Exhibit No.:	
Issue:	Actual Cost Adjustment
Witness:	Kenneth J. Neises
Type of Exhibit:	Direct Testimony
Sponsoring Party:	Laclede Gas Company
Case No.:	GR-96-181

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Missouri Public Service Commission

LACLEDE GAS COMPANY

GR-96-181

DIRECT TESTIMONY

OF

KENNETH J. NEISES

DIRECT TESTIMONY OF KENNETH J. NEISES

Q. What is your name and address?

A. My name is Kenneth J. Neises, and my business address is 720 Olive Street, St. Louis, Missouri 63101.

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

A. I am employed by Laclede Gas Company ("Company") in the position of Senior Vice President-Energy & Administrative Services.

Q. Please state your qualifications and experience.

A. I graduated from Creighton University in 1967, where I received a jurist doctorate degree. In 1970, I received a LL.M. degree from Georgetown University Law Center. From 1967 to 1973, I was employed as a litigation and trial attorney for the Federal Power Commission (now the Federal Energy Regulatory Commission). I left the Commission in 1973 to accept an appointment by the U.S. Postal Rate Commission to represent the interests of the general public in proceedings before that Commission. I then served as a partner in the law firm of Debevoise and Liberman in Washington, D.C. until joining Laclede in 1983 as an Associate General Counsel. I was elected to the position of Vice President in January 1987 and Senior Vice President in January 1994. Prior to assuming my current position, I was Senior Vice President-Gas Supply and Regulatory Affairs. In that position I had overall management responsibility for the Company's gas procurement activities, its participation in proceedings before the Federal Energy Regulatory Commission ("FERC") on matters affecting Laclede and its customers, and Laclede's participation in various regulatory issues and proceedings before this Commission. My current duties include these responsibilities, as well as overall responsibility for labor and community relations and corporate communications.

Q. Have you previously submitted testimony before this Commission?

A. Yes. I submitted testimony in the Company's last rate case proceeding, Case No. GR-96-193.

PURPOSE AND SUMMARY OF TESTIMONY

Q. What is the purpose of your testimony?

A. I will explain why the Company is opposed to the Staff's recommendation in this proceeding that the Commission order the Company to credit ratepayers with 100% of the gains the Company realized from sales of gas to off-system customers during the twelve month Actual Cost Adjustment ("ACA") period ending September 1996 .

Q. Please summarize the Company's position with respect to the Staff's recommendation?

A. The Company strongly opposes the Staff's recommendation for several fundamental reasons: First, the Staff's recommendation to deprive the Company of these gains is directly contrary to the Commission's traditional treatment of gains and losses between rate cases. Staff's proposed departure from this long-standing regulatory practice is especially inequitable in this case since the Staff ignores the far greater earnings deficiency which was being experienced by the Company during the same period the subject off-system sales were made. Second, Staff's recommendation represents an extremely opportunistic and one-sided response to the Company's earlier efforts to implement an overall gas supply incentive program. Third, the Staff has not claimed that its proposed adjustment is required to protect ratepayers from any unnecessary or imprudently incurred costs.

HISTORY AND BACKGROUND

Q. Please explain the origin of this proceeding.

A. In November 1996 the Company submitted, in accordance with its PGA clause, ACA factors to be made effective for the twelve billing months beginning with December 1996. As required by Section C of the PGA clause, such factors were designed to return to the Company's ratepayers the difference between the Company's actual gas costs and the recovery of gas costs from ratepayers for the October 1995 through September 1996 period. In August 1997, after its audit of the ACA factors, the Commission Staff recommended that the Company be required to credit ratepayers with 100% of the $3.6 million in gains the Company realized from off-system sales during the ACA period. In contrast, the Company did not credit such gains but instead allocated to the off-system sales all incremental costs incurred by the Company to complete these transactions -- an approach which ensured that ratepayers would not be financially harmed as a result of these sales.

Q. What is an off-system sale?

A. An off-system sale is a short-term sale of gas made to a non-jurisdictional customer, usually a marketer of gas, on an as-available basis at a point outside of the Company's service area or "off" the Company's distribution system. In fact, during the ACA period under review in this proceeding, all of the off-system sales made by Laclede occurred at points that were not only outside of the Company's service area but outside of the State of Missouri as well. The prices charged in connection with such sales are not governed by an approved tariff, but are determined in the current competitive marketplace.

Q. How do off-system sales occur?

A. The Company has access to gas supplies and transportation capacity that periodically is not required to meet the needs of its traditional on-system sales customers. During these times the Company will attempt to sell gas into markets in other parts of the country which may be able to utilize such resources.

Q. Can off-system sales be made whenever such resources are not immediately required to meet the demands of the Company's jurisdictional customers?

A. Not necessarily. The Company needs to be able to charge a price that is attractive to a buyer and at the same time cover the Company's incremental costs of providing the service. During the ACA period, the Company was able to make such sales in the November 1995 through March 1996 period mainly because the Company was able to find buyers located off its system who were willing to pay amounts for Laclede's gas supplies that exceeded these incremental costs.

Q. Why does the Company periodically have access gas supply resources that can be used to make off-system sales?

A. It is imperative from a supply reliability standpoint that the Company develop a gas supply and transportation portfolio that enables it to meet the weather-sensitive requirements of its on-system customers during "design conditions". Design conditions, in the Company's case, are based on a pattern of extremely cold weather which the Company actually experienced in the 1935-1936 winter season -- a pattern which, if repeated, would make it necessary for the Company to make full use of its gas supply and transportation resources. Because the Company ordinarily does not experience design conditions, it has access to resources that periodically are underutilized and therefore incremental to the levels needed to serve its traditional on-system customers at a given point in time. Rather than let these resources lay idle and provide no potential offset to the inevitable attrition in the Company's earnings caused by other factors, the Company attempted to sell gas into these other markets where either additional gas supplies were needed or where the price of the Company's supply package was more attractive than the customer's alternative.

Q. Is the size and type of the Company's firm gas supply and transportation portfolio in any way affected by the potential for off-system sales?

A. No. Such portfolio is structured solely to meet its on-system customers' requirements under design conditions.

Q. When did the Company receive approval from the Commission to make such sales?

A. It was not necessary for the Company to receive Commission approval before making off-system sales since such sales were authorized by the FERC pursuant to a blanket marketing certificate it issued effective January 7, 1993 in the aftermath of FERC Order No. 636. Such certificate authorized any entity other than an interstate pipeline to sell gas in interstate commerce.

Q. Does the Company incur any additional costs to make these off-system sales?

A. The Company only incurs the incremental, variable costs associated with the purchase and transportation of each MMBtu it sells to an off-system customer. Since such costs are allocated to off-system transactions, no additional costs are borne by the Company's traditional on-system sales customers as a result of these transactions.

Q. Is it possible that in order for the Company to make an off-system sale it may have to use one of its higher-priced gas supply contracts?

A. Yes.

Q. Then how did the Company keep the cost of the more expensive gas supply used for the off-system sales customers from raising the average cost of gas delivered to the on-system customers?

A. The Company assigned to the off-system sales customer the <u>highest</u> cost of gas and transportation on the pipeline on which the sale was made, irrespective of which gas supply contract on that pipeline was actually used to make the sale.

Q. So ratepayers were not harmed when the Company made these off-system sales?

A. That is correct. They were neither harmed financially, nor from a supply reliability standpoint. The first and foremost objective of the Company's gas supply program always has been, and will continue to be, to satisfy the gas requirements of its on-system customers, which, as I explained above, is made possible because the Company has acquired sufficient resources to meet its customers' requirements during a design year. It is only after the Company's obligation to its on-system customers was met that it considered the feasibility of sales to off-system customers. And then, when an off-system sale occurred, the Company assigned a variable cost to the sale in a way that ensured there was no negative impact on the rates on-system customers pay.

Q. How did the Company compute its off-system gains?

A. The gain or margin from each sale was derived by subtracting the incremental variable costs allocated to the transaction, as calculated in the manner I just described, from the price charged by the Company.

Q. In its recommendation, did the Staff contend that these sales should not have been made or that the Company incorrectly accounted for such transactions?

A. No. However, the Staff did suggest that the Company did not have tariff authority to make such sales. As I have already indicated, such Commission authority was not needed because of the blanket certificate issued by the FERC. Thus, it appears that the sole issue in this proceeding is related to whether the Company or its ratepayers are entitled to retain the gains from the off-system sales the Company realized during the ACA period.

Q. Is there any other factual background which is needed to understand the Company's position?

A. Yes. In the late summer and fall of 1995 it had become increasingly apparent that the Company would soon have to file a general rate increase due to the earnings deficiency it was experiencing at that time. Since rate relief would have been as long as eleven months away, the Company examined other potential ways of optimizing its gas supply resources to offset at least some of this deficiency in advance of the effective date of rates in a new case. The sale of gas to off-system customers was one means by which earnings could be potentially increased. In addition, the Company began discussions with the Staff regarding a gas cost incentive program under which the Company and ratepayers would share in potential savings realized by the Company in acquiring , utilizing and managing its gas supply assets. One such element of the incentive plan related to the off-system sale of gas. From the beginning, the Company was hopeful that such a plan could be implemented in a short period of time, but after a series of discussions, no agreement was reached with the Staff and Public Counsel on a structure that would have permitted timely approval and implementation for the 1995-1996 heating season. Consequently, when the Company filed for a general rate increase in December 1995, it included in its filing a gas incentive plan which the Company subsequently proposed be implemented on an interim, expedited basis, effective February 1, 1996. However, such date was opposed by both the Staff and Public Counsel. Ultimately, a Gas Supply Incentive Plan ("GSIP") was included in the settlement of the rate case and became effective October 1, 1996. In the meantime, the Company engaged in off-system sales transactions as a means by which to offset its attrition in earnings, irrespective of the disposition of its proposed incentive program.

THE STAFF'S RECOMMENDATION IS DIRECTLY CONTRARY TO THE COMMISSION'S TRADITIONAL TREATMENT OF GAINS AND LOSSES BETWEEN RATE CASES

Q. Please describe how losses and gains such as those realized by the Company in connection with its off-system sales are customarily treated by the Commission when they occur between rate cases.

A. Barring a specific tariff provision or Commission order to the contrary, such gains and losses are always realized or borne by the utility's shareholders between rate cases.

Q. Was there a specific tariff provision or Commission order pertaining to the Company's off-system sales in effect during the ACA period under review in this case?

A. No, there was not. As I previously indicated, the only tariff provisions which would have addressed off-system sales during this ACA period and provided for a crediting of the gains from such sales, were the tariff provisions which the Company unsuccessfully tried to implement on an interim basis as part of its rate case. Notably, even the Staff, despite having several opportunities to do so, has never been able to identify any tariff language that would authorize its proposed treatment of off-system sales in this proceeding.

Q. Even though it's clear that off-system sales are not referenced in the PGA clause, is there any reason to assume that such treatment was implied?

A. Absolutely not. Off-system sales gains are just that. They represent margin or a mark-up over gas cost, just like the mark-up or margin associated with the Company's on-system sales. The difference between the price the Company charges for an off-system sale and the gas cost allocated to the sale is gain or margin. Once gas costs had been allocated to the off-system sale, there was no more basis for off-system sales gains to be subject to the provisions of a PGA clause than there was for on-system sale gains. Since no tariff authority exists for Staff's adjustment, Commission precedent would dictate that the Company is entitled to retain the benefit of such sales.

Q. Is the Commission's treatment of gains and losses between rate cases intended to provide an incentive for the Company to increase sales and reduce expenses between rate cases?

A. Yes. This principle is commonly referred to as "regulatory lag".

Q. What is regulatory lag?

A. Regulatory lag is the negative impact on margin of incurring costs or losing throughput at a point in time, but not being able to reflect those changes in costs and throughput in approved rates until a much later point in time.

Q. How has regulatory lag generally affected the Company?

A. In general , since the Company is usually faced with steadily increasing costs due, in large part, to escalating labor costs and other inflationary pressures, regulatory lag has had an overall adverse financial impact on the Company. However, this regulatory practice can also enable the Company to offset attrition, at least partially, to the extent it makes additional sales above the level used to establish rates. Since regulatory lag has historically worked against the Company, the Company surely should be entitled to retain one of the infrequent offsetting benefits to such practice.

Q. Are you aware of a recent case in which the Commission acknowledged this regulatory practice?

A. Yes. In its order in the Missouri Public Service rate case proceeding, Case No. ER-97-394, the Commission adopted the position set forth in the rebuttal testimony of Staff witness Michael L. Brosch. In that testimony, Mr. Brosch stated:

> Traditional, cost-based regulation treats all changes in revenues and expenses in the same way between rate cases . The changes that occur between rate cases all accrue to shareholders until a "next" rate case is required. This phenomenon is often referred to as "regulatory lag". While often viewed as a negative characteristic of cost-of-service regulation, regulatory lag serves as an efficiency incentive to management. This is because any increases in costs or declines in sales and profit margins will have a direct impact upon achieved profits of the firm, until such time as they are recognized by regulators within a test period in setting new base rates. If management can grow sales margins or reduce expenses, the benefits of doing so will be retained by shareholders for a period of time. Under

traditional regulation, there is a 100 percent incentive to grow off-system sales margins between rate cases. [Emphasis added]

The signficance of this testimony is two-fold. It not only affirms the Commission's traditional treatment of changes in revenues and expenses between rate cases, it also clearly sanctions this treatment specifically with respect to off-system sales. For the same reasons, the Commission should allow the Company to retain the off-system sales gains it realized during the ACA period.

Q. How does the $3.6 million of off-system sales gains the Company realized during the subject period compare to the attrition in earnings the Company was experiencing at that time?

A. Some ten months after the Company began making such sales, it was granted a rate award of $9.5 million in its 1996 rate case proceeding. Since this rate case proceeding was based on a test year that closely approximated the time during which the off-system sales were made, it appears that the Company's off-system sales gains fell far short of offsetting the revenue deficiency the Company was experiencing at that time.

Q. In view of these facts, would you consider the $3.6 million in off-system sales gains a windfall to the Company?

A. Absolutely not. It certainly was no windfall in terms of putting the Company in an over earnings position. Instead, it was one self-help, stop-gap measure employed by the

Company to alleviate a serious earnings shortfall which otherwise would not have been addressed until the new rates approved by the Commission in the Company's 1996 rate case were permitted to go into effect.

Q. Is this retention of the gains in dispute in this proceeding a one-time occurrence?

A. Yes. Beginning October 1, 1996, pursuant to the Company's GSIP, 70% of any gains the Company realizes from off-system sales are credited to the Company's Deferred Account to be eventually flowed through to ratepayers. Thus, immediately after the Company's first year of off-system sales, and nearly ten months after the Company first submitted tariff sheets proposing a sharing of off-system sales gains, a tariff provision was put in place to capture a large share of future off-system sales gains for ratepayers. However, the Commission would be destroying the built-in incentives of the current regulatory process if it reached back in time to confiscate the Company's past gains from off-system sales, which, when netted against the attrition in the Company's earnings, did not permit the Company to earn its previously authorized return.

STAFF'S RECOMMENDATION REPRESENTS AN EXTREMELY OPPORTUNISTIC RESPONSE TO THE COMPANY'S EARLIER EFFORTS TO IMPLEMENT AN OVERALL GAS SUPPLY INCENTIVE PROGRAM

Q. Please explain the interrelationship between the Company's efforts to undertake off-system sales and its proposed gas incentive program.

A. Well before any off-system sales were made, the Company proposed an incentive plan under which the gains from off-system sales would be shared equally with its ratepayers rather than flowed through entirely to the Company's shareholders in accordance with the Commission's traditional treatment of such gains . At the same time, the Company also proposed a sharing of additional savings and revenues achieved by the Company in other areas of its gas procurement activities--amounts that would have otherwise flowed through entirely to Laclede's ratepayers. Despite repeated efforts by Laclede to implement this proposal, tariff sheets authorizing such treatment were never approved by the Commission. This was due in large measure to the fact that both Staff and Public Counsel opposed early implementation of such tariff sheets.

Q. What is your reaction to Staff's recommendation to deprive the Company of off-system sale gains, in light of Staff's previous rejection of the Company's request for an early implementation date of the proposed incentive plan?

A. The Staff's recommendation is extremely opportunistic. Simply put, I do not believe the Staff should now be allowed to retroactively capture for ratepayers any of the gains that would have otherwise flowed through to shareholders, while simultaneously denying the Company a share of the benefits that would have been realized from the other elements of the incentive program. After all, it was the Company which offered to give up 50% of its off-system sales gains in exchange for the opportunity to benefit from the other elements of its proposed incentive program. Having rejected this proposal and the tariff sheets which would have authorized such sharing, the Staff shouldn't be allowed to turn the tables on the Company and deprive the Company of gains which, according to the regulatory lag principles advocated by Staff in other proceedings, rightfully belong in their entirety to the Company.

THE STAFF HAS NOT CLAIMED THAT ITS PROPOSED ADJUSTMENT IS REQUIRED TO PROTECT RATEPAYERS FROM ANY UNNECESSARY OR IMPRUDENTLY INCURRED COSTS

Q. Has the Staff claimed that its proposed adjustment is required to protect ratepayers from any unnecessary or imprudently incurred costs?

A. No. Staff appears to have recognized that ratepayers were no worse off after the Company made its off-system sales during the ACA period. Through its off-system sales, the Company simply made better use of its access to gas supply and transportation resources which were not fully required to serve on-system customers during the period. As I stated earlier, no additional costs were incurred to serve these off-system customers that were not also recovered from the price charged to such customers. Furthermore, the Company had accounting procedures in place to ensure that on-system customers' rates were not increased as a result of off-system sales. Under a "no harm, no foul" test, the Staff's recommendation should be rejected, especially since such recommendation would discourage further innovative efforts by the Company which can eventually be translated into ratepayer benefits.

Q. Does this conclude your testimony?

A. Yes, it does.

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of Laclede Gas Company's)
Tariff Sheets to be Reviewed in its)   Case No. GR-96-181
1995-1996 Actual Cost Adjustment.)

A F F I D A V I T

STATE OF MISSOURI)
) SS.
CITY OF ST. LOUIS)

Kenneth J. Neises, of lawful age, being first duly sworn, deposes and states:

1. My name is Kenneth J. Neises. My business address is 720 Olive Street, St. Louis, Missouri 63101; and I am Senior Vice President-Energy & Administrative Services of Laclede Gas Company.

2. Attached hereto and made a part hereof for all purposes is my direct testimony, consisting of pages 1 to 17, inclusive and Schedule 1.

3. I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded and the information contained in the attached schedule are true and correct to the best of my knowledge and belief.

K J Neises

Kenneth J. Neises

Subscribed and sworn to before me this 24th day of June, 1998.

Joyce L. Jansen

JOYCE L. JANSEN
Notary Public — Notary Seal
STATE OF MISSOURI
St. Louis County
My Commission Expires: July 2, 2001