for the customer? If the valuable product that was originally supposed to be purchased at a guaranteed price has disappeared, how can there be real cost savings? In other words, when Laclede revoked the guarantee, savings as contemplated by the program were not available since the foundation of the savings calculation did not exist. Certainly, there were "proceeds" that were generated by the ** HC ** but a truly meaningful savings calculation should not ignore that gas costs increased, were unprotected and were escalating to astronomical levels.

Q. Do you have an objective way of determining if Laclede should share in savings that is consistent with the tariffs and the program description?

A. Yes. **Schedule 9** compares what Laclede's early intermediate trading actions yielded versus the gains available from holding the options until the last three days of trading. ** HC____ HC____ HC______________________ ** It is not nearly as beneficial to the customer as an expectation that Laclede should be held to its own original standard, the catastrophic price level guarantee. The Staff believes that savings under the cost reduction component of the PSP cannot be shared with the Company unless the overall early trading was indeed "favorable" and resulted in savings, not merely "proceeds" that exceed ** HC_________ **.

Q. Does this conclude your direct testimony?

A. Yes, it does.

CASES WHERE TESTIMONY WAS FILED

DAVID M. SOMMERER

COMPANY	CASE NO.
Missouri-American Water Company	WR-85-16
Great River Gas Company	GR-85-136
Grand River Mutual Telephone	TR-85-242
Associated Natural Gas Company	GR-86-86
Empire District Electric Company	WR-86-151
Grand River Mutual Telephone Company	TR-87-25
Great River Gas Company	GM-87-65
KPL Gas Service Company	GR-89-48
KPL Gas Service Company	GR-90-16
KPL Gas Service Company	GR-90-50
Associated Natural Gas Company	GR-90-152
United Cities Gas Company	GR-90-233
United Cities Gas Company	GR-91-249
Laclede Gas Company	GR-92-165
United Cities Gas Company	GR-93-47
Western Resources Inc.	GR-93-240
Union Electric Company	GR-93-106
Missouri Public Service	GA-95-216
Missouri Gas Energy	GO-94-318
Missouri Gas Energy	GO-97-409
United Cities Gas Company	GO-97-410
Missouri Gas Energy	GR-96-450
Missouri Gas Energy	GC-98-335

COMPANY	CASE NO.
Laclede Gas Company	GO-98-484
Laclede Gas Company	GR-98-374
Laclede Gas Company	GC-99-121
Laclede Gas Company	GT-99-303
Laclede Gas Company	GR-98-297
Laclede Gas Company	GT-2001-329
Laclede Gas Company	GO-2000-394
Laclede Gas Company	GR-2001-629
Laclede Gas Company	GR-2002-356