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July 23, 2001

Mr. Dale Hardy Roberts
Secretary/Chief Regulatory Law Judge
Missouri Public Service Commission
200 Madison Street, Suite 100
Governor Office Building
Jefferson City, MO 65101

Ameren

Re: MPSC Case No. GT-2001-329

Dear Mr. Roberts:

Enclosed for filing on behalf of Union Electric Company, d/b/a AmerenUE, in the above matter, please find an original and eight (8) copies of its Initial Brief.

Kindly acknowledge receipt of this filing by stamping a copy of the enclosed letter and returning it to me in the enclosed self-addressed envelope.

Very truly yours,

Thomas M. Byrne

Thomas M. Byrne
Associate General Counsel

TMB/dla
Enclosures

cc: MPSC General Counsel
Office of the Public Counsel

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Laclede Gas Company's Tariff Filing to Implement an Experimental Fixed Price Plan and Other Modifications to Its Gas Supply Incentive Plan.	))))	Case No. GT-2001-329

INITIAL BRIEF OF AMERENUE

COMES NOW Union Electric Company d/b/a AmerenUE ("AmerenUE") and, in accordance with the briefing schedule ordered by the Missouri Public Service Commission ("Commission") in this proceeding, hereby files its Initial Brief.

A. Introduction.

AmerenUE has played a relatively limited role in this proceeding. It has not taken a position on any of the specific elements of Laclede Gas Company's ("Laclede") proposed Gas Supply Incentive Plan ("GSIP"). However, because this proceeding requires the Commission to consider broader issues concerning the use of incentive plans to encourage gas utilities to make optimal use of their gas supply assets, the Commission's decision is likely to affect all gas utilities in the state. As a consequence, AmerenUE will take this opportunity to provide its view of what the evidence in this case suggests about the general efficacy and appropriate design of incentives in the gas supply area for Laclede, as well as other utilities in the state.

AmerenUE has only two points to make in this brief. First, the evidence presented in this proceeding clearly shows that properly designed incentives in the gas supply area can and do provide significantly greater benefits to customers than the Commission's traditional practice of reviewing gas supply related decisions for imprudent actions in after-the-fact audits. The public interest will not be served by abandoning the use of incentives at this point and reverting to traditional regulation of the gas supply function. Second, the "Possible Incentive Feature" proposed by the Commission Staff beginning on page 27 of the Rebuttal Testimony of Staff Witness Robert E. Schallenberg is an inappropriate, unworkable and unreasonable approach to incentives which would not benefit consumers. Whatever the outcome of this proceeding, the Commission should not adopt the "Possible Incentive Feature" approach. Each of these issues is addressed in detail below.

B. Argument

1. Gas Supply Related Incentives Provide Greater Benefits to Customers Than Prudence Audits.

AmerenUE strongly believes that properly designed incentives can and do provide consumers with significantly greater benefits than the Commission's traditional process for evaluating gas supply activities, whereby the Staff attempts to review each separate decision for "prudence." Properly designed incentives have many positive qualities. They align the interests of utility shareholders and customers—when gas costs are minimized or gas supply related revenues maximized, both shareholders and customers benefit. Conversely, losses can be shared by both shareholders and customers. (Tr. p. 683.) Incentives also minimize the need for day-to-day supervision of the utility's operations by the Commission or its Staff. Once the parameters of the incentive program are established, the Company's profit motive provides strong incentive for the utility to make optimal gas supply decisions. There is no need for a centralized, command-and-control regulatory process in Jefferson City, or for the Commission or its Staff to attempt to micro-review every decision made by the utility in the course of managing its gas supply function. Finally, incentives in the area of gas supply are desirable because they afford the gas utilities an opportunity to earn money through efficient management of the most significant portion of their costs. Under a properly designed incentive plan the gas supply function would provide both risk for a utility and a commensurate opportunity to enhance earnings when gas supply related savings are achieved for customers.

Based on the record in this proceeding, it is clear that Missouri gas customers have in fact benefited from incentive plans. Laclede has presented exhaustive evidence of incremental savings and revenues attributable to their GSIP which have directly reduced gas costs for their customers. In addition, they have provided detailed descriptions of specific beneficial gas supply practices that they have implemented as a direct result of their incentive program. (*See* Exh. No. 5, pp. 1-10.) Even the Staff has acknowledged that some benefits have resulted from incentive plans. For example, Staff witness Schallenberg testified that "tremendous improvements" on the part of AmerenUE were a significant factor which led the Staff to recently agree to the renewal of AmerenUE's more limited incentive plan. (Tr. p. 1221.)

The benefits of a properly designed incentive program are particularly apparent when compared to the significant deficiencies of the traditional system, whereby all gas supply related decisions are reviewed for prudence. Perhaps the most obvious problem with the traditional system is it focuses the utility's attention on simply avoiding mistakes in managing gas supply assets that could be deemed imprudent in the after-the-fact audit, rather than on optimizing gas supply costs for customers. As a consequence, gas utilities are sometimes very reluctant to take any risks in performing their gas supply function for fear that they will be penalized by a prudence adjustment if the risk ultimately results in higher gas costs. This understandable risk aversion makes the utilities act like a football team using a "prevent" defense to protect a lead late in the game. They avoid having touchdowns scored against them (in the form of major gas supply mistakes), but by being completely risk averse, they may fail to optimize gas costs for their customers.

Evidence of this phenomenon was replete throughout the record in this proceeding. Mr. Neises, Laclede's Senior Vice President in charge of gas supply matters, testified as follows:

> The critical thing you need to understand, particularly with respect to gas procurement, is that an incentive program changes the decision tree. Let me explain what I mean by that. That in the old prudence review, the old command and control kind of regulation, what happens is the utility fundamentally takes the safe route. It won't take any risk, because why should it take risk? There's nothing in it for the utility, so take the safe route. Nobody can—nobody can second guess you, because if you don't, you're going to have—you're going to have a prudence review and somebody's going to be there with a stick and take it out of your hide if things go wrong. But when you get rid of that approach and you go to the incentive approach, it changes the decision tree. Now I know that I can take a certain degree of risk, measured risk, and I'm going to be rewarded for it. And in the event I'm wrong, I'm going to have to pay something. (Tr. pp. 423-424.)

Mr. Jaskowiak, Laclede's Manager of Gas Supply, confirmed the observation that gas companies tend to act very conservatively under traditional prudence review. (Tr. pp. 637-638, 647.) He also pointed out that it is virtually impossible to discover overly conservative behavior in an audit, or support an adjustment to gas supply costs based on such behavior. (Tr. p. 648.) After all, acting conservatively in acquiring gas supplies is not imprudent; it just limits the utilities in their efforts to manage risk and obtain the best gas supply costs for their customers. The bottom line on this issue is that proper management of a gas supply portfolio sometimes requires a utility to take measured risks to achieve the best performance, and the traditional system of prudence reviews discourages this risk taking.

A second significant deficiency with the traditional method of regulation is that it requires the Commission Staff to undertake the extremely difficult, and perhaps even impossible task of auditing literally thousands of gas supply related decisions made by the utility in dynamic and constantly changing markets. At any given minute of the day, gas supply executives are confronted with dozens of options to buy and use various combinations of gas supply and pipeline transportation capacity, sell unused pipeline transportation capacity through the capacity release market, make off-system sales of gas, utilize gas storage fields in various ways and make numerous other decisions. Increasingly complex pricing structure alternatives for gas supply packages add another dimension to this mix. How is it possible for Staff auditors to determine, a year or 18 months after the fact, whether a utility's decision to release a certain package of pipeline capacity at a certain price to a certain customer was the best decision it could make, given the myriad of alternatives available at any given time? How can auditors determine if a particular transportation discount was the best discount that could be obtained on a particular pipeline at a particular time? The answer is that they can't. In fact, it is virtually impossible to make such determinations in an after-the-fact audit, particularly when pipeline discounts, capacity release and off-system sales are involved, as Mr. Neises testified. (Tr. p. 472.) The Staff itself has acknowledged the inherent difficulty of prudence audits. Staff witness Sommerer testified: "...it's been my experience that prudence issues are difficult. They're difficult to litigate. They're difficult to carry forward." (Tr. p. 1008.)

Staff auditors face other problems in conducting such audits. One is that typically none of the Staff auditors have any direct experience participating in the markets that are the subject of their audits. That makes it doubly difficult for them to second guess the gas supply decisions of experienced utility personnel in this area. In addition, because gas costs constitute a high percentage of many gas utilities' cost of service, any imprudence adjustment that forced a utility to absorb even a small portion of gas costs could more than offset the entire net income of a gas only utility, such as Laclede. (Exh. No. 2, p. 20.) The effect of such an adjustment on the overall financial health of a combination utility, such as AmerenUE, would be less drastic, but it would significantly affect the financial results for AmerenUE's gas operations.

As a consequence of all of the foregoing, the Staff engages in a massive paper chase in every ACA audit. The Staff submits several rounds of data requests seeking information on every consideration that went into gas supply decisions made over the course of the period being audited. (Tr. p. 1005.) Utility gas supply personnel have to spend a large portion of their time answering data requests and creating documents memorializing considerations which went into their decisions for no other purpose than to satisfy the Staff. The Staff becomes frustrated when the documents that the utility has do not fully explain every consideration that went into every gas supply decision, so that the Staff can audit those decisions. (Exh. No. 16, p. 22; Tr. p. 1011.) This process consumes a great deal of all of the participants' time, and accomplishes little or nothing in the way of ensuring gas costs are optimized for customers. In fact, because it consumes significant amounts of time of utility gas supply personnel, it arguably diminishes utilities' ability to optimize gas costs.

It is important to point out that the deficiencies in the current process are not the fault of the Commission, the Staff or the utilities. This process evolved in an environment where gas prices were regulated from the wellhead to the burner tip. (Tr. pp. 48-50.) Now that significant deregulation of both natural gas supply markets and pipeline charges has been implemented, and dynamic, competitive markets have emerged, in AmerenUE's view, properly designed financial incentives have become the best method for ensuring that gas supply cost and revenues are optimized for customers.

2. Staff's "Possible Incentive Feature" Should Not Be Adopted Under Any Circumstances.

The Staff has proposed a possible incentive program in this proceeding that AmerenUE believes should not be adopted under any circumstances. Under the Staff's proposal, incentives would be provided to the top four gas "districts" in the state of

Missouri based on the percentage reduction in the delivered gas cost from the previous year. No incentive would be provided to anyone in years when gas costs increased. (Exh. No. 16, pp. 27-30.)

This proposal is a bad idea for several reasons. First of all, gas utilities should not be compared to each other in a contest for gas supply related incentives. If all utilities performed badly in a particular year it would be illogical to provide incentives to the four least bad performers. Conversely, if more than four utilities met goals to lower gas costs to the benefit of their customers, there is no reason to arbitrarily limit the incentives to the top four districts. Contrary to the implicit assumption in Staff's proposal, the use of incentives is not a zero sum game with winners and losers each year. A properly designed program can benefit all consumers and utilities in the state by aligning their interests in obtaining the lowest possible gas costs consistent with reliable service.

The Staff proposal is also deficient because it attempts to compare the gas costs for utilities with very different customer bases and supply portfolios. As was pointed out repeatedly in this proceeding, the various local distribution companies ("LDCs") in the state, and their districts, have different customer load characteristics, different pipeline suppliers and different gas supply sources accessed by those pipelines. Any direct comparison among LDC gas costs is sure to be an apples to oranges comparison. (*See* Tr. pp. 992-999 for a complete litany of the relevant differences among gas utilities.) The Staff does not use industry comparisons to measure management efficiency in other contexts (Tr. p. 1226), and there is no good reason to start this practice for gas supply costs.

These problems are not overcome by the fact that the Staff's proposal only considers the <u>change</u> in gas costs from one year to the next. Year-to-year differences in conditions, such as changes in gas costs for a particular producing region, or capacity constraints on particular pipelines are factors outside of the control of the LDCs which will impact them differently. (Tr. pp. 992-999.) The fact is that comparing the change in LDC gas costs from year to year is and always will be an apples to oranges comparison.

Staff's proposal is also unreasonable because it punishes utilities that perform well in the "base year" and rewards those that perform poorly in that year. As Staff witness Sommerer testified, last winter AmerenUE was able to keep its purchased gas adjustment rate more stable than either Laclede or MGE and at a lower overall rate. (Tr. p. 1027.) It would be unfair and illogical to punish AmerenUE for its success last winter, as Staff's proposal would. Even worse, in future years, the Staff's proposal would provide all LDCs with the perverse incentive to allow gas costs to increase in any year that they know they will not be participating in the incentive, so that they can maximize the reduction in gas costs they can show the following year. Although any responsible LDC would not take such an approach, the Commission should not adopt a proposal which would reward such behavior.

The comparison of utility gas costs in a contest to determine winners and losers is also unworkable because it would result in the same type of discovery disputes that plagued the early part of this proceeding. LDCs who were "losers" in the contest for incentives each year would expect to see, and be entitled to see, proof that the reduction in gas costs of the "winners" actually was greater than their reduction in gas costs. In order to make this determination, the losers would want to analyze gas contract and volume information that all LDCs consider to be highly confidential.

In addition, the Staff's proposal is deficient because it would limit the award of incentives to years when current gas costs were lower than historical gas costs. (Exh. No. 16, p. 29.) Natural gas is a commodity traded in a free market, and as a result, gas costs prevailing in any particular period bear no relationship whatsoever to historical costs. If current gas costs, which were approximately $3.75 per MMBtu at the time of the hearing (Tr. p. 1065), are compared to the average gas costs prevailing over the last five years, the current costs would be considered high. (Exh. No. 5, p. 12.) However, when compared to the gas prices prevailing last winter, which were in excess of $10 per MMBtu in the daily spot market (Tr. p. 722), current gas costs would be considered low. It is unreasonable to tie the application of an incentive to the fortuity of whether current gas costs are at or above the prevailing level in any particular historical period, as the Staff's proposal does. Moreover, by eliminating incentives in any period where gas costs rise above historical levels, the Staff would be casting aside this important tool for reducing gas costs at the very time when it is most needed to protect consumers.

Finally, Staff's proposal should be rejected because it was developed without the necessary input from the natural gas industry (Tr. p. 1161), other interested government agencies (Tr. p. 1157), or even the task force that the Commission recently commissioned to study the whole area of gas cost recovery. (Tr. p. 1157.) Because the Staff did not obtain input from these important stakeholders, the Staff's proposed incentive, which would be applicable not just to Laclede but the entire gas industry, should be rejected.

AmerenUE also objects to another aspect of Staff's proposal—the Staff's apparent belief that benchmarks contained in incentive programs must be continuously ratcheted up, or re-based, to reflect the utility's latest and best performance. (Exh. No. 5, p. 10.) If the utility's performance does not exceed this ever-rising bar, Staff believes it should not be provided any incentives related to its gas supply function.

AmerenUE believes that if benchmarks are constantly ratcheted in this manner, in short order their ability to influence LDC behavior will be completely eliminated. Consider another sports analogy. If a baseball pitcher is provided a financial incentive in his contract to win 15 games in a season, he will be encouraged to work hard to win at least 15 games. But if after each season in which he exceeds the benchmark, the number of games he must win is increased, the incentive will soon cease to have any impact on his behavior. At some point, perhaps when the benchmark requires him to win 23 or 24 games, the pitcher will realize that he has little or no chance to achieve the benchmark. This is exactly the effect the Staff's ratcheting of benchmarks in the gas supply area will have on gas utilities.

Of course benchmarks should change (up or down) in the unusual circumstance when the rules of the game are materially altered. For example, in the case of the baseball pitcher, the benchmark number of games that he has to win should be changed if a rule change, such as the introduction of the use of designated hitters, makes it easier for a starting pitcher to win a game. Or, in the case of a gas utility, the benchmark for transportation discounts, for example, may need to be rebased if the Federal Energy Regulatory Commission materially changes the rules under which discounts are offered. But the benchmarks should not regularly be rebased simply to reflect a utility's most recent of best performance. They should be set at achievable levels and be left alone.

Finally, AmerenUE disagrees with the Staff's general philosophy that only an incentive plan that addresses the overall cost of gas supplies, and not piecemeal components, should be approved. (Exh. No. 16, p. 8.) AmerenUE currently has a limited incentive program which addresses only capacity release revenues, off-system sales revenues and pipeline discounts. Incentives related to these aspects of gas supply are the easiest to design in a manner that is acceptable to all parties. Although AmerenUE agrees that the best type of incentive would encompass all components of gas supply, in the absence of agreement on an overall incentive, more limited incentive programs can still provide benefits to customers, and they should be used.

C. Conclusion.

For the reasons stated herein, the Commission should endorse the use of gas supply related incentives for gas utilities, and decline the Staff's invitation to adopt its "Possible Incentive Feature."

Respectfully submitted,

UNION ELECTRIC COMPANY
d/b/a AmerenUE

By Thomas M Byrne by mag

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Dated: July 23, 2001

CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing was served via first-class, U.S. mail, postage prepaid, on this 23rd day of July 2001, upon the General Counsel of the Staff of the Public Service Commission, Office of the Public Counsel and all parties of record as shown on the attached service list.

Thomas M Byrne by mag
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