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August 1, 2001

FILED²

AUG 1 2001

Missouri Public
Service Commission

Mr. Dale Hardy Roberts
Secretary/Chief Regulatory Law Judge
Missouri Public Service Commission
P. O. Box 360
Jefferson City, MO 65102

RE: Case No. GT-2001-329 - 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.

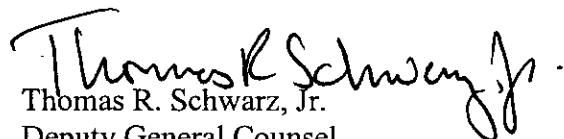
Dear Mr. Roberts:

Enclosed for filing in the above-captioned case are an original and the appropriate number of conformed copies of the **REPLY BRIEF OF STAFF** (highly confidential and non-proprietary versions).

This filing has been mailed or hand-delivered this date to all counsel of record.

Thank you for your attention to this matter.

Sincerely yours,



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Enclosure
cc: Counsel of Record

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

FILED²
AUG 1 2001

Missouri Public
Service Commission

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.

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Case No. GT-2001-329

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August 1, 2001

****DENOTES HIGHLY CONFIDENTIAL****

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**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

STAFF'S REPLY BRIEF

I. INTRODUCTION

All parties agree that the proper purpose of an incentive plan is to provide consumers with benefits that they would not otherwise enjoy by providing financial incentives to the local distribution company. However, Laclede has lost sight of the corollary that benefits to the LDC are merely ancillary, a means to attain the end of benefiting consumers. The true measure of the success of any incentive program is the extent of benefits gained by consumers, net of the cost of the incentives to the LDC. From its initial brief, as well as the evidence in the case, Laclede clearly puts benefits to itself first, and benefits to consumers a distant second. The Commission ended incentive plans for Southwestern Bell and for AmerenUE that failed to provide substantial consumer benefits, and it should end Laclede's GSIP now.

Throughout this case, Laclede repeatedly admits that its principal concern in its proposed incentive plan, or GSIP, is gain for the shareholder. Laclede says so not only in so many words, but also through the design of its plan. Further, Laclede's attempts to disparage Staff's incentive plan only highlight the fact that Staff focuses on benefit to the customer. Staff's plan addresses both positive and negative incentives that encourage

LDCs to work to benefit the customer. In this case, the Commission should adopt Staff's plan.

II. ARGUMENT

Laclede puts itself first, at the expense of its customers. Throughout its testimony Laclede admits it focuses on its own profit, not customers' rates. (Ex. 2, Neises Surrebuttal, p. 5, l. 12; p. 6, l. 4). As a result, the GSIP has created a parallel universe, separate from market, which drives Laclede's efforts. For example, Laclede still operates formally with a supply plan that was crafted for the 1999/2000 heating season. The reason for Laclede's use of an antiquated plan, of course, is that while the market has experienced radical changes in the 2000/2001 heating season, Laclede is still driven by a GSIP designed for conditions of 1999/2000. Laclede's focus on profit under the GSIP also accounts for the fact that it still hasn't so much as written a letter to renew its contract for the upcoming heating season to the supplier of service that provides a substantial portion of GSIP profits. (Tr. 355 HC, 786-87 HC, 790HC). Laclede will not act until this Commission provides the definition of its profit requirements.

Before discussing the GSIP design flaws in detail, Laclede's attempts to disguise those flaws, and Laclede's attacks on Staff, however, Staff must emphasize that the GSIP fails its principal test – customers would be better off without it.

The record provides two clear examples that customers are not better off under Laclede's GSIP. First, an examination of transportation discounts shows plainly that Laclede's claims of customer benefit cannot be sustained. Schedule 5HC to Exhibit 18, Sommerer Rebuttal, attached as Appendix 1 HC, illustrates this fact. In 1995, prior to the

“incentive” of the GSIP, Laclede secured natural gas transportation at \$20,000,000 below FERC maximum rates. Customers enjoyed the full benefit of those savings. In each succeeding year under the GSIP, Laclede secured transportation at approximately the same measure below FERC maximum rates. Under GSIP in each of those years, however, *customers* realized transportation cost reductions less than those they received in 1995. The GSIP has cost customers nearly \$8,000,000 in the aggregate in transportation costs alone. Laclede designed the GSIP to generate profit, without any focus on whether customers would be better off. A baseline that provides rewards for current levels of service, or even worse, for levels below current service levels, does not save customers money – it costs them money through higher rates.

A second example of the GSIP’s failure to produce tangible savings for consumers is its performance last winter. The GSIP’s exclusion of a workable incentive for the principal element of gas cost – the cost of the commodity itself – finally affected customers, and they suffered as a result. The GSIP did not prevent a supplemental winter filing, nor produce customer rates markedly lower than other Missouri LDCs. The test of GSIP design in the crucible of a contrary market did not create results to justify its continuation.

A. GSIP Design Flaws.

Laclede’s GSIP is not well designed to produce benefits for customers, nor is Laclede’s support for GSIP a well-reasoned explanation.

1. The design of the GSIP is far too rigid to adequately deal with the dynamic gas market conditions facing Laclede's customers.

The GSIP does not contain the flexibility to adjust as market conditions change. The Commission made substantial modifications when it re-examined the GSIP in case GO-99-303, at the request of Laclede and other parties. At that time it altered the commodity premium element, the baselines for transportation discounts, and the baselines for off-system sales and capacity release. The Commission also modified the GSIP structure in approving the current one-year extension of the GSIP in GT-2000-395. In that case, the Commission capped overall profits and excluded from transportation discounts any renegotiation of Laclede's contract with Mississippi River Transmission. In a curious twist, Laclede claims that it has proposed these modifications (Laclede Brief, p. 12), when in fact it has resisted at every turn any suggestion by OPC or Staff to eliminate detriments to customers.

Nor are the modifications that Laclede proposes in this case adequate to deal with a dynamic natural gas market. For instance, Laclede's proposal to establish a risk-free zone of fixed price gas contracts may appear to add flexibility to the GSIP, but only superficially. Will there be a gas market where a portfolio of 12% fixed prices will be detrimental to customers? No one can know for sure, but Laclede proposes an open-ended plan, though less than eighteen months ago no one would have predicted \$9.00 gas. A dynamic market regularly goes through such changes, and adopting a fixed portfolio now to insulate Laclede from current market movements only shifts the possibility of harm to customers.

2. Laclede's proposed GSIP is not carefully designed and supported.

Laclede has not carefully and thoughtfully provided the Commission with reasons to continue the GSIP. Indeed, a close examination reveals that the GSIP is an ill-constructed house of cards, ready to collapse the moment it is tested by market stresses.

Laclede's haphazard approach to program design is typified by the fate of the Experimental Fixed Price Program. Proposed in Laclede's direct testimony as a means to provide customers with some element of fixed prices in their portfolio, the EFPP withered under the rebuttal analysis of Staff and OPC, and died unceremoniously in Laclede's surrebuttal.

In an effort to recover from this gaffe, Laclede proposed a fixed price mechanism from which it could profit. Unfortunately, this proposal is as deficient as its short-lived predecessor. Laclede proposes that it will retain ten percent of gains, and share ten percent of losses to a cap of \$1,000,000. However, one cannot tell from the proposal how it will work in practice. Consider an example where Laclede has eight contracts, each of which results in a gain of \$750,000, and also two contracts each of which loses \$1,500,000. Which of the following calculations determines Laclede's share:

\$6,000,000 gains
- 3,000,000 losses
\$3,000,000 net gain
\$300,000 Laclede's share

\$6,000,000 gains
- 3,000,000 losses
3,000,000 net gain
300,000 (Laclede's share of losses)
2,700,000 gains to be shared
270,000 Laclede's share

\$6,000,000 gains
- 300,000 Laclede's share of losses
5,700,000 gains to be shared
\$ 570,000 Laclede's share

Laclede provides no insight to the actual operation of its proposal, leaving that for later litigation.

An even more amazing example of Laclede's lack of thought is its permanent safe harbor of fixing prices for 10 to 25 BCf of gas per year. Mr. Neises admitted on the stand that Laclede performed no analysis, study or report to support these particular levels. (Tr. 338; Ex. 35). Laclede urges the Commission to take responsibility for the purchase of ten percent of Laclede's portfolio on blind faith in Laclede's unsupported judgment. One can only wonder whether Mr. Neises would ask his board of directors to assume the risk of \$45,000,000 in purchases with a similar lack of analysis.

Laclede's request that Commission preapprove 10 BCf of fixed price gas at any price below \$6.00 is also an amazing proposition. How could the Commission explain to customers its approval of a 10 BCf purchase of natural gas from an affiliate at \$5.00, in a market that was at \$4.90? Staff does not suggest that Laclede would necessarily do such a thing, but it would be free to do so under its proposal. Such an oversight undermines the overall credibility of the plan.

Laclede also cuts corners in its analysis of past and future savings under its proposals. The reader cannot tell from Mr. Jaskowiak's Surrebuttal Schedule 2 HC that his calculations fail to include the savings from a bundled contract that amount to millions of dollars a year in lower premiums. Nor can the reader tell the projected costs against which savings are measured are based upon only two contracts and Mr. Jaskowiak's own, admittedly subjective, estimates. (Tr. 790 HC). Nor would an uninitiated reader comprehend that Mr. Jaskowiak's Schedule 4 HC does not account for poor load factors on the new pipelines, higher costs of gas supply, nor the possible

difference in value of released capacity relative to firm pipeline capacity. (Tr. 791-92 HC). Jaskowiak's Schedule 2 HC is attached as Appendix 2 HC, and Schedule 4 HC as Appendix 3 HC.

Laclede's GSIP ignores what Laclede itself repeatedly has stressed as a major problem: the disincentives present in the current ACA prudence review process. Laclede emphasizes that it cannot take otherwise prudent actions because of the potential risk posed in the ACA review. (Laclede Brief, p. 3 (need for regulatory assurances), p. 9 (contrast to old prudence review), p. 25 (Laclede cannot risk even potential prudence reviews); p. 36-37 (need for assurances on fixed price instruments)). The GSIP addresses these concerns by having the Commission simply preapprove any course of action that Laclede chooses, without considering then-existing market conditions, and without regard to the balance of Laclede's portfolio. Such preapproval is grossly inconsistent with the Commission's regulatory responsibilities, nor with good business practice. Only Staff's proposal addresses the disincentives in the ACA process.

Finally, Laclede's GSIP virtually ignores the single largest element of customers' gas costs: the commodity cost of the gas itself. Commodity cost comprises seventy to eighty percent of the customers' cost of gas. The GSIP does provide a small incentive to Laclede for a portion of that cost (10 to 25 BCf per year out of a total of 85 to 117 BCf per year) but leaves the bulk of the gas cost without benefit of incentives.

Judging from the record as a whole, it does not appear that Laclede provides a reasoned basis for its approach to acquiring its customers' gas supply. Rather, Laclede proposes that the Commission insulate it from market discipline by guaranteeing individual elements of profit that otherwise lack a considered explanation. The

Commission should not accept proposals with less explanation than would be given to Laclede's own board if it were asked to accept responsibility for the decisions.

B. Attempted disguises

Laclede attempts to disguise the deficiencies in its presentation in a number of ways. It camouflages its exorbitant retentions by passing references to total cost of gas; it introduces consideration of non-gas costs that are misleading and unlawful for the Commission to consider; it wraps the GSIP in a mantle of nobility by proposing to give ratepayer money to low-income customers; and it takes a series of inconsistent positions on the comparative worth of GSIP's achievements.

In its brief, as in its testimony, Laclede seeks to distract attention from the fact that it proposes to divert from ratepayers 35% of the money that the ratepayers would otherwise keep. The most notable observation is that Laclede suggests its total take under the GSIP only comprises a small percentage of total gas costs. This claim begs the question that for 70% to 80% of gas costs – in other words, the commodity cost – Laclede claims nothing under the GSIP. For each and every element of the GSIP other than fixed price contracts, Laclede proposes to extract fully 30% from ratepayers for itself and an additional 5% for low-income customers. Laclede has provided no example of other purchasing agents who are so richly rewarded, and no explanations or considerations other than its own benefit to support such largesse. Further, Laclede has itself suggested, with respect to its proposed cut for low-income customers, that 5% is a significant figure. (Tr. 487, l. 23-25). The Commission should not permit itself to be blinded by Laclede's attempt to shroud the true cost to customers by reference to total gas costs.

Laclede spends considerable space and effort to generate sympathy by discussing the impact of cold weather and high gas prices on its non-gas costs. The invocation is ineffective and unlawful.

Laclede bases its arguments significantly on the representations of Mr. Buck. Mr. Buck's explanation, however, is not satisfactory. Mr. Buck's analysis of the effects of last winter includes proposals in Laclede's pending rate case, rates that will not go into effect for another eight months, if at all. (Ex. 31). Mr. Buck also failed to use the proper rates of return to calculate carrying costs. (Tr. 523). Finally, Mr. Buck's work papers (Ex. 23) indicate that many of Laclede's supposed cost increases have not been proportional to the combined weather and price effect, and have not precluded Laclede from substantially increasing net income for the period. In sum, analysis of Laclede's numbers demonstrates that they do not support Laclede's claim of hardship.

More importantly, however, Laclede proposes that the Commission consider some, but not all, relevant non-gas cost factors in making its decision on the GSIP. This invitation is unlawful. The Missouri Supreme Court has held that the Commission must consider all relevant factors when setting rates. *Utility Consumers Council of Missouri v. Public Service Commission*, 585 S.W. 2d 41 (Mo. 1979). That pronouncement of the law was followed when the Court of Appeals in *State ex rel. Midwest Gas Users' Association v. Public Service Commission*, 976 S.W.2d 470 (Mo. App. 1998), confirmed that the PGA/ACA process was lawful. Laclede suggests that the Commission need consider only a few of the many factors affecting Laclede's costs. This the Commission cannot do under the controlling decisions.

Laclede also tries to divert attention from the levels of profit it proposes for itself by using the GSIP to transfer additional ratepayer moneys to assist low-income customers. Although Staff acknowledges the extreme burdens that last winter's cold weather and high prices placed on low-income customers, Staff cannot endorse Laclede's proposal to divert 5% of GSIP "gains" to those customers. It is ironic, indeed, that Laclede does not compare this percentage to the entirety of gas costs, or even the total gas costs faced by low-income customers, to provide a better perspective on the relative levels of benefit to low-income customers provided by its GSIP proposal. Laclede's proposal would make much more sense if the percentages were reversed, 5% for Laclede and 30% for low-income customers. However, Laclede proposes that the Commission do indirectly that which it cannot do directly under the controlling statutes – establish a subclass of the residential class of ratepayers. The Commission correctly, if painfully, rejected the proposal when first broached by MGE in Case No. GT-2001-293, and it should do so now. The Commission should urge all interested parties to address these concerns to the General Assembly for a clear expression of its intent in this matter.

Finally, Laclede is wildly inconsistent in its proposed use of comparisons. Laclede repeatedly (Laclede Brief p. 1, 9, 11, 19, 32, 34, 45, 46) claims that its performance under the GSIP is "superior", without ever stating the standard of comparison. The comparisons that Laclede does make are incomplete at best, and its objections to Staff's comparisons thereby become untenable. For example, Laclede relies on the comparisons of pipeline discounts it submitted in GT-99-303, some three years ago. Its own expert, Mr. Henning, acknowledged that the information in that study was a starting point at most, and that its principal use would be as an historical point of

reference to contemporary conditions. (Tr. 161, l. 16 to 163, l. 4). Mr. Henning, of course, did not perform a contemporary study of Laclede-specific comparable pipeline discounts. (Tr. 76). Thus, Laclede has not provided the commission with any comparative evidence on the current state of pipeline discounts other similar shippers obtain.

Nor does Laclede provide any explanation for its claim that year-to-year comparisons of its performance are inappropriate. Indeed, Laclede's own annual report compares for shareholders and lenders its year-to-year performance measured by revenues, net earnings, and earnings per share. (Ex. 23, p. 19). Laclede argues, however, that ratepayers cannot use the delivered cost of gas as a comparative measure of performance. Laclede bases its argument on the existence of many factors that may vary from year to year, an inadequate explanation on at least two counts. First, at least as many factors affect net income from year to year as affect gas cost, but no one suggests that these factors precludes the use of such financial comparisons. Second, Mr. Henning acknowledged on the stand that the non-weather conditions affecting Laclede remain reasonably consistent from year to year, bolstering the use of year-to-year gas cost comparisons. (Tr. 173, l. 22 to 174, l. 13). There is no reason that the delivered cost of gas cannot be used as a meaningful measure of Laclede's performance.

Staff's proposed comparisons of LDC performance consider and avoid the problems suggested by Laclede and AmerenUE. Staff would compare company performance from one year to that same company's performance in the next year. This comparison is analogous to the earnings comparisons universally undertaken with financial results used by Laclede itself, in its own annual report to shareholders. Both

Laclede and AmerenUE miss the point of Staff's comparisons – ratepayers, like shareholders, are interested in results, not explanations or excuses. If another LDC has an advantage in gas supply factors in year one, it will likely have the same advantage in year two. Ratepayers are most interested in how the LDC manages its resources from year to year with respect to the total delivered cost of gas, relative to the performance of other LDCs managing their respective resources. Explanations of the absolute differences in gas price or available resources are not material to these considerations.

In conclusion, the Commission should not be confused by Laclede's attempts to distract attention from the issue of GSIP effects on customers. Rather, the Commission should focus its attention on the best measure of Laclede's performance, how its current results compare to its prior results, and how those results compare with other Missouri LDC's results.

C. Laclede's attacks on Staff are not well taken.

Laclede attacks Staff on a number of points. It argues that Staff's proposed approach to eliminating ACA disincentives will involve Staff and the Commission too much in Laclede's affairs (Laclede Brief, 49; Ex. 2, Neises Surrebuttal, p. 38), that Staff and OPC caused the GSIP's failure to protect customers from last winter's price spikes, that Staff's baseline proposals will destroy any incentive for Laclede to pursue good results for customers (Laclede Brief, p. 17), and that Staff's incentive feature is unworkable. (Laclede Brief, p. 17; Ex. 2, Neises Surrebuttal, p. 35-39). Staff suggests that these criticisms are not sound.

Staff will begin, however, by conceding a point. Staff now concurs that limiting incentives to years in which the total delivered cost of gas is lower than an historical

averages not needed. Outstanding effort in a rising natural gas market deserves a reward. However, Staff makes this concession in the belief that the Commission should establish a delivered cost of gas above which no reward will be given. Staff has suggested \$5.50 as a ceiling. (Ex. 18, p. 14, l. 23 to p. 15, l. 1). This ceiling recognizes that consumers, especially low-income consumers, face real hardship as the delivered cost of gas increases. Because rewards under Staff's proposed incentive will not be determined until the completion of the impending ACA period, the Commission has a year to finalize the details of the reward mechanism. Above some level, Laclede should share in the customers' pain by sacrificing incentive gains.

Laclede suggests that Staff's proposed modification to the ACA process to minimize disincentives to prudent actions will unduly involve Staff in Laclede's purchasing practices. (Laclede Brief, p. 49; Ex. 2, Neises Surrebuttal, p. 38). Laclede cannot sustain its argument. The record is replete with protestations that Laclede cannot and will not take otherwise prudent actions for fear of Staff prudence reviews. (Tr. 630-31; Ex. 2, Neises Surrebuttal, p. 19, l. 16-21; p. 20, l. 19 to p. 21, l. 2). Clearly, Staff is currently a significant presence in Laclede's purchasing decisions, just not an effective and productive one. Laclede appears to justify its position by hinting that it will need to consult Staff prior to making each contract with a supplier or pipeline. Laclede can maintain this contention only by inventing a straw man a program not suggested by Staff. Staff merely proposes to monitor what Laclede should be doing anyway, at the time that Laclede should be doing it. If Laclede prepares a comprehensive gas purchasing plan that reflects its analysis of current market conditions based on current information, it can effectively prevent second-guessing from Staff, OPC and the

Commission. If Laclede fails to prepare such a plan, the fault lies not with the Staff, but with Laclede. In any event, it is hard to understand how Laclede can make this argument while its most recent purchasing plan dates from the 1999/2000 ACA year.

Laclede certainly seeks to involve the Commission in its purchasing process when doing so benefits Laclede. Importantly, Laclede seeks to shift responsibility for significant aspects of its purchasing practices directly to the Commission. For instance, Laclede seeks the Commission's blessing to fix the price of 10 to 25 BCf of its portfolio, and limit its own exposure for fixed price gas purchases to \$1,000,000. Laclede proposes that the Commission do this without benefit of studying Laclede's portfolio structure or predicting the future nature of the gas market. Laclede's board would not buy such a pig in a poke, and this Commission should not do so, either.

Laclede also suggests that somehow the obstinate refusal of Staff and OPC to approve modifications to the GSIP caused the GSIP to fail to protect customers from last winter's price spikes. (Ex. 2, Neises Surrebuttal, p. 17; Laclede Brief, p 3-4). Laclede begs the question, if the GSIP was properly designed to protect customers, why did it need modifications? If Laclede was so certain of the proper course of action in July of 2000, why did it insist on guarantees that customers, not Laclede, would bear the results of any untoward results of its purchasing decisions. Laclede's attacks are another attempt to divert attention from the flaws inherent in a rigid GSIP designed to promote Laclede's interests, not customers' interests.

Laclede's attacks on Staff's proposed baselines are also meritless. Laclede asserts that Staff's proposed baselines are so unachievable that the GSIP would become unworkable. (Laclede Brief, p. 17). Except for pipeline mix, Staff has not proposed a

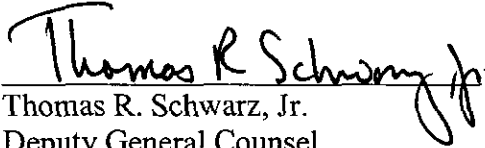
baseline that Laclede has not actually achieved in the past. (Ex. 18, Sommerer HC Rebuttal, p. 14-19; Sch. 2 HC, 5 HC, 7HC, 8 HC). In fact, Laclede achieved Staff's proposed baseline of \$20,000,000 in transportation discounts even before it had a financial incentive to do so. The only purpose frustrated by reasonable, realistic baselines is Laclede's objective to secure a guaranteed level of profit from the GSIP. That has never been the sole, or even the principal, purpose of the GSIP, and the Commission should reaffirm in this case that profits for Laclede are not the primary focus of incentives.

III. CONCLUSION

The GSIP expires without PSC action. For its incentive program to continue, Laclede has burden to establish that its proposal is best for consumers. It has failed to do so. Staff's proposal meets all of the elements of a proper incentive plan, and mitigates the admitted disincentives of the current ACA process. The Commission should adopt Staff's proposal to reduce disincentives in the ACA process, and to provide incentives to Laclede.

Respectfully submitted,

DANA K. JOYCE
General Counsel

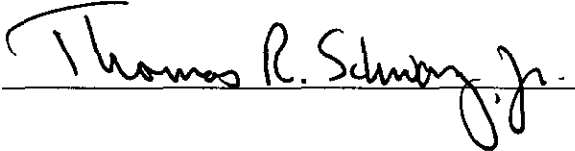

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Certificate of Service

I hereby certify that copies of the foregoing have been mailed or hand-delivered to all counsel of record as shown on the attached service list this 1st day of August, 2001.



**Service List for
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Verified: July 23, 2001 (SW)**

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APPENDICES 1, 2 AND 3

HAVE BEEN DEEMED HIGHLY CONFIDENTIAL