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July 23, 2001

Dale Hardy Roberts
Secretary/Chief Regulatory Law Judge
Missouri Public Service Commission
200 Madison Street, Suite 100
P.O. Box 360
Jefferson City, Missouri 65102

FILED[2]
JUL 23 2001
Missouri Public
Service Commission

RE: *Laclede Gas Company*
Case No. GT-2001-329

Dear Mr. Roberts:

Enclosed for filing in the above-referenced matter are the original and eight (8) copies of Laclede Gas Company's Highly Confidential Initial Brief. Also enclosed are the original and eight (8) copies of the public version of the Initial Brief. A copy of the foregoing Highly Confidential Initial Brief and public version of the Initial Brief have been hand-delivered or mailed this date to each party of record.

Thank you for your attention to this matter.

Sincerely,

James M. Fischer

James M. Fischer

/jr
Enclosures

cc: Office of the Public Counsel
Dana K. Joyce, General Counsel
Diana M. Vuylsteke
Dean L. Cooper
Thomas M. Byrne

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 LACLEDE GAS COMPANY

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July 23, 2001

NONPROPRIETARY

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INITIAL BRIEF OF
LACLEDE GAS COMPANY

COMES NOW Laclede Gas Company ("Laclede" or "Company") and, pursuant to the briefing schedule established in the above-captioned proceeding, submits the following Initial Brief:

I.
INTRODUCTION/BACKGROUND

The primary issue before the Commission in this proceeding is whether it should continue or abandon its innovative use of financial incentives as a means of ensuring that the Company's gas supply assets are procured and managed in a way that creates optimal and reasonable value for Missouri consumers. Based on the evidence presented in this case, Laclede believes there can be no meaningful dispute as to how that issue should be resolved. Simply put, the Commission should determine, as it has on three separate occasions in the past, that Laclede's Gas Supply Incentive Plan "GSIP", as modified in accordance with the Company's recommendations in this proceeding, is in the public interest and should therefore be continued. The Commission should do so because the GSIP, as proposed by the Company in this case, is the only mechanism presented in this proceeding that:

- has proven to be an effective mechanism for creating additional value for the Company's customers funded through revenue streams from, and discounts by, out-of-state entities -- a fact that has been repeatedly demonstrated, both in this case as well as in Case No. GT-99-303, by detailed and virtually undisputed analyses that have specifically identified and quantified approximately $65 million in additional savings and revenues that have been achieved by Laclede as the result of the GSIP and the Company's superior performance thereunder (Exh. 1, p. 5; Exh. 6HC, pp. 3-10, Schedule 1);
- offers a realistic, workable and concrete plan for obtaining additional fixed price protection for the Company's customers in advance of the next winter heating season (*See* Exh. 2, pp. 20-25; Exh. 6HC, pp. 23-24);

- promises to provide a new and significant source of energy assistance funding for Laclede's most vulnerable customers (Exh. 2, pp. 8-11; Exh. 7, pp. 2-7);

- reasonably compromises the divergent views of the parties in this case in that it reflects the Company's substantial concessions to: (a) reduce by 30% its potential share of any benefits achieved under the GSIP (with an additional 10% reduction associated with the Company's proposal to contribute a share of its earnings to providing low income energy assistance); (b) subject its gas commodity costs to prudence reviews; (c) adopt a modified version of Public Counsel's fixed price proposal; (d) maintain an overall cap on the earnings that the Company may retain under the GSIP as proposed by Staff and Public Counsel; and (e) adopt Staff's proposals relating to the treatment of off-system sales and discounts negotiated with the Company's largest pipeline supplier (Exh. 2, pp. 3-26);

- provides the Company with a realistic opportunity to offset the added costs and risks associated with performing its merchant function of buying, financing and storing gas supplies on behalf of its customers and providing the safety net that permits customers to receive critical gas services even when they cannot afford to pay for them; (Exh. 2, pp. 27-30; Exh. 6HC, pp. 10-11, Schedule 1, Exh. 8, pp. 2-4);

- recognizes that far from permitting it to realize "excess profits", the GSIP has only given Laclede a fighting chance to earn the returns on equity authorized by this Commission, as demonstrated by the undisputed evidence which showed that even with its earnings from the GSIP, the Company did not achieve its allowed return on equity in three of the past four years and without such earnings would have had difficulty even meeting its dividend (Exh. 8, pp. 2-4); and

- for a modest opportunity to retain earnings at a capped level that is equal to a few percentage points of the Company overall gas costs, provides the Company with the same financial incentives to lower costs and increase revenues that already apply to dozens of other unregulated firms providing the exact same gas procurement functions as Laclede. (Exh. 14, pp. 61-62).

In view of these considerations, Laclede believes that the Commission should not hesitate to find that continuation of the GSIP is in the interests of Laclede's customers, its shareholders and the public generally. Laclede recognizes, of course, that in making that determination, the Commission must evaluate not only the claims made by the Company regarding the merits and impact of the GSIP, but also the contentions that have been made by the other parties on that score.

To do that properly, Laclede believes it is essential to begin with a discussion of how the GSIP has evolved over time and what the historical record says about the nature and magnitude of the benefits that have been achieved for both the Company and its customers under its auspices. For the same reason, it is also imperative that the Commission have a clear and complete understanding of the regulatory events which preceded the unprecedented increases in wholesale gas prices experienced by Laclede and other LDCs throughout the country last winter.

In the aftermath of that experience, both the Commission Staff ("Staff") and the Office of the Public Counsel ("Public Counsel") have attempted to discredit the GSIP by suggesting that it was somehow responsible for the absence of fixed-price instruments or other measures that could have further mitigated the impact of those wholesale price increases on Laclede's customers. (*See*, e.g. Exh. 18HC, p. 6; Exh. 35; pp. 3-10). Both the historical record and the evidence in this proceeding, however, shows that such assertions are untrue. To the contrary, it is clear that if there was any decisive factor that contributed to the absence of additional price protection last winter, it was the Staff's and Public Counsel's persistent refusal throughout the summer and fall of last year to provide the kind of regulatory assurances that would have permitted the acquisition of market-responsive instruments in advance of the winter heating season. (Exh. 2, pp. 17-19; Exh 6HC, pp. 11-13). Indeed, with only one exception, both Staff and Public Counsel repeatedly opposed the efforts of the state's two largest LDCs to obtain authorizations that would have permitted an expanded or more effective use of call options, fixed price instruments and/or other measures that could have afforded additional price protection. (*Id.*).

Laclede does not know to this day whether such opposition was motivated by an aversion to anything that smacks of pre-approval, a fear of endorsing decisions that might turn out to be unfavorable, or an honest belief that gas prices for the coming winter were likely to fall rather than increase as they ultimately did. Whatever the reason, however, it does not serve the interests of either the Company or its customers to raise their rates by destroying an incentive Plan that, as discussed below, has created tens of millions of dollars in benefits for utility consumers on the pretext that it was responsible for events that, if anything, were preordained by the actions of its opponents.

A. Origins and Initial Structure of the GSIP

The initial GSIP originated as a part of a stipulation and agreement that was approved by the Commission in the Company's 1996 rate case proceeding, Case No. GR-96-193. (Exh. 1, p. 3). At the time the GSIP was approved, the natural gas industry in Missouri and throughout the country had undergone a fundamental restructuring. In the past, LDCs like Laclede had purchased gas for all of their customers from interstate pipelines at rates that were regulated by the Federal Energy Regulatory Commission ("FERC"). (Exh. 24, p. 10). Under that structure, it was the pipelines, rather than the local gas utility, that had the responsibility to procure, finance and transport the gas supplies to the LDC's city gates, to ensure that such supplies were reasonably priced and adequate to meet their LDC customers' needs, and to basically oversee all of the other major elements associated with such functions. (*Id.*).

By 1996, however, this traditional structure had changed and changed dramatically. As a result of various initiatives at the federal level, including FERC Order No. 636 LDCs now had the obligation to procure their own gas supplies and transportation services. (Exh. 24, p. 10). They also had to undertake a myriad of other functions, ranging from nominating gas supply and transportation services on a daily basis to financing the cost of holding gas in storage and coordinating its dispatch with the Company's flowing gas supplies, in order to ensure that natural gas service was available when its customers needed it. (Exh. 24, pp. 10-11). In addition to these structural changes, LDCs also no longer had the exclusive right to sell the gas supplies required by all of their customers. Instead, many of their larger customers were now permitted to purchase their gas supplies and transportation services from unregulated marketers, brokers and integrated energy companies operating in the LDC's service territories. (See Exh. 14, pp. 56-60). These unregulated marketers and brokers were, in turn, permitted to charge whatever the market would bear for their services and, in the process, profit from their successful efforts to obtain or sell gas supplies and transportation services. (*Id.*).

There was one very significant aspect of the LDC's traditional provision of natural gas service, however, that had not changed by 1996 and that remains unchanged today. Specifically, Laclede and other Missouri LDCs continue to have the obligation to provide reliable, dependable gas supplies to all of its residential customers under terms that are rarely, if ever, observed in a competitive marketplace. Among others, these include a continuing obligation to maintain natural gas service to customers, regardless of their ability to pay for such service, whenever temperatures are severe enough (i.e. predicted to drop below 30 degrees) to threaten their health or safety.[1] They also include a continuing obligation to extend extremely favorable credit terms to customers that have difficulty paying for such services – terms that permit their payments for gas service to be spread over many months and even years at no additional cost to the customers.[2] In addition to these measures, LDCs must also follow special notice and service continuation requirements for registered handicapped and elderly customers and any customer with a medical emergency. *See* 4 CSR 240.13.055(3)(D) and 4 CSR 240.13.050(9). In other words, LDCs retained the obligation to provide a safety net for their customers that few if any other firms are ever obligated or expected to provide.

It was within this environment that the GSIP was developed and ultimately approved by the Commission. As originally approved, it had four components to govern the various activities that the Company must undertake to procure and manage its gas supply and transportation assets -- components that were designed to ensure that the Company could extract all of the efficiencies, and exploit all of the opportunities, provided by the new environment.

The first was a gas procurement component to govern the Company's purchase of gas supplies. (Exh. 1, p. 3). In its initial form, this component was based on the incentive procurement structure that had recently been approved by the Commission for Missouri Gas Energy ("MGE"). (*Id.*). In effect, this component permitted the Company to share, within prescribed limits, in any savings achieved as a result of the Company's successful

[1] Under subsection (4)(A) of the Commission's Cold Weather Rule, 4 CSR 240.13.055, gas utilities are prohibited from discontinuing service to residential customers whenever the National Weather Service local forecast predicts that temperatures will drop below 30° F. This prohibition applies regardless of the customer's ability to pay for the service.

[2] Subsections (5) and (8) of 4 CSR 240.13.055, also requires LDCs to enter into payment arrangements that allow their customers to continue to receive service if they agree to pay 1/12 of the amounts they owe and are

efforts to reserve and purchase gas supplies below a predetermined benchmark. (*Id.*). At the same time, the procurement component also required that the Company absorb all or a portion of any increases above a predetermined benchmark. (*Id.*). In exchange for this predetermined retention of savings or absorption of losses, the component provided that the Company's acquisition of gas supplies would be deemed prudent or assumed to be imprudent depending on how its performance compared with the benchmark.

The second component of the GSIP was designed to govern the Company's activities in negotiating what it pays for firm transportation and storage services from its pipeline suppliers. (*Id.*). This firm transportation discount component permitted the Company and its customers to share in savings generated as a result of the Company's efforts to negotiate discounts from the cost of service based transportation and storage tariff rates charged by those pipeline suppliers. The third and fourth components of the GSIP permitted Laclede to share with its customers revenues achieved by the Company from its temporary release of pipeline capacity held by Laclede to brokers, marketers and other non-utility customers or as a result of its efforts to sell gas to off-system customers in the interstate market pursuant to a blanket certificate issued by the Federal Energy Regulatory Commission. (*Id.*).

In addition to these incentive components, the Commission also approved other provisions in conjunction with the GSIP to ensure that Laclede would not sacrifice reliability in its efforts to achieve additional savings and revenues for its customers. Finally, the Commission approved the GSIP for an initial term of three years.

During the ensuing three years, both the legality and reasonableness of the Commission's decision to implement the kind of incentive structure embodied in the GSIP

expected to be charged for utility service. The customer may then pay any remaining amounts over a 12 month budget period or such longer period as the customer and LDC may agree upon. (*Id.*).

were broadly reaffirmed by Missouri courts. Following the Commission's approval of MGE's gas cost incentive plan, Public Counsel and an association of large industrial customers challenged the lawfulness and reasonableness of the Commission's determination that it was appropriate to use incentive provisions to govern a LDC's procurement and management of its gas supply assets. Based on their review of the extensive evidentiary record that had been produced during the proceeding in which the MGE incentive plan was approved, however, both the Circuit Court of Cole County and the Missouri Court of Appeals for the Western District ultimately determined that the Commission's use of such incentive provisions was reasonable and fully consistent with Missouri law. ***Midwest Gas Users' Association v. Public Service Commission,*** 976 S.W.2d 470 (Mo.App. 1998). Indeed, the Court described the gas cost incentive plan approved for MGE as a "cost effective and beneficial" alternative to the traditional method for reviewing gas costs. *Id.* at 482.

B. 1999 Assessment and Continuation of the GSIP

In addition to withstanding judicial scrutiny, the effectiveness of the GSIP's incentive provisions as an instrument of sound public policy was also demonstrated and confirmed during this period. As the expiration of the initial three year term of the GSIP approached, Laclede filed tariffs in January of 1999 to continue the incentive plan with certain modifications. (Exh. 1, p. 3). During the ensuing proceeding that was established by the Commission to consider this tariff filing -- Case No. GT-99-303 -- the Company, as well as all of the other parties, presented extensive evidence regarding the impact that the GSIP had had on the Company's management of its gas supply assets. (Exh. 1, p. 5). Indeed, the evidentiary presentation on this central issue could not have been more thorough, involving as it did extensive discovery, including depositions, three separate rounds of testimony by all of the parties, and three full days of hearings. (*Id*). When all was said and done, the massive amount of evidence presented during the course of Case No. GT-99-303 clearly established that tens of millions of dollars in additional savings and increased revenues had been generated for sharing with the Company's customers as result of the GSIP and the Company's superior performance thereunder, even after the amounts retained by the Company were taken into account. (*Id.*).

The evidence presented in Case No. GT-99-303 showed that a significant portion of these benefits were produced as a result of the Company's successful decisions to take moderate and informed strategic financial risks on behalf of itself and its customers. In each case, these were financial risks that the Company could now take because it was operating under an incentive structure that, in contrast to the old prudence review process, provided clear financial parameters to measure the Company's performance and then reward or penalize the Company depending on the results achieved. With such standards, the Company could now assess beforehand what the specific consequences of its actions would be if it succeeded or failed. The Company could also base its decision solely on what course of action was most likely to benefit it and its customers, rather than what action would most likely pass muster in a subsequent prudence review -- a process where no actions are ever rewarded and the sole focus is on penalizing decisions that fall outside someone's notion of what constitutes "reasonable care". As discussed more fully in subsequent sections, these successful risking-taking actions included, among others:

(1) the Company's successful decisions to lock-in for a multi-year period the demand charges was paying to reserve gas supplies (a strategy that saved $5.9 million when

the market cost to reserve gas supplies subsequently rose as the Company had anticipated) (Exh. 6HC, Schedule 1);[3]

(2) the Company's successful decisions to lock-in for multi-month periods the amounts it was charging to release pipeline capacity (a strategy that produced additional capacity release revenues of $1.3 million when, as the Company correctly anticipated, the market value of such capacity subsequently declined during the locked-in periods) (Exh. 6HC, p. 8; Schedule 1); and

(3) the Company's successful strategy to lower its demand costs by significantly reducing the percentage of its firm gas supplies that had historically been taken by the Company under "swing" and "combination" supply contracts and increasing the percentage of such supplies taken by the Company under "baseload" contracts (a strategy that saved some $2.6 million during the first three years of the GSIP).[4]

The evidence presented in Case No. GT-99-303 also quantified other benefits produced during the first three years of the GSIP that were the result of the kind of innovation, creativity and exceptionally hard work that is inspired when properly designed incentives provide a financial reward for superior performance. These included, among others:

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[3] (Exh. 6HC, Schedule 1). By taking the unusual step of locking-in its demand charges for a multi-year period, Laclede was, of course, taking the financial risk that demand charges might decline below, rather than increase above, the levels that had been locked-in by the Company over this multi-year period. However, since, as Laclede had correctly anticipated, the market cost for reserving gas supplies did, in fact, increase during the locked-in period, Laclede's strategy resulted in millions of dollars in demand cost savings (Exh. 6HC, pp. 7, Schedule 1).

[4] (Exh. 6HC, pp. 5-7; Schedule 1). Because "swing" and, to a lesser extent, "combination" contracts provide an LDC with more flexibility as to when (or even whether) it must take the gas supplies it has contracted for, they generally require the payment of a higher demand charge than "baseload" contracts which typically obligate the LDC to take gas supplies evenly throughout the year. (Exh. 6HC, p. 6). Accordingly, by reducing this flexibility, Laclede managed to save millions of dollars in demand costs.

(1) the Company's successful efforts to negotiate a number of unique and very beneficial supply arrangements under which Laclede was able to purchase significant quantities of gas supplies at below market prices during a time when other companies were paying higher costs for such services (efforts which resulted in additional savings of **$ _______** during the first three years of the GSIP) (Exh. 6HC, p. 7; schedule 1);

(2) the Company's successful efforts to convince Mississippi River Transmission Company ("MRT"), Laclede's largest pipeline supplier, to eliminate its Flexible Contract Demand service and transfer to Laclede a portion of the pipeline capacity that was not being effectively used to provide that service (an effort which permitted Laclede to achieve some $700,000 in savings when the Company subsequently resold that capacity through the secondary market and immediately used the revenues to reduce overall transportation costs to the Company's customers) (Exh. 6HC, pp. 8-9, Schedule 1); and

(3) the Company's superior efforts to negotiate and/or maintain discounts from the rates being charged by its pipeline suppliers for firm transportation services (discounts that were some $20 million in excess of the average level of discounts being achieved by other shippers on the same pipelines) (Exh. 6HC, Schedule 1).

Altogether, Laclede was able to specifically quantify at least $45 million in additional savings and revenues as a result of these various initiatives that had been undertaken by the Company. (Exh. 6HC, p. 4). And as great as these direct benefits were, it is clear from the evidence it presented in Case No. GT-99-303, as well as the evidence in this proceeding, that they represent only a portion of the financial benefits achieved as a result of the GSIP. For example, despite the Company's efforts to quantify the impact of some of the major initiatives undertaken during the first three years of the GSIP, it was simply not possible then, and is not possible now, to identify fully all of the efficiencies that are produced when financial incentives are introduced in a given area. Nor did the Company attempt to capture in its benefits analysis indirect ratepayer savings from the GSIP such as the millions of dollars in reduced rates that customers received as a result of the Company's ability, because of the earnings and savings opportunities afforded by the GSIP, to defer requests for general increases in its base rates. And, of course, the record in Case No. GT-99-303 did not reflect the nearly $19.3 million in additional GSIP-related savings that the Company was able to achieve during the one year period following the conclusion of that proceeding. (*See* Exh. 6HC, Schedule 1).

Even without any consideration of these additional savings, however, the Commission was ultimately able to issue a Report and Order in Case No. GT-99-303 in which it determined that the GSIP should be continued, with certain modifications.[5] In doing so, the Commission properly determined that, based on the extensive evidentiary record that had been compiled in that case, the modified GSIP was "in the public interest." *See **Re:***

[5] Most of these modifications had been proposed by Laclede in an effort to address concerns that had previously been raised by the Staff regarding the structure and operation of gas cost incentive plans or to incorporate certain enhancements that Staff had previously recommended be made to the gas procurement strategies of various Missouri LDCs. (Exh. 1, p. 4). For example, Laclede recommended that the structure of the procurement component of the GSIP be modified so that the Company could not financially benefit merely because gas prices had increased. (*Id.*). It did so by proposing that the demand cost element of the procurement benchmark be changed from one that constantly varied with the price of the Company's wholesale gas supplies to one that would be fixed each year based on a competitive bidding process that utilized requests for proposals from numerous suppliers. (*Id.*). By proposing this change, Laclede was able to address Staff's concerns that the amounts retained by the Company not increase simply because prices had risen and, at the same time, incorporate Staff's previous recommendations that LDCs rely more extensively on competitive bidding procedures when acquiring gas supplies. (*Id.*). In response to Staff's recommendation that LDCs should focus more on the potential use of fixed priced contracts, the Company also proposed that a fixed price component be added to the GSIP to encourage the use of fixed price instruments when market conditions appeared particularly favorable. (*Id.*). Finally, to address a Staff concern that the structure of the GSIP might give utilities a perverse incentive to procure less expensive gas supplies in exchange for procuring more expensive transportation services, Laclede proposed to add a provision that would financially penalize the Company if its overall transportation costs increased because of a change in the mix of its pipeline suppliers. (Exh. 1, pp. 5-6). In addition to adopting these modifications, the Commission also approved other changes, including a proposal by Public Counsel to remove off-system sales from the GSIP and include it in base rates and a proposal to establish a $13 million baseline for the firm transportation discount component of the Company's GSIP.

Laclede Gas Company, Case No. GT-99-303, *Report and Order*, p. 14 (September 9, 1999). Having made this fundamental policy determination, the Commission accordingly extended the term of the GSIP for another year, pending a review of any legislative developments that might lead to a further unbundling of LDC services.

C. The 2000 Extension of the GSIP and Events Relating to the Experience of Last Winter

The GSIP was once again extended in 2000 as the result of the Commission's approval of a Stipulation and Agreement that was filed in April of that year by the Company, Staff and Public Counsel in Case No. GO-2000-395.[6] Pursuant to that Stipulation and Agreement, the GSIP was extended for another year, with several modifications. (Exh. 1, p. 6). These included the imposition of an overall $9 million cap on the amounts that could be retained by the Company for the fifth year of the program and, at the request of the Commission Staff, the exclusion of any rate discounts that might be negotiated by the Company in the interim with its largest pipeline supplier, MRT. (*Id.*).[7] Perhaps most significantly, the parties agreed in the Stipulation to participate in a "good faith effort to negotiate and implement a mandatory fixed rate trigger for gas supply commodity costs, with the understanding that the overall objective [would] be to develop a mutually-acceptable and workable multi-year incentive program." (*Id.*).

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[6] Case No. GO-2000-395 had been commenced by the Commission earlier in the year for the purpose of monitoring the Company's performance under the extended GSIP.

[7] As previously discussed, making such modifications to the GSIP in order to address concerns raised by Staff and Public Counsel was nothing new for the Company. Unfortunately, every change made, whether it be to add a mix of pipeline supplier provision to discourage uneconomic substitutions of gas supplies for transportation, the implementation of an RFP fixed cost demand charge benchmark, or the exclusion of MRT discounts from GISP consideration, only leads to subsequent complaints by Staff and Public Counsel that those features are inadequate as well. Indeed, in describing alleged flaws in the GSIP in his rebuttal testimony, two of the three examples cited by Mr. Schallenberg – namely the exclusion of MRT discounts from GSIP consideration and the transfer of off-system sales revenues to base rates – were GSIP modifications that had been proposed by Staff and Public Counsel, rather than Company. Given this track

The overall objective of developing a workable, multi-year incentive program, as set forth in the Stipulation and Agreement, was an important one. In view of the benefits previously achieved under the GSIP, treating gas cost incentive programs as a conventional and proven mainstay of the regulatory framework, rather than something that needed to be reviewed each year, seemed warranted. (Exh. 1, p. 14). Moreover, one of the important lessons learned from the first three-year term of the GSIP was that additional savings can sometimes be achieved if the time horizon over which gas supply and transportation-related transactions are entered into is extended. (Exh. 1, pp. 14-15). A multi-year program, or one with no fixed termination date at all, would facilitate such transactions by establishing longer-term standards and ground rules to govern the economic consequences of those transactions for the Company and its customers. (*Id.*).

The Stipulation and Agreement's emphasis on pursuing fixed rate triggers also grew in importance as the summer and fall of 2000 progressed. Throughout the spring and summer of 2000, wholesale gas prices ascended to, and remained at, record high levels. In fact, the change in market conditions was radical enough that Laclede had to opt out of the Price Protection Incentive of the Price Stabilization Program in early June of 2000. Laclede did not, however, lessen its efforts to obtain price protection for its customers in advance of the winter heating season. To the contrary, as early as July of 2000, Laclede filed an application with the Commission in which it requested various authorizations designed to address these market developments in a proactive manner. (Exh. 2, pp. 18-19). These included requests to increase the level of funding for its Price Stabilization Program, to relax the minimum volume requirements under the Program so that instruments with lower strike

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record of criticizing their own handiwork, Laclede believes the Commission should view with considerable caution the recommendations that Staff and Public Counsel have submitted in this case.

prices could be purchased, and authorization to use fixed price instruments and costless collars at market responsive prices and pass through the financial benefits and costs of those instruments in their entirety to the Company's customers. (*Id.*).

Except for the elimination of the minimum volume requirement, Staff and Public Counsel consistently opposed the efforts of the Company to obtain such authorizations. The Staff also opposed a request by MGE in the fall of 2000 for Commission authorization to make market responsive modifications to its hedging program in advance of the winter heating season. (Exh. 2, p. 19). In fact, the only form of Commission authorization for fixed price instruments that Staff and Public Counsel *were* willing to consent to during this period was a fixed rate trigger mechanism for MGE, that was filed in the spring of 2000 as part of an overall incentive plan and that would only be triggered if prices declined to an historically-derived average of gas prices.[8]

In short, in the spring of 2000, Staff and Public Counsel both acknowledged and endorsed through filed agreements with the Commission the need to pursue greater rate stability through fixed price or fixed rate mechanisms. They also implemented or agreed to pursue the development of multi-year, gas cost incentive plans for the state's two largest LDCs. Throughout the remainder of 2000, however, as gas prices rose and warnings were sounded by those same LDCs regarding the need to pursue additional price protection measures, both Staff and Public Counsel energetically opposed in practice what they had endorsed in theory, refusing at nearly every turn to support any form of Commission authorization that would have permitted the expanded use of financial instruments. (Exh.

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[8] Even at the time this agreement was filed with the Commission, however, the market price for financial instruments already exceeded by tens of millions of dollars the historically-based, trigger price of $2.25 per MMBtu that was contained in the agreement. (Exh. 6HC, p. 12). Despite these circumstances, however, and the fact that the agreement explicitly permitted the parties to propose an increase in the trigger price in response

6HC, pp. 12-13). And now that the events of last winter have transpired, Staff and Public Counsel have attempted to use the cold weather and high wholesale gas prices that they played such a decisive role in leaving unmitigated last winter as a pretext for eliminating the very kind of workable, multi-year incentive program that they had pledged to work toward. As discussed below, there is simply no justification for eliminating a GSIP that has produced tens of millions of dollars in benefits for the Company's customers, particularly one that, as proposed by the Company in this case, offers the only realistic and concrete alternative for fostering the kind of fixed price protection that will prevent any reoccurrence of the events of last winter.

II.
ARGUMENT ON SPECIFIC ISSUES

(A) Should an incentive mechanism similar in structure to the Company's current Gas Supply Incentive Plan ("GSIP"), an alternative incentive mechanism, or no incentive mechanism, be used in connection with the management of Laclede's gas supply and transportation assets on and after September 30, 2001?

Based on the evidence presented in this proceeding, it is clear that an incentive mechanism similar in structure to Laclede's current GSIP, albeit with certain modifications designed to address the concerns of other parties, should continue to be used to govern the management of the Company's gas supply and transportation assets. As previously noted, Laclede has operated under the GSIP for nearly five years now. Like virtually every other successful economic system and enterprise in the world today, the GSIP is rooted in the proposition that such incentives do, in fact, work to produce additional savings, efficiencies and innovation. Although the basic truth of this proposition has been repeatedly confirmed by Laclede's actual experience under the GSIP, the Staff and Public Counsel have

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to changing market conditions, no such adjustment was ever agreed upon by the parties before the winter and sharply higher prices arrived. (*Id.*). Again, perceptions prevailed over market driven factors.

nevertheless proposed that the GSIP be eliminated in this case. Their preferred approach for accomplishing that goal is to have the Commission reject the GSIP outright in favor of either a return to the old system of evaluating gas costs through retrospective prudence reviews,[9] or the adoption of a new, hybrid review process that, for all intents and purposes, would make the Staff and Public Counsel the ultimate arbiters of how gas supply and transportation services are procured, managed and hedged by Missouri LDCs. And failing an outright rejection of the GSIP, they have proposed to destroy it by alternative means -- namely by recommending arbitrary baselines and benchmarks that are so unachievable that they would render the GSIP unworkable for any purpose, including its use as an incentive mechanism. In short, they have done everything possible to ensure that nothing resembling a workable incentive mechanism is approved for what is by far the largest component of the costs incurred by the Company to render natural gas service.

As discussed below, Laclede believes that such a result would be detrimental to the interests of both its customers and shareholders. At the same time, however, Laclede fully recognizes that no program or plan, including the GSIP, is immune to improvement. And as it has in the past, the Company has made a concerted effort in this proceeding to propose modifications to the GSIP that address in a reasonable manner the concerns and

[9] Staff's and Public Counsel's recommendations for a partial or wholesale return to the old prudence review system is particularly puzzling. As the Court in ***Midwest Gas Users Association,*** *supra,* stated, one of the benefits cited by the Commission in approving incentive plans was to reduce the significant burdens on the Commission and the utility associated with having to conduct prudence reviews of every cost variation, no matter how small. *Id.* at 476. In addition to being burdensome, however, it is clear from the evidence in this proceeding that such reviews are also ineffective. As Mr. Neises testified, there is simply no way through a prudence review to determine whether an LDC has done the best job possible in negotiating pipeline discounts, releasing capacity or making off-system sales revenues. (Tr. 472). Indeed, Mr. Sommerer testified that capacity release and off-systems sales transactions were so numerous, that Staff would probably not conduct any detailed review at all for many of those transactions (Tr. 990-991). And the prudence review process for pipeline discounts is apparently so ineffective and ill-defined that Public Counsel witness Busch could not even recall whether prudence reviews, or some other process, was used to evaluate the reasonableness of such transactions prior to the GSIP. (Exh. 10, pp. 30-37)

recommendations that have been presented in the testimony of Staff and Public Counsel. Specifically, Laclede has proposed or agreed to:

- significantly reduce the overall share of GSIP benefits that it is permitted to retain under the plan and, in the process, equalize those percentages across all elements of the plan (Exh 2, pp. 3, 6-8);

- contribute a significant portion of its already reduced share of any benefits under the GSIP to funding energy assistance for its most vulnerable customers (Exh. 2, pp. 3, 8-11);

- remove off-system sales revenues from base rates and once again include them in the GSIP as proposed by the Staff (Exh. 2, pp. 3, 12);

- maintain an overall cap on the amount the Company may retain under the GSIP as proposed by Staff and Public Counsel – a cap that will also apply to off-system sales revenues (Exh. 2, pp. 3, 13-14);

- add language to the GSIP that would explicitly permit further modifications to be made to the GSIP in the event the Commission ultimately adopts any recommendations from its gas cost recovery task force that are inconsistent with the Plan's provisions (Exh. 2, pp. 3, 14-15); and

- perhaps most importantly given the events of this past winter, significantly alter the gas supply commodity component of the GSIP in order to better ensure that fixed priced instruments can, in fact, be used in coming winters to provide customers with additional protection from any price spikes in wholesale gas supplies. Specifically, the Company proposed to obtain a minimum level of fixed-price instruments equal to 10 Bcf for this coming winter. For future periods, the Company has also proposed to implement a modified version of Public Counsel's proposal for procuring fixed price instruments, subject to the limitation that the Company losses from the use of such instruments would be limited to $1 million in each annual period of the plan. (Exh. 2, pp. 3, 15-26).

The Company proposed these modifications because it firmly believes that continuation of the GSIP is critical to both its customers and shareholders. Having done so, the Company believes that its GSIP proposal offers far more in the way of potential benefits for its customers than any other alternative presented in this proceeding. As discussed below, this conclusion is confirmed by an examination of what the evidentiary record says about the Company's GSIP and its previous and future impact on the Company and its customers.

1. **<u>The GSIP, as proposed by the Company, should be approved because it has proven to be an effective mechanism for creating additional value for the Company's customers from out-of-state sources.</u>**

As previously discussed, and as the Commission itself has recognized by its prior extensions of the GSIP, the GSIP has enabled the Company to achieve significant net benefits for its customers. Although some of the witnesses for Staff and Public Counsel suggested, or simply assumed, a lack of such benefits in their rebuttal testimony, they offered no substantive analysis in support of their views. Indeed, as Company witness Jaskowiak's explained in his surrebuttal testimony, these unsubstantiated claims simply ignored the evidence from Case No. GT-99-303 which, as previously discussed, fully described and quantified at least $45 million in net benefits that would not have been available in the absence of the GSIP and the Company's superior performance thereunder during the first three years of the program. Moreover, Mr. Jaskowiak's analysis also demonstrated that since the conclusion of Case No. GT-99-303, these actions, as well as others, had generated additional net benefits of at least $19.3 million by the end of Laclede's fiscal year ending September 30, 2000. (Exh. 6HC, p. 4, Schedule 1). Altogether, Laclede was able to identify and specifically quantify nearly $65 million in added savings and revenues that had been made available for sharing with the Company's customers during the first four years of the GSIP's operation. (*Id.*). The breakdown of those savings by component and by time period, as presented in Schedule 1 to Exh 6HC is reproduced below:

Total GSIP Incremental Savings Fiscal 1997 through Fiscal 2000	
	$ Millions
Gas Procurement	$26.3
Capacity Release	$2.4
Off-System Sales	$4.8
Pipeline Mix	$1.9
Transportation Discounts	$28.9
Total	$64.3

GT-99-303 - GSIP Incremental Savings for Fiscal 1997 through Fiscal 1999	
Gas Procurement	**Millions**
Reduced Flexibility	$2.6
Long Term Fixed Supply Premiums	$5.9
Index Minus Supplies	$
	$18.2
Capacity Release Revenue	
Multi-Month Arrangements	$1.3
Elimination of MRT Flexible Contract Demand	$0.7
	$2.0
Off-System Sales	**$4.8**
Transportation Discounts	
Greater than Other Shippers	**$20.0**
TOTAL	**$45.0**

GSIP Incremental Savings for Fiscal 2000	
Gas Procurement	**Millions**
Reduced Flexibility	$1.5
Low Supply Premiums	$3.6
Index Minus Supplies	$
	$8.1
Capacity Release Revenue	
Elimination of MRT Flexible Contract Demand	$0.4
	$0.4
Pipeline Mix	**$1.9**
Transportation Discounts	
Greater than Benchmark	**$8.9**
TOTAL	**$19.3**

As shown by the uppermost table, these savings included some $26.3 million in gas procurement related savings. (Exh. 6HC, p. 5). Of this amount, approximately $4.1 million ($2.6 million in fiscal years 1997-1999 plus $1.5 million in fiscal 2000) was achieved by the Company's successful efforts to lower the "demand" or "premium" costs its pays to reserve firm gas supplies by contracting for less flexible firm gas supplies. (Exh. 6HC, pp. 4-7). In effect, the Company was able to achieve this savings by significantly reducing the percentage of its firm gas supplies that had historically been taken by the Company under more expensive "swing" and "combination" supply contracts and increasing the percentage of such supplies taken by the Company under less expensive "baseload" contracts.[10] As a result of

[10]As explained by Mr. Jaskowiak in his surrebuttal testimony, "baseload" contracts represent the least flexible and lowest cost contract. Under these contracts, the Company generally agrees to take a uniform daily amount

the Company's efforts in this regard, the amount of firm baseload gas in the Company's portfolio increased from an average of 14% prior to the GSIP to an average of 24% during the GSIP. (Exh. 6HC, p. 6). Conversely, the amount of combination and swing in the Company's portfolio decreased from an average of 72% and 14% prior to the GSIP to an average of 66% and 10% respectively during the GSIP. (*Id.*). Unquestionably, in return for a share of the potential savings under the GSIP, the Company was willing to assume the risk of decreasing the flexibility in its supply portfolio in order to reduce costs. (*Id.*).

Another $9.5 million in demand cost savings ($5.9 million in fiscal years 1997-1999 plus 3.6 million in fiscal year 2000) was achieved by the Company as a result of its successful decision to lock-in over a multi-year period the amount of demand costs or premiums that it paid for reserving the majority of its gas supplies. (Exh. 6HC, p. 7). As a result of this initiative, the Company produced these significant gas procurement savings when, as the Company had correctly anticipated, the market cost for reserving gas supplies significantly increased over the locked-in period. (*Id.*). Once again, the Company took the risk that the market might have moved in the opposite direction, but as a result of its willingness to take that risk under a GSIP that provided a financial reward for correct market assessment, both the Company and its customers benefited.

The remaining**$

of supply regardless of fluctuations in demand or the market. (Exh. 6HC, p. 6). Conversely, "swing" contracts represent the most flexible and highest cost contract. (*Id.*). Such contracts generally provide for 100% daily flexibility with no minimum take requirements. (*Id.*). Finally, "combination" contracts have characteristics in common with both baseload and swing contracts and are therefore typically priced somewhere in between. This contract type typically provides daily flexibility but contains some type of minimum take requirements. (*Id.*).

____.** (Exh. 6HC, p.7, Schedule 1).

As shown in the uppermost box, the Company also took a number of initiatives under the GSIP to increase its capacity release revenues – efforts that produced approximately $2.4 million in incremental revenues from 1997 to 2000. (Exh. 6HC, pp. 7-9). Of this amount, $1.3 million was achieved through the Company's successful strategy of entering into multi-month arrangements for the sale or release of pipeline capacity held by the Company. (Exh. 6HC, pp. 8-9). The Company's objective in entering into these arrangements was to lock-in for a number of months the price that third parties were willing to pay for this capacity based on the Company's assessment that the market value of such capacity was likely to decline during the locked-in period. To get the buyer to lock-in the price for an extended period, however, the Company had to take the risk of offering the capacity at prices below the pipeline's maximum rate.[11] Because the clear financial standards set forth in the GSIP provided Laclede an opportunity to assess the risks of these transactions beforehand, and share in any benefits in the event its assessment of the market turned out to be correct, the Company's pursuit of these multi-month release arrangements became common practice. (*Id.*).

Another initiative that was thoroughly discussed in Case No. GT-99-303, relates to the Company's successful effort to minimize inefficiencies embedded in the services provided by its pipeline suppliers. As a result of this initiative, the Company determined that

[11] Prior to the GSIP, the Company released most of its capacity on a monthly basis. The limited number of multi-month capacity release arrangements that it did enter into were almost all done at the pipelines' maximum applicable rates. (Exh. 6HC, pp. 8-9). Since the maximum allowable amounts of revenues were being generated under these arrangements, the Company believed these multi-month release arrangements were easily supportable and not subject to being second-guessed in a prudence review. (*Id.*). It was only after implementation of the GSIP that the Company began to pursue multi-month release arrangements that, while

the under-utilized capacity associated with MRT's Flexible Contract Demand could be better utilized through the elimination of such service. (Exh. 6HC, pp. 8-9). Since MRT's firm shippers were essentially paying for the under-utilized capacity through straight-fixed variable rate design, the Company aggressively pursued having MRT eliminate such service and allocate such capacity to the shippers who pay for the capacity anyway. (*Id.*). As a result of these efforts, the Company was allocated, without any overall increase in costs, an additional 12,480 MMBtu/D of contract demand, which it then released for approximately $1.1 million in incremental revenue through the Company's most recent fiscal period ending September 2000. (*Id.*).

Another major benefit produced under the GSIP was the $28.9 million in incremental savings achieved by the Company's as a result of its successful efforts to negotiate pipeline discounts. (Exh. 6HC, p. 5, Schedule 1). Although the actual level of firm transportation discounts negotiated by the Company was significantly higher than this amount, the Company's savings analyses only quantified those firm transportation discounts that were *greater* than the average level of discounts being achieved by other, similar shippers on the same pipelines serving Laclede. (*Id.*). In fact, it was this same average discount level that was used by the Commission in Case No. GT-99-303 to establish the current $13 million baseline that Laclede must exceed before it can begin to share in any firm transportation discounts it negotiates. (Exh. 6HC, p. 5; Schedule 1). In addition to these savings, the GSIP also permitted the Company to flow through $1.9 million from optimizing the Company's mix of upstream transportation alternatives and over $4.8 million in off-system sales

priced under the pipelines' maximum rate, generated more revenue by locking-in rates in what turned out to be declining market. (*Id.*).

revenues that would have otherwise gone entirely to the Company's shareholders. (Exh. 6HC, p 5; Schedule 1).

This quantification of savings clearly demonstrates the value of the Company's GSIP and the need to continue it in the manner proposed by the Company. Contrary to the conclusory and unsupported assertions that have been made by Staff and Public Counsel, it is clear that the GSIP, and the Company's management of its gas supply and transportation assets under that Plan, have produced substantial net benefits for Laclede customers. Moreover, by approving an extension of the GSIP and determining that it was reasonable and in the public interest in Case No. GT-99-303, the Commission also recognized the beneficial role that the GSIP has played in this regard. In view of these prior determinations, Laclede believes it was incumbent on any party who disputed the GSIP's effectiveness in producing such benefits for the Company's customers to provide a sound analysis showing how the Company's quantification of these benefits is in error. Despite the fact that the vast bulk of the analysis and data underlying the Company's quantification of these benefits had been available for nearly two years, however, there was nothing presented in the rebuttal testimony submitted by Staff and Public Counsel that would constitute such an analysis. (Exh. 6HC, p. 10). In view of these considerations, it is clear that GSIP has significantly benefited the Company's customers and should be continued.

2. **The GSIP, as proposed by the Company, should be approved because it is the only mechanism proposed in this proceeding that offers a realistic, workable and concrete game plan for obtaining additional fixed price protection for the Company's customers in advance of the next winter heating season.**

Throughout their rebuttal testimony in this proceeding, both Staff and Public Counsel decried the absence of fixed priced protection in the Company's gas supply portfolio last winter. (*See*, e.g. Exh. 18HC, p. 6; Exh. 35; pp. 3-10). They also sought to attribute the absence of such protection to certain provisions of the GSIP which they claim discouraged the acquisition of such instruments. (*Id.*).

As previously discussed, these criticisms are misdirected in that they fail to recognize that the decisive factor in the absence of any fixed price instruments in the Company's gas supply portfolio was Staff's and Public Counsel's persistent opposition to the granting of any Commission authorization that would have provided Laclede with reasonable assurances regarding its ability to flow through to its customers the benefits and costs of those instruments. (Exh. 2, pp. 17-19; Exh. 6HC, pp. 11-13). Prior to the GSIP, the Company had never purchased fixed-price instruments and, with or without the GSIP, the Company was not about to risk prudence adjustments that could have easily exceeded its net income by two-fold or more, particularly in the face of Staff's and Public Counsel's refusal to endorse the purchase of such instruments at anything above a clearly inadequate historical price level.

What is particularly inexplicable about Staff's and Public Counsel's approach in this case, however, is that they have continued to pursue measures that are equally ineffective in addressing this critical need in the future. For its part, the Staff has suggested that rather then seek Commission authorization for such purchases, LDCs could simply present their plans to use such instruments to the Staff as part of its proposed integrated planning process and, assuming Staff's concurrence, proceed to purchase such instruments free of any fear from subsequent prudence reviews. As discussed in the final section of this Initial Brief, however, such a process provides little economic definition, and even less, assurance based on the evidence presented at the hearing. Indeed, in the course of only a few hours, the Staff witness who would be primarily responsible for overseeing this process, Mr. Sommerer, definitively asserted that Staff would retain its right to seek a prudence review even where it had initially agreed with the Company's actions while Mr. Schallenberg testified that there was a 99.9% chance that Staff would not. (*Compare* Tr. 940-941 to Tr. 1180-1181). Moreover, regardless of what Staff might ultimately do, it was clear that other parties, such as Public Counsel, would retain their rights to seek a prudence review if the purchase of such instruments led to an unfavorable result. (Exh. 36, pp. 3-4). In short, Staff's integrated planning approach provides little or no assurances with respect to the purchase of fixed price instruments.

Public Counsel's proposal is equally deficient in that it would condition Laclede's ability to use such instruments either on its willingness to subject itself to the standard prudence review process or its agreement to automatically absorb, without any limitation, 50% of any losses or gains associated with the use of such instruments. The potential of losing tens of millions of dollars under either scenario, of course, simply means that the Company would be unable to acquire fixed price protection for any portion of its gas supply portfolio.

In contrast to these recommendations, the Company has come forward with a proposal which guarantees that it will purchase fixed price instruments for at least 10 Bcf of its gas requirements for this winter, so long as such prices remain below $6.00 per MMBtu, a result that seems very likely given current market conditions. (Exh. 2, p. 22). Moreover, as discussed in more detail below, the Company has proposed a workable fixed price mechanism for future periods as well that would require the Commission to do no more than authorize a moderate range of volumes for which such instruments may be purchased, with significant, but limited, financial penalties and rewards to ensure that the Company is responsible for its performance in procuring instruments within this range. (Exh. 2, pp. 22-25). Such a mechanism represents the only realistic and workable solution to the fixed price concerns that Staff and Public Counsel have raised but not rectified in this proceeding. (*Id.*). It, together with the other elements of the Company's GSIP proposal, should accordingly be approved.

3. **The GSIP, as proposed by the Company, should be approved because it is the only mechanism proposed in this proceeding that promises to provide a new and significant source of energy assistance funding for Laclede's most vulnerable customers.**

Another GSIP measure that has been proposed by the Company in this case to help its customers cope with rising wholesale gas prices, is its commitment to contribute a significant share of its GSIP earnings to Dollar-Help. In the event the Commission approves the 35% sharing retention percentages and other modifications proposed by the Company in this proceeding, Laclede has committed to contributing 5% or 1/7 of this retention amount to the Dollar-Help Program in order to provide additional energy assistance to its most vulnerable customers. (Exh. 2, pp. 8-11). The amount of increased funding generated by this proposal would, of course, ultimately depend on how successful the Company was in achieving savings and revenues for all of its customers under the GSIP. (Exh. 2, p. 9). For illustration purposes, however, an analysis performed by Mr. Jaskowiak in his surrebuttal testimony showed that had this proposal been in effect during the 1999-2000 ACA period, it would have generated more than $1 million in increased funding for low-income energy assistance. (Exh. 6HC, Schedule 3).

Implementation of this proposal would, of course, result in a further reduction in the amount of earnings ultimately achieved by the Company as a result of the GSIP. In fact, when combined with the reduction in the Company's overall share of GSIP benefits, this further commitment would reduce the Company's earnings potential under the GSIP by nearly 40% compared to the current structure. (Exh. 2, pp. 9-10). Nevertheless, the Company is agreeable to making such a contribution for several good reasons.

First, as discussed in the surrebuttal testimony of Mr. John Moten, Laclede has always been extremely active in supporting efforts aimed at obtaining public and private sources of funding for low-income energy assistance. (Exh. 7, pp. 4-5). Laclede's proposal in this case is therefore a natural extension of the Company's traditional commitment in this area. (Exh. 2, pp. 9-10). So too is the selection of Dollar-Help as the organization for distributing these funds. As Mr. Moten indicated in his surrebuttal testimony, Dollar-Help has been an extremely successful and cost-effective program for helping low-income customers with their energy bills, as evidenced by its success in raising over $9 million for that purpose since the program was first initiated. (Exh. 7, p. 5).

Second, the proposed modification would also address concerns raised by both Staff and, to a lesser extent, Public Counsel regarding the appropriateness of permitting the Company to retain a share of the savings achieved under the GSIP in those circumstances where there has been a significant increase in customer bills because of rising wholesale gas prices or colder than normal weather. (Exh. 2, p. 10). This concern seems to be based, in part, on the proposition that utility consumers may be offended or prejudiced by any incentive mechanism that permits the Company to retain a share of GSIP benefits when bills are high and that the Company should therefore be prohibited from doing so under such circumstances. (Exh. 2, pp. 10-11).

Although Laclede found absolutely no evidence that this concern was shared by its customers, the Company nevertheless recognizes that special measures need to be taken whenever sharp increases in customer bills impose particularly difficult burdens on low-income customers, the elderly and those customers living on a fixed income.[12]

In addition to all of Laclede's other efforts in this regard, the proposal to contribute a significant portion of the Company's GSIP earnings to Dollar-Help would further that goal. In effect, it ensures that as the Company strives to save money for all of its customers under the GSIP, it will be sharing any success it achieves on its own behalf with its most vulnerable customers.

4. **<u>The GSIP, as proposed by the Company, should be approved because it is the only mechanism proposed in this proceeding that provides the Company with any realistic opportunity to offset the added costs and risks associated with performing its merchant function of buying, financing and storing gas supplies on behalf of its customers and providing the safety net that permits customers to receive critical gas services even when they cannot afford to pay for it.</u>**

Continuation of the GSIP, as proposed by the Company, is also appropriate because such a result gives at least some recognition to the risks that have been undertaken, and the unrecovered costs that have been incurred, by Laclede in connection with the merchant services it provides on behalf of its small customers. As pointed out in the surrebuttal testimony of Laclede witness Glenn Buck, these merchant related costs include, among others: 1) financing costs associated with underground storage and propane inventories; 2) the cash working capital effect of natural gas purchases; 3) the carrying costs associated with deferred gas costs exclusive of the GSIP and PSP programs; 4) the gas cost related portion of

[12] As Mr. Neises testified, contrary to the concerns voiced by Staff and Public Counsel, the Company did not receive a single letter from its customers or a single informal customer complaint from the Commission last winter complaining about the GSIP. (Tr. 476-477). Nor did he recall seeing any article in the St. Louis Post Dispatch citing any customer dissatisfaction in this regard (*Id.*). Indeed, the reports Laclede did receive regarding consumer reaction to what happened this winter would suggest that they are far more open to the wisdom of using incentives as a means of producing superior results in the gas cost area than either Staff or Public Counsel. (Exh. 2, p. 11). Moreover, the Company firmly believes that the only circumstances under which there could be an adverse reaction of this nature would be in those situations where consumers were

payment plan arrangements mandated under the Cold Weather Rule; and 5) the gas cost component of uncollectible accounts. (Exh. 8, p. 3). Although these merchant-related costs arise from the same gas supply and transportation procurement activities that are governed by the GSIP and the Company's PGA Clause, approximately $10 million of such costs are addressed through base rates rather than the Company's PGA mechanism. (*Id.*). And because these costs can vary from year to year, sometimes by dramatic amounts, a portion of them will not be recovered anywhere, but instead absorbed by the Company's shareholders. Indeed, for the twelve months ended February 2001, Mr. Buck conservatively estimated that more than $4 million of these had or would be absorbed by the Company's shareholders (Exh. 8, p. 3). Notably, a substantial portion of these unrecovered costs will have been incurred by the Company in an effort to provide its customers with a safety net which permits them to receive critical natural gas service even when they cannot afford to pay for such services for many months into the future, if at all. (*Id.*).

This simply should not be. Indeed, the Commission's own rules mandate that the Commission should recognize and permit LDCs to recover the operating expenses they incur in complying with the various safety net provisions of the Commission's Cold Weather Rule. 4 CSR 240.13.055(10). Although continuation of the GSIP would not permit the Company to recover these merchant-related costs, it will at least give it an opportunity to also benefit modestly from its merchant role as it goes about the business of creating additional gas cost savings for its customers. Moreover, while such a result would be reasonable under any circumstances, it is particularly appropriate in light of the fact that scores of other unregulated marketers of natural gas, who have none of the safety net obligations and costs

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misled into believing that they have not received significant net benefits as a result of the Commission's innovative efforts in this area. (Id.).

of Laclede, are being permitted to financially benefit when they successful perform the same exact functions as Laclede does under the GSIP.

5. The GSIP, as proposed by the Company, should be approved, because its continuation is critical to the Company's financial health.

The opportunity to achieve a modest level of earnings under the GSIP has also become critical to the overall financial health of the Company. As demonstrated by Laclede witness Glenn Buck, even with the earnings realized by the Company under the GSIP, Laclede was still unable to achieve its authorized rate of return in three out of the past four fiscal years. (Exh. 8, pp. 4-5). And without those earnings, the Company would have not even had enough net income in the last two years to cover its dividend payment to shareholders -- a payment that has been consistently made by Laclede for more than fifty years. (Exh. 2, p. 5). This significant and growing shortfall was graphically demonstrated by the following table at page 4 of Mr. Buck's surrebuttal testimony:

Fiscal Year	Authorized/Implied Return	Actual Return On Average Equity	Return On Equity Excluding GSIP Income
1997	11.00%	12.66%	10.88%
1998	11.00%	10.65%	9.15%
1999	10.19%	9.48%	8.27%
2000	10.50%	8.95%	6.90%

In short, far from being "excess profits," as some have claimed in this proceeding, Laclede's GSIP's earnings have done nothing more than give it the slimmest of opportunities to achieve the returns that have, in fact, been authorized by the Commission and to continue a dividend policy that has been critical to the Company's financial structure for over half a century. Given these considerations, continuation of a workable GSIP is also absolutely essential to the Company's shareholders -- a reality that Laclede has acknowledged by proposing the kind of reasonable modifications that should eliminate any concerns over whether such a course of action is appropriate.

6. **<u>The GSIP, as proposed by the Company, should be approved because it is the only workable incentive plan that has been submitted in this proceeding.</u>**

In contrast to Laclede, neither Staff nor Public Counsel have offered any realistic or workable incentive plan for the Commission's consideration in this proceeding. In his rebuttal testimony, Staff witness Schallenberg did briefly outline in summary form what he termed a "possible" incentive plan. (Exh. 16, pp. 27-29). The evidence presented in this case, however, clearly established that Mr. Schallenberg's proposal could not even be considered an incentive plan, let alone a workable one.

As Company witness Neises explained in his surrebuttal testimony, the entire justification for an incentive plan is to utilize financial incentives in a way that encourages utility management to achieve superior results by rewarding it depending on whether and to what extent it achieves such results with respect to areas or transactions whose outcome it can influence. (Exh. 2, p. 35). By tying its incentives to how an LDC's per customer delivered cost of gas changes over time compared to the relative change in the delivered cost experienced by other Missouri LDCs, Staff's proposal defeats this fundamental purpose. (*Id.*). It is clear that the per-customer delivered cost of gas achieved by one LDC compared to another can vary over time based on factors that differ from one LDC to the next and that are completely outside the control of the LDC. (*Id.*). For example, LDCs have different customer growth rates from year to year because of demographic considerations that they cannot influence. (Exh. 2, pp. 35-36). Some LDCs are also exposed to significantly greater variations in weather temperatures than other LDCs. (Exh. 2, p. 36). Each of these factors can have a significant impact on the magnitude of the per customer change in those portions of the LDC's delivered gas costs that are relatively fixed, such as the cost of transportation services and gas supply demand charges. (*Id.*). Staff's proposed mechanism completely fails to distinguish or correct for these differences. (*Id.*).

Relative differences in the gas prices in the different production fields that the LDC can access, as well as differences in the terms and conditions under which they can access and utilize pipeline storage and transportation services, can also affect year to year changes in their relative performance. (Exh. 2, p. 36). So too, of course, can differences in the manner in which each LDC's tariffs at the state level permit customers with access to alternative suppliers to purchase gas from the utility or use the LDC's facilities for balancing purposes. (*Id.*).

The fact that these operational differences exist between Missouri LDCs, that a number of them are largely outside the control of the LDC, and that they can have a varying impact on the relative gas cost performance of each LDC from one year to the next, were all acknowledged by Staff witness Sommerer during cross-examination. (Tr. 992-999). Nevertheless, Staff's proposal does nothing to account for these differences.[13]

Staff's "possible" incentive plan is also unworkable for other reasons. According to Staff witness Schallenberg, the plan would only permit LDCs to retain a share of the gas cost

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[13] It should also be noted that while these differences can have a profound effect on the degree to which one LDC's per-customer, delivered cost of gas may vary from year to year compared to that experienced by another Missouri LDC, there is no way to determine what that impact is without full access to the procurement plans, operational characteristics and results achieved by each LDC. (Exh. 2, pp. 36-37). And this again illustrates another major flaw in Staff's approach, namely that for it to ever be implemented in a fair and effective manner, each LDC would have to have access to such information from every other LDC. (*Id.*). Unfortunately, the need for such access would potentially bring with it its own set of real world, adverse consequences by eroding any competitive advantage LDCs can achieve by maintaining a certain degree of confidentiality regarding their gas procurement strategies. (*Id.*). Indeed, the practical difficulties inherent in such an approach have already been demonstrated by Staff's need to withdraw certain LDC-specific information upon which it based its proposal in this case because of Laclede's inability to obtain access to the critical data, contracts and other material underlying that information. (*Id.*).

savings they achieve in those instances where the delivered cost of gas has declined from the previous year. (Exh. 16, pp. 27-28). In effect, such a proposal would completely eliminate any incentives when they are needed most, namely, in a rising market. (Exh. 2, p. 37). Moreover, it would create the very kind of "perverse incentives" for which Staff is always criticizing other incentive plans. (*Id.*). For example, consider the impact of Staff's proposal in a rising market that each LDC knows, because of the magnitude of the increase, will result in a delivered cost of gas higher than that achieved the prior year. Under such circumstances, the only incentive produced by Staff's recommended approach would be one that essentially tells the LDC that the higher its cost of gas goes this year the better positioned it will be in the next year to claim savings since its relative performance will then be measured from a higher, less exacting base. (Exh. 2, p. 37). By the same token, LDCs that did a superior job in one year will be put at a distinct disadvantage versus others who did not, since their performance would now be measured from a lower, more daunting base for purposes of determining whether they will be rewarded in the future. (Exh. 2, pp. 37-38). For all of these reasons, which are enunciated in detail in the evidentiary record, it is clear that Staff's possible incentive plan is completely unworkable and far more likely to retard rather than promote its asserted goals. In any event, it is clearly inferior to the Company's approach in this case to continue an established program with modifications designed to address the concerns of all parties.

(B) <u>If an incentive mechanism is used, what should be the terms of such a mechanism</u>?

It is Laclede's position that the GSIP should be structured in the following manner, as set forth in the list of issues:

(1) **How should Laclede's gas supply commodity and demand costs be incorporated in the structure?**

No change should be made to the existing treatment of gas supply demand costs under the GSIP, except for the modifications relating to the Company's proposal to adopt uniform sharing percentages that increase the customer's share of the overall benefits achieved under the GSIP and the other parties' proposal to eliminate the commodity portion of the gas procurement component. As previously discussed, Laclede has achieved substantial savings in demand costs over the years as a result of its innovative efforts to lock-in demand charges, reduce contract flexibility and other measures. Moreover, no substantive arguments have been presented as to why the GSIP's existing Request for Proposal process should not continue to be used to determine the demand cost benchmark that will be used to measure the Company performance in this area. Accordingly, consistent with its revised sharing proposal, Laclede should be permitted to retain or required to absorb 35% of any demand charge amounts that are less or more than the RFP benchmark amount.

Laclede does not object, however, to the proposals of other parties to terminate the commodity portion of the gas procurement component of the GSIP. Laclede also is willing to subject its gas procurement actions to prudence reviews in the future, except for those actions covered by the demand cost benchmark and those relating to the level and cost of financial instruments procured by the Company, the financial consequences of which would be addressed in accordance with the proposal outlined below.

(2) **What provision, if any, should be made for the use of fixed price contracts and/or instruments?**

In its initial tariff and direct testimony, the Company proposed that the Commission approve an Experimental Fixed Price Plan ("EFPP") that would have permitted the acquisition of financial instruments when they appeared to be favorably priced in comparison to recent historical trends or when the NYMEX strip price for such instruments declined to an average price of $3.75 per MMBtu.

Although they offered no realistic fixed price proposal of their own, both Staff and Public Counsel expressed concerns that the Company's proposed mechanism would not trigger for this winter. Based on current market conditions, however, it now appears that those concerns were unfounded. Nevertheless, to address these concerns and still provide the Company with reasonable assurances, Laclede proposes that, for this winter only, it be authorized to purchasing fixed price instruments for at least 10 Bcf of its winter gas requirements for December, January and February, as long as they can be purchased below a $6.00 per MMBtu price in these months. (Exh. 2, p. 22). In the event, the Company makes such purchases within these guidelines, any prudence reviews would be limited to matters other than the level and cost of the financial instruments purchased by Company. (*Id.*).

In addition, for periods after the completion of this winter season, Laclede proposes that the Commission adopt a modified version of Public Counsel's fixed price proposal in this case. (*Id.*). Like Public Counsel's proposal, the financial consequences associated with the Company's use of fixed price financial instruments would be determined by comparing whether, and to what extent, the fixed price instruments procured by the Company actually resulted in gains and losses.[14]

Unlike Public Counsel's proposal, however, there would be specific limits on the level of reasonable losses or gains that the Company would absorb or retain under its

[14] For convenience and ease of administration, the determination of gains and losses for futures contracts would be made by reference to the NYMEX settlement price for the month that the futures contract was purchased. (*Id.*). For fixed price gas supply contracts, gains and losses would be measured by comparing

recommended approach. Specifically, the Company would be required to absorb 10% of any losses associated with the use of such instruments up to a total amount of $1 million, and be permitted to retain 10% of any gains, to the extent that such retention could be accommodated within the overall earnings cap of $10 million that Laclede has recommended in this case. (Exh. 2, pp. 22-23). As Mr. Neises testified, absent some limitation, purchasing any significant amount of these instruments could expose the Company to losses of a magnitude sufficient to wipe out its entire net income for a year or more. (Exh. 2, p 20). That is not a risk that the Company can or should be asked to take, consider the potential impact of such a result on it and its customers. (*Id.*).

As part of its proposal, the Company has also recommended that the Commission establish a range of volumes, of between 10 Bcf and 25 Bcf, that the Company would be authorized to cover with fixed price instruments, rather than mandate that a specific level of volumes be protected. (Exh. 2, p. 23). Given the concerns that have been expressed by the parties in this case regarding the need for the kind of price protection that can be afforded by fixed price instruments, the Company believes it is appropriate that it be authorized to fix at least some minimum amount of its volume requirements (i.e. 10 Bcf); and that its proposal accomplishes this objective.[15]

the fixed price associated with the commodity, excluding any demand charges necessary to reserve gas supply, and the index price applicable to the location of delivery. (Exh. 6HC, p. 24).

[15] As Mr. Neises explained in his surrebuttal testimony, when combined with the 40% of normal winter supplies covered by the financial instruments purchased under the Company's Price Stabilization Program -- another innovative program that is part of the Company's overall risk management strategy -- the purchase of fixed contracts equal to the 10 Bcf of the Company's winter flowing requirements would ensure some form of price protection for nearly 60% of the Company's normal winter purchases. (Exh. 2, p. 24). And if the Company purchased financial instruments for its winter flowing supplies equal to the 25 Bcf maximum, the amount of normal winter purchases covered by financial instruments would rise to 87%. (Exh. 2, p. 24). Either of these scenarios, or any scenario in between, would afford customers with significant price protection from any substantial spike in wholesale gas prices while still enabling them to receive significant benefits from any large declines in the market price of gas. (*Id.*).

The Company's proposal to establish a range rather than adopt a specific volume requirement for fixed price instruments also addresses other concerns that have been raised in this proceeding. In their rebuttal testimony, both Staff witness Schallenberg and Public Counsel witness Meisenheimer discussed the pros and cons of the Commission pre-approving a specific course of action, such as the Company's EFPP proposal to procure fixed instruments for a specific volume of its gas requirements if certain triggers are reached. (Exh. 2, p. 24). They also noted, however, the substantial risks faced by the Company in the absence of any clear standards regarding the possible financial consequences associated with using fixed price instruments. *(Id.)*. The Company's proposal to establish a range reconciles these potentially conflicting considerations by having the Commission do nothing more than recognize that a range of results is reasonable where any scenario within that range will bring significant diversity to the Company's efforts to balance price and stability. (*Id.*). At the same time, such an approach would give the Company the flexibility to decide what specific scenario is optimal, with the certain knowledge that it will be financially responsible for how good a job it does in selecting that scenario. (Exh. 2, p. 24).

(3) <u>How should firm transportation pipeline discounts be incorporated into the incentive mechanism</u>?

For the reasons discussed throughout this Initial Brief, the firm transportation discount component of its GSIP should not be changed, except for the modifications relating to: (a) the Company's proposals to adopt uniform sharing percentages that increase the customer's share of the overall benefits achieved under the GSIP and provide an additional source of energy assistance funding for low-income customers; and (b) the Staff's proposal that the Company should be permitted to retain a share of any discounts negotiated with MRT if the resulting rates are below the contract rates that MRT is charging Laclede and the discounts being achieved by Laclede are not being made available by MRT on a system wide basis. (Exh. 2, pp. 13-14; Exh. 18HC, p. 16).

(4) **How should pipeline mix be incorporated into the incentive mechanism?**

For the reasons discussed throughout this Initial Brief, the pipeline mix component of the GSIP should not be changed, except for the modifications relating to the Company's proposals to adopt uniform sharing percentages that increase the customer's share of the overall benefits achieved under the GSIP, and to provide an additional source of energy assistance funding for low-income customers.

(5) **What treatment should be afforded to capacity release credits or revenues?**

For the reasons, discussed throughout this Initial Brief, the capacity release component of the GSIP should not be changed, except for the modifications relating to the Company's proposals to adopt uniform sharing percentages that increase the customer's share of the overall benefits achieved under the GSIP, and to provide an additional source of energy assistance funding for low-income customers.

(6) **What treatment should be afforded to revenues from off-system sales?**

Both Staff and Public Counsel expressed a concern in their rebuttal testimony that the varying treatment afforded capacity release revenues versus off-system sales revenues (i.e., with the former being dealt with in the PGA and the other in base rates with different sharing consequences for both) may provide the Company with an incentive to favor one kind of transaction over another. While neither Staff nor Public Counsel have cited a single example in this case where the Company has improperly favored one kind of transaction over the other, Laclede nevertheless has no objection to Staff's proposal for addressing this concern, namely, its recommendation that off-system sales be reincorporated in the PGA. (Exh. 2, p.

12). This assumes, of course, that the Commission also adopts Staff's proposal to increase the Company's gas costs by $900,000 so that Laclede can be compensated for the $900,000 reduction in its base rates that was approved by the Commission when a level of off-system sales revenues was imputed in those rates in Laclede's last rate case proceeding. (*Id.*). Laclede's concurrence in removing off-system sales from base rates is also based on adoption of the Company's recommendations regarding the sharing percentages that should be applied to this component of its GSIP and its position that no baseline is appropriate for these totally opportunistic transactions. (*Id.*).

(7) **How should any savings or revenues associated with these components be determined and allocated between Laclede and its customers and what role, if any, should baselines play in that process?**

In their rebuttal testimony, both Mr. Sommerer for the Staff, as well as Mr. Busch for Public Counsel, proposed that the Commission establish new or increased baseline levels for all of the components of the GSIP. Staff witness Sommerer also proposed reductions in the percentage share that the Company may retain in connection with most of these components.

As discussed more fully below, Laclede believes these proposals should be rejected because they are unreasonable, plainly inconsistent with current market conditions and, if adopted, would render the GSIP unworkable. Despite these fundamental differences, however, the Company nevertheless developed a proposal in this case that gives substantial recognition to Staff's and Public Counsel's position on this issue by significantly reducing the overall share of benefits that may be retained by the Company under the GSIP and significantly increasing the share of such benefits received by the Company's customers.

Under the current GSIP, the Company is permitted to retain 50% of the savings achieved under the gas procurement component of the Plan and 30% of the savings or revenues achieved under the other components of the Plan, with the exception of the capacity release component which varies from 10% to 30%. (Exh. 2, p. 6). In addition, the Company is permitted to retain 100% of the off-system sales revenues it achieves between rate cases once the $900,000 baseline included in rates is exceeded. (*Id.*). Under the Company's proposed modification, however, the sharing percentages for all of these components would be equalized to 35%, with the exception of the sharing percentage for the commodity portion of the gas procurement component which would be reduced to zero. (*Id.*).

Compared to the retention percentages in the existing GSIP, the adoption of these uniform sharing percentages, together with the complete elimination of any sharing percentage for the gas procurement component, would significantly reduce the Company's share of GSIP benefits and, conversely, increase the share received by its customers. (Exh. 2, pp. 6-7). For example, had these percentages been in effect during the 1999-2000 ACA period, the Company would have received nearly $3 million less than the approximately $10 million in savings and revenues it retained that year from both the GSIP and its off-system sales. (Exh. 2, p. 7; Exh. 6HC, Schedule 3). This is equivalent to an overall reduction of approximately 30% in the share of GSIP and off-system sales benefits that may be retained by the Company. (Exh. 2, p. 7). Moreover, the amounts ultimately retained by Laclede under the GSIP would be reduced by another 10% in the event the Commission approves the Company's proposal to contribute 1/7 of its GSIP earnings to Dollar-Help, as previously discussed in this Brief.[16]

[16] The adoption of uniform sharing percentages, as proposed by the Company, also serves to address Staff's and Public Counsel's concern that applying different sharing percentages to capacity release and off-system sales revenues may give the Company an incentive to favor the latter over the former. (Exh. 2, p. 8). Although Laclede disagrees that the GSIP has actually had such an effect, adoption of the Company's proposal to implement uniform sharing percentages should serve to eliminate any such concerns in the future. (*Id.*).

In contrast to the Company's constructive efforts to meet the other parties half way on this issue, however, Staff and Public Counsel have proposed to establish benchmarks or baselines, and sharing percentages, that are simply designed to eviscerate the GSIP as a workable incentive mechanism. Their recommendations should be rejected for several reasons.

First, it is clear that under current market conditions, their proposals would effectively deprive the Company of any meaningful opportunity to achieve earnings in connection with its gas acquisition and management efforts. As shown by the analysis presented by Mr. Jaskowiak in Schedule 2 to his surrebuttal testimony, application of the baselines proposed by Staff and Public Counsel to the non-gas procurement components of the Company's existing GSIP would barely permit the Company to break even on these components. (Exh. 6HC, Schedule 2). And that assumes that the Company was actually able to replicate all of the savings and revenue enhancements that it has previously achieved in these areas. (Exh. 2, p. 28). Moreover, Staff's proposal goes one step further down the path of unworkability by proposing a benchmark for the gas procurement component of the Company's GSIP that would immediately require the Company to absorb more than $3 million in gas supply costs based on current market conditions. (Exh. 2, p. 28). There should be absolutely no misunderstanding regarding the cumulative effect of these proposals on the Company. In addition to being unfair and unworkable, they send the unmistakable message to the Company that, for the sake of its shareholders and its customers, Laclede would have to seriously re-evaluate its future merchant role should such proposals be adopted. (*Id.*). As previously discussed, the Company is already incurring millions of dollars in unrecovered costs in connection with its merchant role of buying, storing and financing the gas supplies required to serve its customers and providing the safety net for customers who cannot to afford to pay for such services. (Exh. 8, p. 3). (*Id.*). And it is on top of this already substantial net cost, that Staff and Public Counsel have proposed to make the merchant function even less economic for the Company by taking away any meaningful opportunity to share in any gas costs savings achieved by the Company or, even worse, by exposing the Company to over $3 million in unrecovered costs.

But it doesn't even end there. In addition to having the Company absorb millions of dollars in unrecovered gas costs from the start, both parties would also expose the Company to the risk of even greater losses as a result of potential disallowances from future prudence reviews. (Exh. 2, p. 29). It is difficult to conceive of any business that would willingly submit to selling gas under these kinds of punitive and patently uneconomic conditions. Indeed, during his deposition, Public Counsel witness Busch candidly admitted that he could think of no unregulated gas marketing firm that would voluntarily agree to provide services under such a one-sided arrangement. (Exh. 10, pp. 61-62). Since Laclede competes with such firms for investor dollars and confidence, why should it? Nor is the Company compensated for these risks by the earnings it receives from distributing gas to customers.[17]

Aside from their adverse, financial impact on the Company, there are a variety of other reasons why the Commission should reject the proposals by Staff and Public Counsel to

[17] As previously discussed, even with the income realized by the Company as a result of its efforts under the GSIP, Laclede has still not been able to earn its authorized returns in three out of the last four fiscal years. (Exh. 8, p. 4). And without that income, it would have been extremely difficult for the Company to even cover the dividend it has been paying for more than fifty years. (Exh. 2, p. 29). The cold, hard reality is that Staff's approach to establishing base rates in recent years has not even come close to providing the financial resources necessary to fund the distribution side of our business. (Exh. 2, pp. 29-30). And now Staff, together with Public Counsel, have proposed to eviscerate, in this proceeding, the only mechanism that has given the Company at least a fighting chance to make up for some of the lost ground caused by Staff's indifference to the Company's financial needs in these other areas. (*Id.*). Unfortunately, unlike utilities that have operations in other states or receive substantial revenues from other lines of utility or non-utility business, Laclede has no way to compensate for this continuing and, it seems, growing unwillingness on the part of the Staff to recommend the financial resources required to provide utility service. (*Id.*).

establish new or higher baselines for various components of the GSIP. At the core of both Staff's and Public Counsel's proposal is the assumption that historically-derived baselines for the various components of the GSIP should be established just as the Commission establishes discrete levels of expenses and revenues in a general rate case proceeding. As explained by Company witness Neises, however, such an approach is really nothing more than a method for ensuring that all incentive programs will inevitably be terminated. (Exh. 2, p. 32). Contrary to the positions taken by Staff and Public Counsel, it is simply not possible for Laclede or any other LDC to achieve even greater levels of savings and revenues through the management of their gas supply and transportation assets. (*Id.*). In fact, if carried to its logical but absurd conclusion, such a view would suggest that to continue to operate under an incentive plan, an LDC must eventually achieve a level of performance where suppliers and transporters are giving away their services and products for free, or even paying the LDC to take them. (*Id.*). Since it is, of course, impossible to achieve such a result, the rebasing approach suggested by Staff and Public Counsel would inevitably lead to a situation where the so-called incentive becomes worthless because it will only reward a level of performance that cannot be achieved.[18]

The positions taken by Staff and Public Counsel also fail to recognize that in an ever changing competitive marketplace, nothing is ever permanent and nothing can ever be taken

[18] And there is every reason to believe that the specific rebasing proposals made by Staff and Public Counsel would produce such a result in this case. (Exh. 2, pp. 32-33). For if it was somehow possible to achieve significantly higher levels of savings and revenues than Laclede has in the past, the Company would have already done so by now given the fact that its has operated under a GSIP for nearly five years now that has given it an incentive to achieve as great a level of savings and revenues through the management of its gas supply assets as it could without endangering reliability or taking unwarranted risks. (*Id.*). Indeed, when Public Counsel witness Busch noted in his rebuttal testimony that the overall level of savings and revenues achieved under the GSIP have remained fairly constant (despite changes in the amounts achieved under individual component), such an observation only served to confirm the point that the Company may have already extracted as much in the way of additional savings and revenues as it is possible to achieve under current conditions. (Exh. 2, p. 33).

for granted. (Exh. 2, p. 33). Looking back does not provide insight for tomorrow. Savings and revenues achieved today, can be gone tomorrow absent constant efforts to maintain them. (*Id.*). Given these considerations, it is completely misguided to suggest that management performance can only be deemed superior and worthy of financial recognition if it continues to produce an ever greater level of savings and revenues than it has in the past. (*Id.*). To the contrary, in a tightening market like the Company faces today, the most exceptional manifestation of superior performance can be to simply retain what it has already achieved. (*Id.*).

The Company's successful efforts over the recent past to negotiate pipeline discounts at or below historical levels in a tightening market are a good example of the kind of performance that merits continued recognition and that demonstrates the unreasonableness of Staff's and Public Counsel's rebasing and sharing percentages proposals. As previously discussed, in Case No. GT-99-303, the Commission determined that a $13 million baseline should be the firm transportation discount component of Laclede's GSIP, noting Laclede's analysis that such a baseline represented the average level of discounts being achieved by other shippers on the same pipelines from which Laclede was receiving service. ***Re: Laclede Gas Company***, Case No. GT-99-303, *supra*, at 11-12, 16-17. Given that determination, a party seeking to change that baseline or reduce the related sharing percentage had an obligation to demonstrate that circumstances relating to the ability to negotiate such discounts have changed sufficiently to justify a modification in these parameters. No such evidence was been presented in this case, however, by either Staff or Public Counsel.

To the contrary, the only substantive evidence presented on the issue was furnished by Laclede witness Bruce Henning, the Director of Regulatory and Market Analysis for

Environmental Analysis, Inc., a nationally recognized provider of natural gas forecasts and analysis. (Exh. 3, p. 1). Based on an exhaustive analysis of all of the pipeline corridors serving Laclede, Mr. Henning found that the ability to negotiate pipeline discounts, particularly at existing levels, was likely to decrease in the future in most regions in the country and along the pipeline corridors serving Laclede. (Exh. 3, p. 4). According to Mr. Henning's analysis, the factors contributing to the tightening of capacity that would make negotiating such discounts more difficult were: (a) a substantial increase in demand for natural gas, which as a result of gas fueled electric generation and growth in other markets, would approach 30 Trillion cubic feet by 2010; (b) a 30% increase in the annual load factors for pipelines moving gas from Louisiana to Missouri by 2005; and (c) the abandonment of a major segment of the Trunkline pipeline as the result of its conversion to a products pipeline. (Exh. 3, pp. 4-5). In view of these factors, Mr. Henning concluded that Staff's and Public Counsel's rebasing proposals would result in unachievable baselines and, in the process, eliminate any effective incentive in this area. (*Id.*) He also noted that adoption of such proposals would be particularly inappropriate in that it would penalize the Company for its superior and recently concluded efforts to negotiate discounts with a number of its pipeline suppliers. (Exh. 3, p. 3). For all of these reasons, the Commission should reject Staff's and Public Counsel's rebasing recommendations and approve the Company's far more reasonable sharing modifications instead.[19]

[19]Staff and Public Counsel also suggested that their rebasing proposals were consistent with how revenues and expenses are determined in a general rate case proceeding. As Mr. Neises explained, however, there is simply no way to analogize the two. For example, in a rate case, once the level of revenues and expenses are determined, the utility is permitted to keep 100% of any savings or increased revenues above or below the baseline level. (Exh. 2, p. 34). In sharp contrast, the most that the Company would be permitted to retain in this proceeding, even under its own proposals, is 35% of any savings or revenues. (*Id.*). Moreover, this tradeoff between retention percentages, and whether or how high a baseline should be set, has previously been recognized by the Commission as well. (*Id.*) In addition, the utility is not subject to prudence reviews in a rate case that can retrospectively change the level of costs or revenues that will be recognized in rates for a past

(8) Should an earnings cap be placed on the savings and revenues retained by Laclede?

In their rebuttal testimony, both Staff and Public Counsel proposed that an overall cap of $9 million be maintained on the level of earnings that the Company may retain under the GSIP. As indicated in the Company's surrebuttal testimony, while Laclede does not believe such a cap is necessary, it is nevertheless agreeable to maintaining such with one modification. Specifically, it should be recognized that at the time the present cap was established, off-system sales revenues had been completely excluded from GSIP consideration through their inclusion in base rates. (Exh. 2, p. 13). As previously noted, however, Staff has proposed such that revenues once again be included in the GSIP, with a $900,000 adjustment to the Company's gas costs. In view of this recommendation, the cap should be raised from $9 million to $10 million to account for the fact that the cap will now apply to those revenues as well. (*Id.*). It should be noted that even with this modest adjustment to $10 million, the cap will still limit any potential earnings by Laclede to an amount that is only a few percentage points of its overall gas costs. (*Id.*).

(9) Should a specific term for the incentive mechanism be established?

In its rebuttal testimony, Staff suggested that a term of one year for the GSIP is appropriate due, in part, to the work that is being done by the Commission's gas cost recovery task force and the potential impact of that work on the GSIP. Public Counsel on the other hand proposed that the GSIP be authorized for a term of three years in the event the Commission decided to continue it.

period. (Exh. 2, p. 34). Finally, unlike most costs and revenues that are addressed in a rate case, the ones that are addressed in the GSIP are, by and large, far more volatile in nature, a fact that makes them particularly unsuited to the type of baseline approach recommended by Staff and Public Counsel. (Exh. 2, pp. 34-35).

For its part, the Company recognizes that the work of the gas cost recovery task force could ultimately have some bearing on the structure and future of GSIP. However, Laclede does not believe that this consideration warrants the adoption of an artificial one-year term for the GSIP since there are other, less-disruptive, ways to accommodate Staff's potential concern and still permit the implementation of a multi-year incentive plan.

Specifically, the GSIP already contains a provision that permits any party to recommend modifications to the GSIP in the event there is a significant change in conditions. (Exh. 2, pp. 14-15). This same provision can be supplemented to explicitly provide that the GSIP may also be modified or even terminated in the event the Commission decides, after hearing, to adopt recommendations from the task force that are inconsistent with the GSIP or its provisions. (*Id*). Such an approach will allow the work of the task force and its inter-relationship to the GSIP to be fully considered and accommodated without artificially limiting the term of the GSIP. The Company would accordingly recommend that a modification incorporating such language in the GSIP be made in response to the concerns raised by Staff. In view of this proposed modification, Laclede does not believe it is at all necessary to establish a specific term for the incentive mechanism.

(10) <u>How should bundled sales and transportation contracts be treated?</u>

Although this was identified as an issue in this proceeding, Laclede is unaware of any specific recommendation in the testimony of either Staff or Public Counsel that purports to endorse or support some form of special treatment for bundled sales and transportation contracts. Indeed, bundled sales and transportation contracts were only mentioned in passing by Staff witness Sommerer in his discussion of the firm transportation discount component of the GSIP. They were not mentioned, let alone dealt with, however, in the eight recommendations set forth in Staff's testimony. Accordingly, Laclede believes there is no evidence to support any new or special treatment for such contracts and that the Commission should therefore find that they will be accorded the same treatment that they have been given in the past.

(C) <u>If an incentive mechanism is not used, what alternative can or should be implemented in its place?</u>

As discussed, above neither Staff nor Public Counsel have proposed a workable incentive plan in this proceeding. Nor have they offered any reasonable or effective alternatives to the use of incentives such as those contained in the GSIP.

In his rebuttal testimony, Staff witness Schallenberg did propose a new process for evaluating the gas procurement plans and strategies of Missouri LDCs. And as a general matter, Laclede is supportive of any effort that will help to expedite the ACA review process and potentially limit the magnitude and number of prudence issues that may have to be resolved through that process. However, as Mr. Neises explained in his surrebuttal testimony, Staff's proposal raises fundamental questions regarding how involved Staff or the Commission should be in the gas acquisition strategies of LDCs. (Ex. 2, p. 38). Laclede also has serious reservations regarding the feasibility of conducting such an elaborate review process within the time constraints suggested by Mr. Schallenberg and does not, in any event, believe that such a review process is necessary for any portion of the Company's gas costs that are subject to incentives. (*Id.*). And, as previously discussed, Laclede has reservations regarding whether such a process will only exacerbate rather than diminish concerns over prudence adjustments. Nevertheless, the Company will certainly work with both the Staff and Public Counsel to implement improvements to the current process and will maintain an open mind on the form that those improvements should take. It does not believe, however, that Staff's proposal can or should be adopted as a substitute for the modified GSIP proposed by the Company in this proceeding.

III.
CONCLUSION

As it has in the past, Laclede has again made a sincere and concerted effort throughout this proceeding to modify its incentive plan proposal in order to address, in a reasonable manner, the concerns and recommendations made by Staff and Public Counsel in their rebuttal testimony. The end result of these efforts is a workable incentive plan that will permit the Company to continue its successful efforts to achieve additional gas cost savings and revenues for all of its customers, while, at the same time, affording the Company a meaningful opportunity to enhance its historic support of programs designed to assist our most vulnerable customers. Perhaps most importantly, given the events of last winter, it provides a framework for the effective acquisition and use of the kind of fixed price instruments that can help further stabilize customers' bills. Moreover, it represents the only workable incentive plan that has been presented in this proceeding. For all of these reasons, the GSIP, as proposed by the Company in this proceeding, should be approved by the Commission.

Respectfully submitted,

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I do hereby certify that a true and correct copy of the foregoing Initial Brief of Laclede Gas Company has been hand-delivered or mailed by First Class, U.S. Mail, postage prepaid, this 23rd day of July 2001, to:

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