BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of the PGA Filing for	)	**Case No. GR-2004-0273**
Laclede Gas Company	)	

POST-TRIAL BRIEF OF LACLEDE GAS COMPANY

COMES NOW Laclede Gas Company (hereinafter "Laclede" or "Company") and, pursuant to the Commission's procedural order, submits its Post-Trial Brief in this case.

A. Introduction and Executive Summary

At the opening of the evidentiary hearing in this case, counsel for the Staff suggested that this was a "technical and complex" case that needs to be broken down and simplified for the Commission. (Tr. 9, lines 16-18). If there is any complexity at all to the issues raised in this proceeding, however, that complexity arises solely from the Staff's attempt to manufacture out of whole cloth a claim of imprudence where none exists. Once one strips away the gross exaggerations and distortions that Staff has cobbled together toward that end, the facts, the law, and the outcome they compel in this case, are quite simple and straightforward.

The evidentiary hearing held in this case did just that and, in the process, thoroughly reinforced what Laclede had already established in its pre-trial brief. Specifically, the evidence confirms that the Staff has not come anywhere close to satisfying the legal standards that must be met in order to sustain its proposed prudence disallowance of approximately $2 million in swing supply demand charges that Laclede paid during the 2003/2004 ACA period. As the Staff noted in its own pre-trial brief, those legal standards presume that a utility's expenditures are reasonable and prudent. Indeed, the issue of prudence is not even joined unless another party can create a "serious doubt" regarding the prudence of a particular expenditure. ***State ex rel. Associated Natural Gas Co. v. Pub. Serv. Comm'n,*** 954 S.W.2d 520, 529 (Mo. App. W.D. 1979). Assuming that such a showing is made, and the utility cannot dispel that serious doubt, the party claiming imprudence must then also show that customers were actually harmed by the allegedly imprudent act or decision.[1]

It is clear from the record established at the evidentiary hearing that the Staff has not even met its threshold burden of creating a serious doubt regarding the prudence of Laclede's decision to continue its long-standing practice of paying demand charges in order to obtain the right to purchase its swing supplies at first of the month ("FOM") prices. To the contrary, the evidence produced at the hearing affirmatively showed that this practice has been one of the most cost-effective hedging tools ever employed by Laclede. It has allowed the Company to protect customers from intra-month or daily price spikes in full accord with the Commission's stated preference for robust hedging programs and with Staff witness Sommerer's previous position that LDCs must hedge the price risk in the daily markets. (Ex. No. 11, p. 61, lines 4-10). Indeed, as Mr. Godat demonstrated on redirect in response to questions from Commissioner Clayton, paying demand charges to obtain FOM pricing on gas supplies is absolutely essential to ensuring that customers will be price protected throughout the month since call options and other forms of financial instruments typically expire just prior to the beginning of the month.

[1]In determining whether utility management acted prudently, the Commission must base its assessment on what a reasonable person would or should have done at the time the transaction took place. ***Associated Natural Gas Co. v. Pub. Serv. Comm'n,*** 954 S.W.2d 520, 529 (Mo. App. W.D. 1979). Moreover, the Commission must look at the facts and circumstances that existed at the time the transaction took place and may not use hindsight to arrive at its conclusion. *Id.*

(Tr. 267, line 23 – Tr. 270, line 5). At the same time, paying demand charges to obtain FOM pricing also allows Laclede to generate off-system sales revenues that are, in turn, also used to lower the Company's base rates in general rate case proceedings. Because of these dual features, Laclede was able to generate nearly $11 million in net benefits for its customers over the five year period immediately preceding the 2003/2004 ACA year under consideration in this case – a result that is all the more remarkable given the commonly accepted notion that hedging will tend to increase costs over the long-term. (Ex. No. 6, pp. 1-2; Schedule 1). Notably, while the Staff quibbled with Laclede's calculation of these benefits, it never provided an alternative one of its own or attempted to "correct" Laclede.[2]

As a result of the evidentiary hearing, it is equally clear that Staff's attempt to impugn this long-standing practice is based on a tissue of errors and outright distortions. Having knowingly acquiesced in Laclede's use of this practice over nearly a decade of multiple ACA reviews, gas supply incentive proceedings, and even a special management audit of Laclede's gas supply functions, (Ex. No. 4, p. 5; lines 6-20), the Staff had to come up with *some* reason for suddenly converting to the view that this long-standing practice was no longer prudent. And the best that Staff could do in that regard was its claim that Laclede should have conducted a more recent study of the historical costs and

[2]In addition to being unquantified, Staff's criticisms of the Company's study are unfounded. Its assertion that Laclede could have used storage or other contracts to protect against daily price spikes was thoroughly refuted by Mr. Godat in his rebuttal testimony. (Ex. No. 5, pp. 3-5). Moreover, such assertions are directly contrary to the position that the Staff was taking in an ACA audit review in 2004. In that case, the Staff criticized MGE for doing exactly what it claims Laclede should have done in this case, namely for use storage early in the winter heating season so as to avoid spiking gas prices. (Ex. No. 11, p. 60, lines 1-24). Staff's second criticism that Laclede's study failed to adjust for reservation charges was corrected for the study that showed nearly $11million in benefits. (Tr. 80, line 23 – Tr. 81, line 10). Finally, Staff's criticism that Laclede should have excluded off-system sales revenues when calculating customer benefits is simply erroneous for the reasons discussed elsewhere in this brief.

benefits of paying demand charges because such charges had "nearly doubled" from the previous ACA period. (Ex. No. 1, pp. 9-11)

It is abundantly clear now, however, that there is absolutely no substance to this claim. In fact, Staff's own calculations show that Laclede's overall demand charges had increased by less than 70% from the prior ACA period and that, even with such increases, they remained well within the 2-5% range of overall gas costs that the Commission's own 2001 Gas Price Commodity Task Force Report had recognized was typical for LDCs like Laclede. (Tr. 43, lines 12-19; Tr. 45, lines 3-11). Even more significantly, the evidence indicates that the swing supply demand charges at issue in this case had increased by an even smaller percentage, climbing by approximately 30% compared to the amount experienced during the prior ACA period. (Tr. 43, lines 20-22). In short, there was nothing unusual – nothing at all – about what was happening with demand charges during the ACA period that should have triggered the need for a special study of such charges and no amount of exaggeration by Staff can change that fact.

The evidentiary record also indicates that even if these phantom increases in demand charges had occurred, there would have still been no sound reason to conduct the kind of historical study that Staff claims was necessary to establish the prudence of Laclede's decision to continue this practice. To the contrary, Staff witness Sommerer acknowledged during the hearing and in his deposition that he himself had not performed such historical studies when making his own recommendations in the past as to how much utilities should be authorized to spend on Commission approved hedging activities, relying instead on the very same kind of ongoing market analysis, experience and judgment that Laclede personnel employed in making the decision being challenged in this case. (Ex. No. 11, pp. 36-41).

Moreover, if prudence truly demanded that Laclede conduct an historical study of the relative cost of paying demand charges versus the savings associated with avoiding intra-month price spikes, then the same prudence considerations would similarly dictate that the such cost/benefit studies be performed by those LDCs who have chosen the alternative approach of paying the daily price spikes in order to save on demand charges. Indeed, the need for such studies would seem to be particularly acute given how extraordinarily high those daily price spikes have and can go. Nevertheless, Mr. Sommerer testified that Staff had *never* received such a study from any Missouri LDC that follows the latter practice, nor ever insisted that such a study was necessary for them to establish the prudence of paying whatever intra month price the spot market might bring. (Ex. No. 11, pp. 43-52). Needless to say, Staff's complete lack of interest in seeking similar studies from other utilities belies its claim this kind of historical analysis was in any way essential to a prudent evaluation by Laclede of whether it should continue its long-standing practice of paying demand charges to obtain FOM pricing on its swing supplies. To the contrary, it is simply one more illustration of the fact that Staff's entire claim regarding the need for such a study is nothing more than a pretext, and an obvious one at that, for making an otherwise unsupported prudence adjustment.

The evidentiary hearing also demonstrated the Staff's utter failure to meet its legal obligation to show that customers were ever harmed by this practice. As previously noted, while the Staff quarreled with several elements of Laclede's calculation of the nearly $11 million in benefits that customers received as a result of this contracting practice during the five year period prior to the 2003/2004 ACA year, the Staff never provided an alternative calculation of its own or reconciled any adjustments to Laclede's. And even for the ACA year itself, the Staff was only able to assert that customers were harmed by this practice by completely excluding from its cost/benefit analysis for this period all of the off-system sales revenues that were generated as a direct result of the FOM and intra-month price differentials created by Laclede's use of this practice.

In attempting to justify this inexplicable exclusion of real dollars that have benefited and continue to benefit customers in the form of lower rates, Staff witness Sommerer claimed in his testimony that the link between Laclede's payment of demand charges on its swing supplies and the Company's realization of off-system sales revenues for its customers was simply too speculative for such revenues to be considered. During the evidentiary hearing, however, this link was unmistakably established, and not only by Laclede, but by Staff's own workpapers as well. As shown by Ex. No. 14, which contains those workpapers, the Staff was not only able to identify the specific swing supply volumes that were used to make off system sales during the ACA period, but also calculate the overall benefits that were actually realized once these off-system sales volumes are taken into account, as they should be. When shown these workpapers during cross-examination, Mr. Sommerer acknowledged that the additional benefits derived from these off-system sales volumes amounted to nearly $2.4 million during the ACA period, a figure that exceeds (and more than offsets) the entire value of Staff's proposed adjustment of $2,055,000. (Tr. 145, line 3 – Tr. 146, line 4). Given this fact, and Mr. Sommerer's acknowledgment that the regulatory practice in effect during the ACA period was to flow such revenues back to customers through a reduction in base rates, there is absolutely no basis for concluding that Laclede's customers were harmed by its use of this practice.

In light of the paucity – indeed, the complete absence – of any evidence showing that Laclede was imprudent or that customers were harmed as a result of this practice, the question naturally arises as to why the Staff pursued such an adjustment in the first place. The evidentiary hearing has provided an answer to that question as well by making it abundantly clear that the Staff has raised these implausible claims of imprudence for one reason and one reason only: as a subterfuge to obscure what is in reality an impermissible attempt by the Staff to renege on the agreement it voluntarily signed, and the Commission approved, in Case No. GR-2002-356. Under paragraph 12 of the Stipulation and Agreement approved in that case, Laclede agreed to impute $3.8 million in net off-system sales and capacity release revenues as an offset to its base rates. (*See* Ex. No. 12). By doing so, Laclede essentially guaranteed its customers that they would receive this financial benefit year in and year out regardless of whether Laclede was actually able to achieve the imputed level of revenues. In exchange, the Stipulation and Agreement explicitly stated that "the Company shall be permitted to retain 100% of any revenues realized from such transactions during the period the rates established in this proceeding are in effect. It is expressly understood that during such period no other treatment of such revenues shall be implemented as the result of any action taken in another Commission case, except upon mutual recommendation of the Parties and approval of the Commission." (*Id.*).

It should be noted that this concept of imputing a guaranteed level of net off-system sales revenues in base rates in exchange for the right to retain any net revenues that the Company might achieve between rate cases did not originate with Laclede. To the contrary, it was a concept that had initially been advocated by the Office of the Public Counsel, with Staff's concurrence, in Laclede's 2001 rate case proceeding as an alternative to the Company's proposal that such revenues continue to be reflected in Laclede's Purchased Gas Adjustment as part of the Company's Gas Supply Incentive Mechanism. (*See* ***Re: Laclede Gas Co.***, Case No. GT-99-303, *Report and Order,* 8 Mo. P.S.C. 322, 326-27, (September 9, 1999). Nevertheless, once the Commission determined, over Laclede's objection in that case, that such an approach was appropriate, Laclede negotiated in good faith to establish the basic terms and conditions that would implement this concept in its subsequent 2002 rate case proceeding. Thus was paragraph 12 of the Stipulation and Agreement in that case born.

It is now apparent that having received the benefit of the bargain it struck in 2002 in the form of lower base rates, the Staff is now seeking to renege on its obligation not to propose any adjustment or take any other action that would deprive Laclede of its right to retain the benefit of the off-system sales revenue achieved by the Company between rate cases, including the revenues achieved during the ACA period under consideration in this case. In computing what those off-system sales revenues are, it has always been recognized that the gas supply demand charges required to make such sales are to be borne by the Company's ratepayers and recovered through the PGA/ACA process. Indeed, this concept has also been consistently reflected in the Company's tariff sheets applicable to off-system sales which, in calculating what those revenues are, assume that any demand charges required to make such sales are being recovered through the PGA/ACA. (Tr. 279). And that is the exact custom and practice that has been consistently followed by Laclede and the Staff over the years in computing such revenues in multiple ACA and general rate case proceedings.[3] By disallowing the demand charges associated with the off-system sales made by the Company made during this period, the Staff is undeniably seeking to decrease the revenues that Laclede had an unqualified right to retain under paragraph 12 of the 2002 Stipulation and Agreement and, in the process, retroactively alter the fundamental components of an agreement that it voluntarily entered into with eyes wide open in 2002.

Even worse, the Staff has attempted to justify this impermissible effort to re-trade its agreement by repeatedly urging the Commission to take a pejorative view of the fact that Laclede did exactly what it was entitled, and even encouraged, to do under paragraph 12 of the Stipulation and Agreement: namely, make an increasingly greater level of off-system sales. (Tr. 280, lines 15-19). Staff's distaste for the Company's success in this regard was not, of course, so strong that the Staff was dissuaded from once again capturing the benefits of these efforts for the Company's customers through an even higher imputation of off-system sales in Laclede's 2005 rate case proceeding. Having captured that benefit as well, however, the Staff is knocking at the door yet again with its obviously disingenuous prudence claims in this proceeding.

The Commission should not sanction this transparent effort to circumvent an agreement that was freely entered into by the Staff and endorsed as just and reasonable by the Commission itself. Paragraph 12 of the Stipulation and Agreement in Laclede's

[3]In fact, the Staff has acknowledged from the very beginning that in computing off-system sales revenues the demand charges required to make them are to be recovered through the PGA/ACA process. Thus, in explaining why a level of off-system sales revenues should be included in the base rates established in the Company's 1999 general rate case proceeding, the Staff stated that such action was necessary because otherwise, "Laclede will retain 100% of the profits from the off-system sales transactions, even though the transactions are funded by the ratepayers through the transportation reservation and *gas supply demand charges* which the customers pay through the PGA/ACA process." ***Re: Laclede Gas Company,*** Case No. GR-99-315, *Report and Order,* 8 Mo. P.S.C. 436, 451 (December 14, 1999) *emphasis supplied.*

2002 rate case said what it meant and meant what it said. Nor should Laclede be required to pursue multiple appeals or have to rely on the Supreme Court of Missouri to vindicate the meaning and effect of this agreement, as was the case in ***State ex rel. Riverside Pipeline Company, L.P., Mid-Kansas Partnership and Missouri Gas Energy, Respondents v. Public Service Commission of the State of Missouri,*** Case No. SC87495, Opinion Issued January 30, 2007. Instead, this Commission should discharge that duty by rejecting Staff's proposed adjustment in this case.

B. Was it imprudent of Laclede to purchase the right to buy swing supply gas at first-of-month pricing during the 2003-2004 ACA period?

Far from being imprudent, the evidence in this case conclusively establishes that Laclede's decision to pay demand charges in order to obtain FOM pricing on its swing supplies was an integral, long-standing and highly effective component of its overall gas purchasing strategy. As explained by Laclede witness Godat, Laclede had consistently paid demand charges in connection with these swing supplies for at least a decade prior to the ACA period under consideration in this case. (Ex. No. 4, p. 7).

In addition to ensuring that Laclede would have gas available when needed to meet the demands of its customers, this contracting practice also benefits Laclede's customers in several other ways. First, by effectively hedging the costs of its swing supplies at FOM prices, it protects customers from daily, intra-month price spikes, caused by cold weather or other factors, since Laclede is able to buy needed swing supplies at the lower FOM price under these circumstances. Second, if warmer weather in Laclede's service area causes a decline in the demand for gas by Laclede's customers, these lower priced swing supplies can be used by Laclede to make sales of gas to entities located off its system, thereby generating revenues which were also used to offset the cost of utility service for the Company's on-system customers. (Ex. No. 4, pp. 4-5).

It is difficult to overstate the intrinsic value of such a practice to Laclede's customers. It is commonly understood that while hedging a commodity will help to stabilize the price of that commodity, it cab also increase its cost over the long-term. For example, the 2001 Final Report of the Commission's Natural Gas Commodity Price Task Force specifically recognized that while hedging should be part of a balanced portfolio, the use of such instruments may result in higher gas prices over the long term. As the Report stated:

> Part of a balanced portfolio will be over market at times and this is necessary to dampen price volatility. It is also recognized that gas price stability, which is desired and valued by customers, *may result in higher gas prices over the long term due to the costs of hedging and fixed price contracts.* Report, p. 35.

The Commission's own Natural Gas Price Volatility Mitigation rule, which is set forth at 4 CSR 240-40.018, also acknowledges and accepts the principle that it is prudent to use hedging instruments even though they may result in prices that are occasionally above the spot market price for gas.

In contrast to most other hedging strategies, however, the practice of paying demand charges to obtain FOM pricing has actually allowed Laclede to protect its customers from intra-month price spikes at no long-term cost, once all of the financial effects of the practice are taken into consideration. And based on the facts and circumstances that prevailed at the time Laclede made its contracting decisions in 2003, there was every reason to believe that such a practice was, and remained, a reasonable one, both in terms of its impact on gas costs and in terms of its usefulness in stabilizing prices.

As Mr. George Godat, Laclede's Director of Gas Supply, explained in his testimony, a study conducted by Laclede for the winter of 1995-1996 had showed that the benefit of buying gas at first-of-month pricing outweighed the cost of the demand charges. (Ex. 4, p. 8). Since that time, Laclede had continued to monitor this hedging strategy and, prior to the subject ACA period, had seen no evidence to indicate that such a strategy had become imprudent or was not cost-effective. (*Id.*) To the contrary, as recently as the February before the winter of 2003-2004, Laclede had seen huge intra-month price spikes in the natural gas markets (and record low storage levels that threatened to drive such prices even higher in the future), that had broadly reconfirmed the wisdom of using such a hedging strategy to mitigate such intra-month spikes. (*Id.*).

Notably, the Commission and its Staff had also taken note of these developments as reflected in a letter that was sent to each Missouri LDC in the summer of 2003. In that letter, the Staff stated that the natural gas market currently had "very high prices" and that a number of groups had suggested that such prices might not go down before next spring, but instead might "go even higher." Staff also noted that "few factors at this time provide much comfort in this market" citing figures showing that national, storage inventory levels were some 28% below the five year average. Staff also recognized in its letter that a continuation of current prices, even with normal winter weather, could put a tremendous burden on Missouri's natural gas customers and requested that LDCs provide information regarding their storage and hedging situation. (Ex. No. 11, pp. 68-70). Based on all of these factors, as well as its intimate, day-to-day knowledge of what was then happening and had happened in the natural gas markets, Laclede decided to continue its decade-old practice of paying demand charges in order to hedge its gas supplies against daily price spikes in the upcoming winter heating season.

Given the cost-effectiveness of this practice as a hedging tool, Staff's long concurrence in its use over many years of ACA audits and other reviews, and the challenging circumstances that were prevailing at the time, one might reasonably expect that the Staff would have enthusiastically endorsed the practice rather than question its prudence when it filed its ACA recommendation in this case. Nevertheless, based on a retrospective and highly selective review of only a portion of the overall financial effects of this practice during the ACA proceeding, the Staff erroneously claims that Laclede was imprudent for paying demand charges on its swing supplies.

In support of that claim, Staff witness David Sommerer contended that since the level of demand charges paid by Laclede had nearly doubled since the previous ACA period, Laclede should have conducted a more recent study of the historical savings and costs of paying demand charges to obtain FOM pricing on its swing supplies before deciding to continue that long-standing practice. (Ex. 1, 9-12). Staff's claim that such a study was necessary to establish the prudence of continuing this practice during the ACA period is a complete and utter canard.

First, as previously discussed, the very reason given by Staff as to why such a study was necessary is premised on a grossly exaggerated and distorted depiction of the magnitude of the demand charge increases that Laclede actually incurred on its swing supply contracts. Although Mr. Sommerer asserted in his testimony that demand charges had nearly doubled during the ACA period, his own schedules show that they, in fact, had increased by about 70% (i.e. compare $11.9 million in 02/03 to $20.3 million in 03/04 as set forth on pages 9-10 of Ex. No. 1). Even with a charitable view towards the virtues of rounding, saying that something has "nearly doubled" (or nearly increased by 100%) when it has, in fact, increased by 70%, hardly provides an accurate or fair assessment.

Moreover, even saying that Laclede's demand charges increased by this lower 70% amount would only be true if one considers *all* of the demand charges paid by Laclede on *all* of its contracts, including baseload, combo, and swing contracts. In both his pre-filed testimony and deposition, however, Mr. Sommerer himself insisted that the prudence of paying demand charges to obtain FOM pricing should be based on a separate evaluation of each kind of contract and the specific levels of demand charges paid in connection therewith. (Ex. No. 1 p. 14, lines 20-21; Ex. No. 11, p. 18).

Disaggregating Laclede's contracts and demand charge payments in the manner recommended by Mr. Sommerer reveals that the demand charges paid by the Company for its swing contracts did not come anywhere close to doubling over the previous year's level. Instead, such charges went up by less than 30%, or less than a third of what they had been the year before. (Ex. No. 1, Schedule 2-11, which refers to a 28% increase in these charges; Tr. 43; lines 20-22). Accordingly, even if one were to accept the dubious proposition that a 70% increase in demand charges should have set off alarm bells (notwithstanding the huge price increases that were also being experienced in virtually every segment of the natural gas commodity and financial markets), no such alarms were sounding when it came to the swing supply demand charges at issue in this case. As a result, Staff's entire claim of imprudence rests on a highly misleading and wildly exaggerated depiction of demand charge increases that, in the case of swing contracts, never occurred. Indeed, because of this fundamental error, Staff finds itself proposing a disallowance ($2 million) that is three times as big as the increase in swing supply demand charges ($600,000) that Laclede actually experienced over the prior ACA year – a year in which Staff apparently believed such charges were both reasonable and prudent. (Tr. 67, line 11 – Tr. 68, line 20). Laclede respectfully submits that this gross flaw alone should lead the Commission to reject Staff's proposed disallowance.

As egregious as this flaw is, however, there is an even more fundamental problem with Staff's single-minded fixation on the fact that demand charges had increased as support for its assertion that Laclede should have performed a special study before continuing its practice of paying such charges to obtain FOM pricing. That problem involves the total lack of perspective and context that Staff has brought to the discussion of these increases. To hear Staff tell it, one would think that demand charges were escalating in an unusual or unexpected way that set them apart from what was happening with other natural gas pricing mechanisms and instruments and therefore mandated some kind of special scrutiny. Nothing could be further from the truth.

As Mr. Sommerer confirmed in his deposition, the Commission's own Natural Gas Commodity Price Task Force Report recognized that as far back as 2001, the amount of demand charges being paid by LDCs on their gas supply contracts had typically ranged between 2% and 5% of their overall gas costs. (Ex. No. 11, pp. 21-22) Even with the increase in overall demand charges that Mr. Sommerer cites in his testimony, the amounts incurred by Laclede for such charges during the 2003/2004 ACA period still fell well within this historical range, totaling less than 4% of Laclede's overall gas costs. (Tr. 44, line 25 – 45, line 11). Compared to Staff's myopic, out-of-context focus on a single cost element, this more complete assessment of how demand charges were performing relative to overall gas costs paints an entirely different, and far more meaningful, picture of the continuing reasonableness and efficacy of such charges. Of course they were increasing, but so was everything else! The important point is that based on overall market trends there was absolutely no reason to conclude in 2003 that there was something amiss or unusual about how demand charges were escalating, let alone something that should have prompted Laclede to conduct a special study of such charges or even consider abandoning its long-standing practice of using them to obtain FOM pricing on its gas supplies.

To the contrary, an overall assessment of what was happening in the natural gas markets at the time strongly indicates that just the opposite was true. Indeed, all one needs to do to reach that conclusion is compare what was happening with swing supply demand charges at that time relative to the price movements that had recently occurred in the intra-month daily market that such charges are designed to hedge. Such a comparison shows that by the fall of 2003 such charges on Laclede's swing contracts had only increased by less than 10 cents an MMBtu compared to the charges in effect during the previous ACA period. (Tr. 271, line 9 – Tr. 272, line 12). In comparison, Mr. Sommerer indicated in his deposition that the daily, intra-month price for natural gas during the preceding winter had spiked by as much as 20 *dollars* an MMBtu on certain days. (Ex. No. 11, p. 30). Given these relative price movements, it is nothing short of astonishing that Staff would now claim that Laclede should have been wary of the demand charge increases that were occurring in the fall of 2003 and only continued its practice of paying them upon completion of some kind of formal study. It doesn't take a formal study – indeed, it takes little more than open eyes and the ability to distinguish between dollars and cents – to conclude that paying an additional 6.5-8 cents an MMBtu to avoid potential price spikes of 20 dollars an MMBtu was a reasonable thing to do.

In fact, if the marketplace events of 2003 raised any concerns at all regarding the need for additional study and analysis, those concerns would have been more properly focused on why it was appropriate and reasonable for LDCs to expose themselves to such huge intra-month price spikes when such exposure could have been avoided through the payment of producer demand charges. Staff's insistence on formal studies as a means of establishing prudence, however, apparently only applies when the amounts being evaluated are relatively small, and such insistence inexplicably dissolves when the expenditures are far larger. Although Mr. Sommerer indicated during his deposition that Staff had informally asked other Missouri LDCs (who do not pay demand charges to obtain FOM pricing on swing supplies) to provide studies on whether such an approach had benefited their customers, he stated that no such studies had been provided. (Ex. No. 11, pp. 42-44, 47). Despite the absence of such studies, however, Mr. Sommerer indicated that Staff had never questioned the prudence of an LDC's decision to pay whatever price the daily, intra-month market might bring rather than pay demand charges to obtain FOM pricing on its contracts. (Ex. No. 11, pp. 51-52). And since such studies have never been provided, Staff has apparently decided that the prudence of exposing customers to potentially massive increases in the daily price of natural gas in order to save on demand charges can be established (or perhaps just assumed) without the benefit of any historical analysis that quantifies whether such an approach has or has not worked to the benefit of those customers.[4] There is absolutely no reason for the Commission to give any credence to a Staff position that effectively advocates that Laclede change a practice when the Staff has absolutely no idea – no idea at all – as to whether its preferred alternative of not paying demand charges on swing supplies and exposing customers to intra-month price spikes has benefited or harmed the customers of those LDCs who have followed such an approach.

The Staff's insistence that a more recent historical study of the relative costs and savings of an FOM versus non-FOM approach was necessary to establish the prudence of continuing this practice is also directly contrary to what the Staff has previously said is required to make such decisions. As previously discussed, Mr. Sommerer himself has also recognized the appropriateness of basing such decisions on judgment and a knowledge of prevailing market conditions, rather than on some kind of historical cost/benefit analysis. Thus, when hedging programs were first approved for Laclede and Missouri Gas Energy after the price spikes that occurred in the 1995/96 winter heating season, Mr. Sommerer was actively involved in recommending what volumes of gas should be covered, what kind of hedging instruments should be used, and how much money should be spent in procuring such instruments. As Mr. Sommerer confirmed during his deposition, he did not believe at the time that any kind of formal cost/benefit analysis or study was necessary to make these determinations, nor did he attempt to perform any. (Ex. No. 11, pp. 38-42). Instead, Mr. Sommerer believed it was perfectly reasonable and prudent to base such decisions – decisions that involved expenditures

[4]Laclede does not mean to imply that other LDCs may have been imprudent for not pursuing the same strategy as Laclede has on paying demand charges to obtain FOM pricing. Different systems, storage capabilities, pipeline suppliers and other factors may very well justify different approaches. At the same time, Laclede believes it is highly inappropriate for the Staff to recommend that the Commission penalize Laclede for not performing a study often enough that Staff has *never* insisted that any other LDC perform *at all* and that Staff has never tried to perform itself.

comparable to those at issue in this case – on experience and knowledge of the natural gas markets. (*Id.*). And to this day, Mr. Sommerer continues to believe that he acted reasonably and prudently in basing his decision on such informed judgment. (*Id.*, p. 73).

That is also precisely what Laclede did in reaching its decision to continue the practice of paying of demand charges to hedge its swing supplies at FOM prices during the 2003/2004 ACA period. Specifically, Laclede looked at the huge shortfall in storage inventories at the national level, took note of the extraordinary intra-month price spikes that had been experienced during the later part of the 2002/2003 ACA period, examined forward prices and, with a detailed knowledge of how cold weather and increased price volatility could have affected Laclede's gas costs, determined that it was reasonable to pay the surprisingly modest 30% increase in demand charges in order to obtain FOM pricing on its swing supplies. (Ex. No. 6, p.7; Tr. 205).

Laclede's decision to continue its practices of paying demand charges on its swing supplies was also fully consistent with the advice given just a year prior to that time by the Staff's own hedging expert. After the price spikes of 2000/2001, Mr. John H. Herbert was employed by the Commission to evaluate and make recommendations regarding the gas purchasing and hedging practices of the Missouri LDCs regulated by the Commission. (Ex. 11, pp. 62-64). His recommendations were formally submitted to both the Commission and the state's LDCs in March of 2002 in a document entitled "The General Report on Analysis of Gas Supply and Hedging Practice by Regulated Natural Gas Utilities in Missouri." (Ex. 11, p. 64, lines 1-4). Notably, Mr. Herbert recognized, like Laclede, that FOM pricing on swing contracts can help to reduce intra-month price spikes. (Ex. No. 11, p. 64, lines 5-14). He further indicated that the rising cost of obtaining this and other forms of hedging protection should not be used as an excuse for leaving customers exposed to monthly or daily price spikes, particularly in markets where there is great price volatility. (*See* Ex. No. 11, p. 64, line 15 – p. 65, line 21). Although Mr. Sommerer stated in his deposition that he agreed with these observations (Ex. No. 11, p. 64, lines 13-14; p. 65, lines 7-10), his proposal to disallow demand charges paid on Laclede's swing supplies effectively repudiates them.

Finally, it is important for the Commission to recognize that all of the demand charges paid by Laclede have been established through a competitive bidding process. Indeed, Laclede had utilized the very competitive bidding process recommended by Staff to confirm the validity of these market prices. As a result, there was every reason to believe that such demand charges were reasonably priced and fairly reflected the value of stabilizing prices given the demonstrated price volatility that had been experienced in the market. (Ex. No. 4, pp. 8-9). Given the complete absence of any evidence suggesting that this competitive process was somehow flawed, there is no reason to believe that an historical study would have added anything of substance to the determination of whether Laclede's payment of demand charges to obtain FOM pricing during the ACA period represented a reasonable expenditure.

In view of these considerations, there is absolutely no basis for Staff's assertion that Laclede was imprudent because it did not perform a more recent study of the relative costs and benefits of FOM versus non-FOM pricing before deciding to continue this long-standing practice of paying demand charges when contracting for swing supplies for the 2003/2004 winter heating season. Indeed, it is clear that Staff's claim that such a study was necessary is nothing more than a pretense to justify what is obviously an impermissible attempt to disallow costs based on a distorted hindsight view of how things turned out rather than a fair evaluation of what was known by Laclede at the time.

Even more egregious in this case, however, is the fact that Staff has chosen to make this impermissible adjustment without any advance warning and after nearly a decade of ACA reviews, management audits, and other proceedings in which Staff had the opportunity to question the propriety of this practice, but did not. To the contrary, Staff sent just the opposite message in the years immediately preceding the ACA period, filled as they were with Staff letters and reports emphasizing the potential for higher and even more volatile gas prices and the need to pursue measures aimed at mitigating the impact of such prices on utility customers. Indeed, had Laclede suddenly abandoned, rather than continued, its practice of paying demand charges to protect its customers from intra-month price spikes in the face of such circumstances, it is quite likely that the Staff would have found *that* decision to be imprudent, especially if the weather had been even normal, rather than warmer than normal, or if prices had spiked that winter, as they had in two of the three preceding winters. For all of the reasons discussed above, however, Staff is decidedly wrong in proposing an adjustment in this case and the Commission should not hesitate to reject its proposed adjustment.

C. If Laclede was imprudent, were Laclede's customers harmed by this action?

Even if one were to erroneously assume that Staff was correct in asserting that Laclede was somehow imprudent for continuing its long-standing and successful practice of purchasing the right to buy its swing supplies at FOM prices, Staff's proposed disallowance would still be impermissible because there is no evidence to suggest that Laclede's customers were harmed by such a practice, as required by the prevailing legal standards previously discussed. As previously noted, the Staff has proposed to disallow approximately \$2 million of the \$4.6 million in demand charges that were paid by Laclede in connection with its swing supplies during the ACA period. (Ex. No. 11, p. 5). According to the Staff, the remaining demand charges were reasonable and should be allowed because they were either offset by the net savings achieved in avoiding intra-month price spike or were incurred to ensure the availability, rather than the pricing, of those supplies. (Ex. No. 11, pp. 7, 11).

In suggesting that \$2 million of these costs should be disallowed, however, Staff has completely ignored the off-system sales revenues that Laclede was able to generate for its customers as a result of being able to buy swing gas at a lower price than the market rate for a given day. (Ex. No. 4, p. 10). As Mr. Godat explained in his testimony, Laclede has been making these off-system sales since the mid-1990s. And as Mr. Sommerer acknowledged during his deposition, the regulatory practice in effect during the ACA period under consideration in this case was to impute a representative level of such revenues into the Company's base rates – an approach that directly reduced what customers would otherwise have to pay in base rates for utility service. (Ex. No. 11, pp. 15-17). Indeed, this very practice was followed in both the Company's 2002 and 2005 rate case proceedings. (*See* Ex. Nos. 12 and 13). As a result, the Commission approved a Stipulation and Agreement ("Stipulation") which expressly recognized that Laclede's annual revenue requirement had been reduced to reflect an imputed \$3.8 million in off-system sales and capacity release revenues. (Ex. 4, p. 11, Ex. No. 12). In effect, this means that regardless of the level of off-system sales or pipeline capacity release actually achieved by Laclede, its customers were *guaranteed* $3.8 million through lower rates. (*Id.*).

In his testimony, Mr. Sommerer acknowledged that the Company's strategy of paying demand charges to lock in the price of its swing supplies at FOM prices facilitated the Company's ability to make these off-system sales. (Ex. No. 5, p.3, lines 2-5). He also had no problem identifying the specific off-system sales volumes that had actually been made with these swing supplies. (Ex. No. 11, p. 12). Nevertheless, Mr. Sommerer completely ignored such revenues in calculating his proposed adjustment.

There is simply no justification for ignoring these benefits in determining whether Laclede's customers were harmed by the Company's practice of paying the demand charges that made those sales possible. This is particularly true in light of Mr. Sommerer's acknowledgement that nearly $2.4 million in these off-system sales revenues were made from the swing supplies at issue in this case – a figure that exceeds (and more than offsets) the entire value of Staff's proposed adjustment of $2,055,000. (Tr. p. 145, line 3 – p. 146, line 4). In view of these considerations, off-system sales revenues should have been factored into Staff's calculation of the costs and benefits associated with paying demand charges on the Company's swing supplies. When they are, the result more than negates Staff's proposed disallowance of $2 million by eliminating any notion that the Company's ratepayers were somehow harmed by this practice.

Finally, Staff's proposed disallowance gives absolutely no recognition in this case to the intangible benefit that hedging instruments – and the protection they provide against price spikes – afford customers. Mr. Sommerer expressly recognized this value during his deposition and indicated that it should be recognized even in those instances where a particular hedging transaction loses money but nevertheless provides customers with protection while it is in effect. (Ex. No. 11, pp. 105-107).

This intangible benefit is also reflected in the Commission's Natural Gas Price Volatility Mitigation rule which was adopted for the express purpose of encouraging LDCs, like Laclede, to use various contracting practices and financial instruments to achieve greater price stability on behalf of their customers. *See* 4 CSR 240-40.018. The rule promotes this objective by explicitly acknowledging and accepting the fact that prudent contracting and hedging practices aimed at promoting more stable prices may occasionally result in prices that are higher than spot market prices. (Ex. No. 4, p. 12). In other words, it recognizes that a more stable price is not always going to be the lowest price given the way market prices can decline as well as increase from what was assumed or prevailing at the time a hedging decision was made. (*Id.*). By providing this kind of assurance, the rule tells utilities that they will not be penalized with disallowances simply because their price mitigation practices result in higher rates in a given year than would have been the case had the utility simply relied on the spot market. (*Id.*).

By giving Laclede absolutely no credit for the intangible benefit provided by FOM pricing on swing supplies, the Staff's proposed disallowance strikes at the heart of the rule and what it was intended to accomplish. Indeed, by disallowing any and all demand charges that were paid to lock-in the price of swing gas, Staff's proposed adjustment essentially says that *not one cent* above and beyond the immediate savings achieved through the payment of the demand charges should have been incurred by Laclede to hedge for intra-month price spikes. (Ex. No. 4, p. 13). As a result, Staff's proposed disallowance is directly contrary to the explicit wording and intent of the

Commission's Price Volatility Rule and Staff's own acknowledgement that there is an intangible value to affording such protection to customers. If permitted to stand, it would actively discourage hedging by telling utilities that the practice is acceptable only if, and to the extent, it produces a favorable outcome in each and every ACA period. That would send exactly the wrong message at a singularly inappropriate time given the gas price environment faced by local distribution companies and their customers today. For all of these reasons, Staff's proposed adjustment should be rejected by the Commission.

D. If customers were harmed, in what amount were they harmed, and what amount of gas costs, if any, should be disallowed to Laclede?

Since Laclede was not imprudent and its customers were, in any event, benefited rather than harmed by Laclede's decision to pay demand charges on its swing supplies there is no basis for disallowing any amount in this proceeding. For all of these reasons, Laclede respectfully requests that the Commission reject Staff's proposed adjustment.

Respectfully submitted,

/s/ Michael C. Pendergast
Michael C. Pendergast, Mo. Bar #31763
Vice President and Associate General Counsel
Rick Zucker, Mo. Bar #49211
Assistant General Counsel - Regulatory

Laclede Gas Company
720 Olive Street, Room 1520
St. Louis, MO 63101
Telephone: (314) 342-0532
Fax: (314) 421-1979
Email: mpendergast@lacledegas.com
rzucker@lacledegas.com

Certificate of Service

The undersigned certifies that a true and correct copy of the foregoing pleading was served on the General Counsel of the Staff of the Missouri Public Service Commission and the Office of Public Counsel on this 5th day of March, 2007 by United States mail, hand-delivery, email, or facsimile.

/s/ Michael C. Pendergast