Exhibit No.:	
Issues:	
Witness:	Thomas A. Shaw
Sponsoring Party:	MO PSC Staff
Type of Exhibit:	Direct Testimony
Case No.:	GC-98-335

MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

DIRECT TESTIMONY

OF

THOMAS A. SHAW, CPA

MISSOURI GAS ENERGY

A division of

SOUTHERN UNION COMPANY

CASE NO. GC-98-335

Jefferson City, Missouri
February, 1998

DIRECT TESTIMONY

OF

THOMAS A. SHAW, CPA

MISSOURI GAS ENERGY

CASE NO. GC-98-335

Q. Please state your name and business address.

A. Thomas A. Shaw. My business address is 3675 South Noland Road, Suite 100, Independence MO 64055.

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

A. I am employed by the Missouri Public Service Commission (MPSC or Commission) in the Utility Services Division as Assistant Manager of Accounting.

Q. Please summarize your educational and professional background.

A. I hold a Bachelor of Science degree in Business Administration with an emphasis in Accounting from Central Missouri State University. Additionally, I hold a Certified Public Accountant's license and am a member of the Missouri Society of Certified Public Accountants.

Q. Please explain your responsibilities during your employment with the Commission.

A. I accepted my current position in the Utility Services Division as Assistant Manager of Accounting in March 1997. My responsibilities as Assistant Manager include daily oversight of the operations of the MPSC's Kansas City Office and general supervision, guidance, training, preparation and development of auditors. I am also responsible for active participation in cases before the MPSC which may include the roles of lead auditor and/or coordination responsibilities encompassing the review of work papers, recommendations and testimony of other Staff witnesses.

My initial employment with the MPSC began in October 1985 as a Regulatory Auditor in the Generating Facilities section of the Electric Department and continued until November 1990. My responsibilities during this period included developing methods for estimating short-term customer electric usage, analysis of purchase power opportunities and simulation of electric utility operations through the use of hourly chronological computer dispatching models.

Upon the Commission's reorganization in November 1990, I was transferred to the Rates section of the Energy Department in the Utility Operations Division. Additional responsibilities within the Energy Department included review of natural gas rate design, reliability of natural gas supply, processing PGA filings and general tariff administration for all MPSC-regulated gas and electric utilities.

From October 1993 through November 1996, I was employed as a Regulatory Auditor with the Procurement Analysis Department of the Utility Services Division. My responsibilities during this period included reviewing and analyzing the prudence of amounts charged by local distribution companies (LDCs) through the Purchased Gas Adjustment (PGA) Clause and subsequent reconciliation in Actual Cost Adjustment (ACA) filings. I have also presented testimony regarding the development and implementation of gas cost incentive mechanisms.

Q. Did you participate in a case involving Missouri Gas Energy (MGE or Company) in which an experimental gas cost incentive mechanism was authorized and approved by the MPSC?

A. Yes. Case No. GO-94-318, Phase II established the incentive mechanism MGE is currently operating under. My participation in Case No. GO-94-318, Phase II included the filing of direct, rebuttal and surrebuttal testimony as well as testifying under cross-examination at the hearing held by the MPSC.

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

A. The purpose of my testimony in this case is to provide an overview regarding the background, issues, incentive framework and objectives addressed by the Commission in Phase II of Case No. GO-94-318. I will also provide Staff's opinion as to whether MGE's gas cost incentive mechanism as currently designed is accomplishing the stated goals and objectives of the MPSC.

BACKGROUND

Q. Please explain the origin of Case No. GO-94-318, Phase II.

A. On April 8, 1994 MGE filed a motion based on a Unanimous Stipulation and Agreement of parties to Case No. GR-93-240. Case No. GR-93-240 was the last rate case filed by Western Resources, Inc. d/b/a Gas Service, a Western Resources Company (WRI) prior to MGE's purchase of the Missouri assets (exclusive of WRI's Palmyra service territory) from WRI. According to the terms and conditions of the Unanimous Stipulation and Agreement filed in Case No. GR-93-240, WRI (or MGE as its successor) agreed to make a filing which addressed the continuing necessity of costs being passed through the Purchased Gas Adjustment Clause.

On April 15, 1994 the MPSC issued an Order and Notice which established a prehearing conference. Subsequent to the prehearing conference, the parties to Case No. GO-94-318 jointly filed a list of issues and separately filed statements of position and responses to the recommendations of various parties.

On January 27, 1995 the MPSC issued an Order Establishing Procedural Schedule which separated Case No. GO-94-318 into two phases. The issue framed by the Commission for consideration in Phase II of Case No. GO-94-318 stated:

> Whether MGE's Purchased Gas Adjustment/Actual Cost Adjustment (PGA/ACA) tariff provisions should be modified or eliminated to effectuate a gas cost recovery mechanism where MGE bears financial risk in connection with gas procurement practices in addition to or distinct from the current prudence review mechanism.

The issue presented above was subsequently divided into several subissues to be decided by the Commission.

ISSUES

Q. Please list the issues as identified by the parties in the Hearing Memorandum filed in Case No. GO-94-318, Phase II.

1. Should the PGA/ACA process be eliminated?

2. Should traditional rate case treatment be used in lieu of the PGA and incentive PGA mechanisms?

3. Should the current PGA/ACA process be modified exclusive of an incentive PGA mechanism?

4. Should MGE's minimum filing requirements under the current PGA/ACA process be modified?

5. Are the incentive PGA mechanisms proposed by MGE and Staff legal?

6. Should MGE be required to unbundle services as a prior condition to implementation of any incentive PGA mechanism?

7. If the Commission adopts an incentive PGA mechanism for MGE, should it be the proposal of MGE or Staff?

Q. Please discuss the various positions on the current PGA/ACA process at that time.

A. The positions ranged from considering each company on an individual basis, to retention, modification or elimination of the PGA/ACA process. Certain parties also opined that the PGA/ACA process is single-issue and/or retroactive ratemaking.

Q. What did the Commission determine in respect to the current PGA/ACA process at that time?

A. In its Report and Order in Case No. GO-94-318, Phase II, the Commission determined that elimination of the PGA/ACA process in lieu of addressing natural gas costs during traditional rate cases could be addressed as a single issue. The Commission determined the PGA/ACA process was the only process presented to date that resulted in LDCs maintaining a level of business risk that ensures the financial viability of LDCs while preserving just and reasonable rates. The Commission also determined that the PGA/ACA process is not single-issue or retroactive ratemaking. As of this date, gas costs continue to be addressed through the PGA/ACA process for all Missouri regulated LDCs.

Q. Please discuss the positions presented with respect to whether the PGA/ACA process should be modified exclusive of an incentive mechanism?

A. Both MGE and Staff seemed to agree that the PGA/ACA process at that time could be administered more efficiently and may not provide the proper procurement "signals" to LDCs. MGE believed its proposed incentive mechanism was properly designed and administratively efficient.

In addition to presenting its own incentive proposal, Staff critiqued the Company's proposal and recommended the trigger mechanism for filing a PGA change be increased to 2% to 5% of total gas costs. The trigger mechanism specified a minimum change in annualized gas costs that must be exceeded prior to MGE requesting a change in its PGA factor. Staff believed increasing the trigger mechanism would reduce the number of PGA filings addressed by the Commission.

Q. What did the Commission determine with respect to modifying the PGA/ACA process exclusive of an incentive mechanism?

A. The Commission determined Case No. GO-94-318, Phase II was not the appropriate docket to implement changes in the threshold amount required to trigger a change in PGA factors. The Commission found the purpose of Case No. GO-94-318, Phase II was to consider fundamental changes to the PGA/ACA process in relationship to the prudence review mechanism. The Commission stated the PGA threshold issue was one of "mechanical detail" not ripe for a docket dealing with the broad policy issue regarding a fundamental modification to the PGA/ACA process.

Q. Has the Commission subsequently addressed the number of PGA filings for MGE?

A. Yes. As a result of Case No. GC-97-409, MGE currently may not change its estimated PGA factor more than three times a year.

Q. Please discuss the positions presented regarding minimum filing requirements.

A. Staff believed certain information being filed prior to the ACA period to be reviewed would limit Company arguments that the ACA process presents the opportunity to perform "after-the-fact" prudence reviews. MGE stated Staff has the ability to access all relevant data and additional filing requirements were not necessary nor desirable.

Q. What did the Commission determine with respect to additional information being filed prior to the ACA period under review?

A. The Commission ordered MGE to file information relevant to gas supply reliability data prior to the next ACA period beginning. The Commission was concerned that a gas cost incentive mechanism had the potential of causing MGE to modify its purchasing strategy too much in favor of short term supply and, thus, potentially jeopardizing reliability.

Q. What did the Commission determine in regards to whether it could force MGE to implement a financial incentive mechanism which the Company did not desire to implement?

A. The Commission determined it had the lawful authority to order MGE to enter into a financial incentive mechanism other than the one proposed by MGE so long as the decision results in setting just and reasonable rates based on competent and substantial evidence. The Commission stated it had no interest in forcing MGE to implement a financial incentive mechanism the Company did not want to implement. The Commission found it had an interest and obligation to establish the reasonable characteristics of a financial incentive mechanism.

Q. What did the Commission determine with respect to whether services should be unbundled prior to implementing an incentive PGA mechanism?

A. The Commission determined there was no logical connection between requiring the unbundling of services and the implementation of a gas cost incentive mechanism.

Q. What did the Commission determine in regards to whether the proposal of MGE or Staff should be adopted?

A. The Commission adopted MGE's proposed incentive mechanism "framework" for an incentive mechanism and authorized implementation of such proposal assuming certain modifications were made. MGE's current incentive mechanism "framework" is discussed in more detail in the following section.

INCENTIVE FRAMEWORK

Q. Please explain the incentive framework proposed by MGE in Case No. GO-94-318, Phase II.

A. MGE proposed that a benchmark based on historical gas supply purchases be established, with a corresponding tolerance zone, and upper and lower sharing grids. Under MGE's proposal, if natural gas procurement costs were determined to be in the upper or lower sharing grids, the Company would share in 50% of the increase (loss) or decrease (gain) in costs, respectively, up to a specified level. MGE's proposal of "sharing" changes in gas costs provided the Company with financial rewards not otherwise available under the traditional PGA/ACA process of dollar-for-dollar pass-through. Under MGE's proposal, if natural gas procurement costs were determined to be within the tolerance zone, the traditional PGA/ACA process of dollar-for-dollar pass-through would apply. Furthermore, MGE's proposal provided that an ACA prudence review of natural gas procurement costs would not occur if the Company's actual procurement costs are below the ceiling of the upper sharing grid.

Q. Please explain MGE's proposal regarding the benchmark calculation.

A. MGE proposed the benchmark be calculated based on historical purchases assuming a weighted average spot market index of 70% Williams Natural Gas (WNG) and 30% Panhandle Eastern Pipe Line Company (PEPL). MGE proposed a tolerance zone of four percent be established above the benchmark determination.

Q. Of what importance is the benchmark and sharing grids?

A. Due to the magnitude and volatility of natural gas costs, the starting point (i.e. benchmark) and sharing grids for measuring changes in costs is critically important. Even a small percentage change in the benchmark and/or sharing grids would have a significant impacts on MGE and its customers.

Q. Please explain.

A. Based on MGE's monitoring report for the first year of the incentive mechanism (July 1, 1996 through June 30, 1997), a one percent reduction in the benchmark would have reduced the Company's annual benchmark gas costs by more than $1.5 million. Thus, MGE's procurement "savings" (i.e. profit) during the first year of the incentive mechanism would correspondingly have been reduced by more than $750,000.

Q. Does the volatility of natural gas also affect the calculation of "sharings" under MGE's current incentive mechanism?

A. Yes. MGE's benchmark, tolerance zone and sharing grids are based on spot market indices of natural gas. Therefore, changes in spot market gas costs either increase or decrease the benchmark on a continuing basis.

Q. Would you please provide an example of this volatility?

A. Yes. Based on the initial monitoring report filed by MGE (July 1, 1996 through June 30, 1997) under the incentive mechanism, the Company's actual weighted average benchmark was $2.7706/MMBtu. A five percent change in the weighted average spot market indices (decrease to $2.6387/MMBtu or increase to $2.9092/MMBtu respectively) would affect MGE's sharings by more than $200,000 without any change in contract mix.

Q. Did the Commission determine that natural gas costs were both "significant" and "volatile" during Case No. GO-94-318, Phase II?

A. Yes. The MPSC specifically determined that "...the spot market price of natural gas fluctuates significantly" and "...approximately 60 percent of the expenses of a typical Missouri LDC are expenses that the LDC incurs to purchase natural gas..."

Q. Does MGE have the ability to "control" the spot market cost of gas?

A. No. This fact was recognized by all parties to Case No. GO-94-318, Phase II.

Q. Did Staff present testimony in Phase II of Case No. GO-94-318 which indicated MGE was purchasing natural gas at premiums below the specified benchmark?

A. Yes. Assuming three adjustments were made, Staff believed MGE's actual annual premium was 3.85 percent of the weighted average spot market index proposed by the Company.

Q. Please explain Staff's recommended adjustments to MGE's proposed benchmark premium.

A. Staff proposed the following adjustments in Case No. GO-94-318, Phase II:

1. Costs resulting from the Wyoming Tight Sands (WTS) contracts should not be included in the calculation of the benchmark or savings.

2. Costs resulting from the renegotiated Oxy contract which was the subject of pending ACA dockets should be adjusted.

3. Historical purchases from the Mid-Kansas Partnership (MKP) contract should be adjusted to reflect the premium currently being paid.

Q. What was the resolution of Staff's proposed adjustments?

A. The MPSC ordered that costs associated with the WTS gas supply contracts were not to be included in the determination of sharings. In regards to the renegotiated Oxy contract, MGE's tariff sheets submitted for Commission approval stated the procurement costs would be "delivered-to-pipe" prices. Therefore, transportation costs that were previously included in Oxy's gas supply invoices are not included in the sharings calculations. Staff's recommendation regarding the MKP contract was not addressed.

Q. Please explain why adjusting the historical MKP premiums was necessary in Staff's opinion.

A. The Staff's recommended adjustment to the MKP contract reflected known and measurable reductions in premiums that would be paid by MGE on a going-forward basis. Staff quantified the impact of this known and measurable change in Schedule 1 attached to my rebuttal testimony in Case No. GO-94-318, Phase II based on MGE's historical purchases under the MKP contract. As demonstrated in my Schedule 1 in Case No. GO-94-318, Phase II, MGE had negotiated a reduction in premium, in addition to a change to a more favorable spot market index, which had the affect of significantly lowering procurement costs under the MKP contract on a going-forward basis. This reduction in premium and associated index was calculated to exceed $1.5 million annually during the period under review.

Q. Did Staff also believe MGE had the ability to achieve even further gas cost reductions that were not included in the proposed $1.5 million adjustment related to the MKP contract?

A. Yes. In addition to the changes in procurement costs, Staff also informed the Commission that MGE had the ability to "economic dispatch" the MKP contract. Economic dispatch provides MGE the ability to either increase or decrease purchase volumes based on the costs of alternative suppliers. Previously, MGE had been required to purchase contractually specified monthly volumes of natural gas from MKP without regard to price. With this change to economic dispatch, Staff informed the Commission that MGE "should be able to obtain equal or lower prices for the historical MKP purchases included in the adjusted benchmark premium."

Q. In addition to the reduction in premium, did Staff also have other concerns regarding the MKP contract?

A. Yes, MGE's proposed incentive mechanism did not address transportation charges. Staff stated that transportation charges are particularly important when determining the "delivered" cost of gas. Staff believed, "...situations can arise where the wellhead cost of gas would allow MGE to recognize a gain even though the ultimate delivered cost to customers would increase."

Q. Is another transportation pipeline and source of gas supply currently available to MGE which is not addressed by the incentive mechanism?

A. Yes, Staff witness Mr. David M. Sommerer will be presenting testimony on the Pony Express Pipeline which is now being utilized by to MGE. The Pony Express Pipeline is connected to a historically low cost production basin which is not factored into MGE's current incentive mechanism.

Q. Was the information regarding the Pony Express Pipeline known or available to Staff during the Case No. GO-94-318, Phase II time period?

A. No.

Q. In Case No. GO-94-318, Phase II, did Staff express concern using MGE's proposed weighted average spot market indices for determining the benchmark?

A. Yes. At page 4 of my rebuttal testimony in Case No. GO-94-318, Phase II, Staff advised the effect of shifting transportation volumes from WNG to PEPL would cause gas costs to increase assuming everything else held constant. This testimony further stated, "If MGE does implement a procurement strategy which shifts a portion of its historical transportation volumes from WNG to PEPL, I would hope that total annual gas costs do not increase because of the change in pipeline suppliers. However, under MGE's proposed incentive mechanism, **the impact of changes in pipeline suppliers or services is not addressed.**" (Emphasis added)

Q. Did MGE propose the 70% WNG, 30% PEPL weighted average spot market index?

A. Yes. MGE witness Langston testified that "over the long term", MGE anticipates 30 percent of the annual volumes consumed within the Missouri distribution system will flow through PEPL.

Q. Has MGE's representation regarding transportation volumes flowing through PEPL materialized?

A. No, the Pony Express Pipeline has displaced PEPL volumes. Staff witness Sommerer's direct testimony will address this in greater detail.

Q. Did MGE's incentive mechanism proposal include other areas in addition to the gas supply premium?

A. Yes, MGE also proposed a capacity release incentive mechanism which was approved by the Commission.

Q. Please explain MGE's proposed incentive mechanism relating to capacity release.

A. MGE proposed to retain the following percentages of capacity release revenues each ACA period:

1. 50% of the first $200,000.
2. 40% of the next $200,000.
3. 30% of the next $200,000.
4. 20% of the next $200,000.
5. 10% of amounts in excess of $800,000.

Q. What was Staff's position regarding an incentive capacity release mechanism?

A. Staff supported MGE's incentive capacity release proposal. Staff believes that determining the maximum capacity release revenues available during any period is difficult to ascertain during the normal PGA/ACA process. Therefore, Staff believes a capacity release incentive which provides LDCs the opportunity to share in increased capacity release revenues for items within its control is desirable.

OBJECTIVES

Q. Please identify the goals and/or objectives identified by the Commission in its Report and Order in Case No. GO-94-318, Phase II.

A. The Commission identified the following as goals and/or objectives when authorizing MGE's proposed gas cost incentive mechanism, as modified:

> 1. The benchmark should be set which provides an equal likelihood of achieving results in the upper and lower sharing grids.
> 2. An implicit assumption is that the mean of the probability distribution for results should be at the benchmark level.
>
> 3. The benchmark should be set in a manner so that the most likely level of gas costs is equal to the benchmark plus one-half of the tolerance zone.
>
> 4. The approach makes it equally likely that MGE shareholders will gain or lose under the plan.
>
> 5. This is an experimental program, new and useful information should come about in the course of utilizing the gas cost incentive mechanism.

Staff agrees with the goals and objectives as identified by the Commission in Case No. GO-94-318, Phase II.

ACCOMPLISHMENT OF STATED OBJECTIVES

Q. Does Staff believe MGE's current gas cost incentive mechanism is accomplishing the stated goals and objectives of the MPSC?

A. No.

Q. Please explain.

A. Staff does not believe MGE's incentive mechanism as currently designed achieves balance and symmetry between the interests of ratepayers and shareholders. MGE's current incentive mechanism provides the Company an opportunity to profit from changes in market conditions which it does not control. In fact, Staff believes changes in market conditions have rendered the likelihood of financial risk to MGE under the current incentive mechanism virtually nonexistent while allowing the Company to reap windfall profits.

Q. Has Staff identified areas of disagreement regarding MGE's current incentive mechanism for Commission resolution?

A. Yes. Upon review of MGE's initial monitoring report, the Staff Recommendation in Case No. GO-96-243 identified areas of disagreement regarding the Company's current incentive mechanism. The Commission held an on-the-record presentation and subsequently established a prehearing conference intended to establish a process to resolve these areas of disagreement.

Q. Was a process established to resolve these areas of disagreement regarding MGE's current gas cost incentive mechanism?

A. No, Staff's complaint in this case is that process. Staff believes it has a duty and obligation to inform the Commission whether MGE's current gas cost incentive mechanism is accomplishing the goals and objectives of the MPSC. Staff believes the Commission has the right, interest and obligation to establish the reasonable characteristics of a financial incentive mechanism that provides just and reasonable rates. Staff does not believe these goals are being accomplished under MGE's incentive mechanism as currently designed.

SUMMARY

Q. Would you please summarize your direct testimony?

A. MGE's incentive mechanism is the result of commitments made in Case No. GR-93-240 (WRI's last rate case in Missouri) to address concerns whether the PGA/ACA process should be modified or eliminated. Due to the magnitude and volatility of natural gas costs, the MPSC determined in Case No. GO-94-318, Phase II that the PGA/ACA process should not be eliminated. The Commission further stated it had no desire to force MGE to implement a financial mechanism which the Company did not want. Therefore, the MPSC authorized and approved an experimental gas cost incentive mechanism under which MGE is currently operating.

Staff does not believe MGE's current incentive mechanism is accomplishing the stated goals and objectives of the MPSC. Therefore, Staff recommends the Commission terminate MGE's incentive mechanism. Staff believes termination of MGE's incentive program and a return to the traditional PGA/ACA process is the proper regulatory policy to address the appropriate balance between the Company's ratepayers and shareholders at this time.

Q. Does this conclude your direct testimony?

A. Yes.

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

STAFF OF THE MISSOURI PUBLIC SERVICE COMMISSION, COMPLAINT,	)	
vs.	)	Case No. GC-98-335
THE MISSOURI GAS ENERGY DIVISION OF SOUTHERN UNION COMPANY, RESPONDENT.	)	

AFFIDAVIT OF THOMAS A. SHAW, CPA

STATE OF MISSOURI)
) ss.
COUNTY OF COLE)

Thomas A. Shaw, CPA, is, of lawful age, on his oath states: that he has participated in the preparation of the foregoing Direct Testimony in question and answer form, consisting of 18 pages to be presented in the above case; that the answers in the foregoing 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.

Thomas A. Shaw

Thomas A. Shaw, CPA

Subscribed and sworn to before me this 20th day of February, 1998.

Roberta A. McKiddy

Notary Public

My Commission Expires: ROBERTA A. McKIDDY
Notary Public, State of Missouri
County of Cole
My Commission Expires 09/11/99