Exhibit No.:
Issue: Policy/Overview
Witness: Kenneth J. Neises
Type of Exhibit: Surrebuttal Testimony
Sponsoring Party: Laclede Gas Company
Case No.: GT-2001-329

LACLEDE GAS COMPANY

GT-2001-329

SURREBUTTAL TESTIMONY

OF

KENNETH J. NEISES

May 30, 2001

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

AFFIDAVIT

STATE OF MISSOURI)
) SS.
CITY OF ST. LOUIS)

Kenneth J. Neises, of lawful age, being first duly sworn, deposes and states:

1. My name is Kenneth J. Neises. My business address is 720 Olive Street, St. Louis, Missouri 63101; and I am Senior Vice President - Energy & Administrative Services of Laclede Gas Company.

2. Attached hereto and made a part hereof for all purposes is my surrebuttal testimony, consisting of pages 1 to 38, inclusive.

3. I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded are true and correct to the best of my knowledge and belief.

K J Neises
Kenneth J. Neises

Subscribed and sworn to before me this 29th day of May, 2001.

Joyce L. Jansen
JOYCE L. JANSEN
Notary Public — Notary Seal
STATE OF MISSOURI
St. Louis County
My Commission Expires: July 2, 2001

SURREBUTTAL TESTIMONY OF KENNETH J. NEISES

Q. What is your name and address?

A. My name is Kenneth J. Neises, and my business address is 720 Olive Street, St. Louis, Missouri 63101.

Q. Are you the same Kenneth J. Neises who previously caused prepared direct testimony to be filed in this proceeeding?

A. Yes, I am.

PURPOSE OF SURREBUTTAL TESTIMONY

Q. What is the purpose of your surrebuttal testimony?

A. The purpose of my surrebuttal testimony is twofold. First, I want to describe the further modifications that the Company is willing to make to its gas supply incentive plan ("GSIP") in response to the concerns that have been raised by Staff and Public Counsel in their rebuttal testimony. In doing so, I will also explain why I believe our proposed plan, as modified, represents the only alternative presented in this case that is both workable and consistent with the interests of both the Company's customers and its shareholders. Second, I will address a number of the claims that have been made by the witnesses for Staff and Public Counsel in support of their proposals that I believe are either unwarranted or inconsistent with the facts.

Q. Is surrebuttal testimony also being submitted by other Company witnesses?

A. Yes. Mr. John Moten, the Company's Vice President for Community Relations will address one of the modifications that Laclede is proposing in response to concerns that have been raised regarding the impact of rising gas prices on the

Company's customers. Specifically, he will address the need for, and impact of, our proposal to contribute a significant share of the Company's earnings under the GSIP to the Dollar-Help Program – an organization that has a long history of providing energy assistance to our most vulnerable customers. Mr. Scott Jaskowiak, who also presented direct testimony in this case, will address various assertions that have been made regarding the structure of the GSIP and the level of benefits that have been achieved by the Company under its auspices. Mr. Glenn Buck, the Company's Manager of Financial Services, will respond to those claims that have unfairly sought to portray the GSIP as a risk free mechanism that allows Laclede to earn excess profits from its merchant function by providing the Commission with a more balanced and more comprehensive perspective of the risks and costs that the Company actually incurs in connection with its merchant duties. Finally, Mr. Bruce Henning, a former economist with the American Gas Association and a current member of Energy and Environmental Associates will discuss why the proposal to raise the baseline associated with the pipeline discount component of the GSIP is inappropriate in light of current market conditions. He will also explain why Staff's proposed incentive plan, which relies on a comparison of the relative changes in delivered gas costs experienced by Missouri LDCs, is unworkable as a meaningful measure of management performance and ill-designed to benefit consumers.

PROPOSED MODIFICATIONS
DESIGNED TO ADDRESS PARTIES' CONCERNS

Q. You indicated that the Company was willing to make a number of modifications to its GSIP proposal in order to address concerns that have been raised in the rebuttal testimony submitted by Staff and Public Counsel. Would you please summarize what those modifications are?

A. There are six major modifications that Laclede is prepared to make to its GSIP proposal in an effort to address the concerns or incorporate the recommendations set forth in the testimony of Staff and Public Counsel:

- First, the Company is willing 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.
- Second, Laclede is proposing to devote a significant portion of its already reduced share of any benefits under the GSIP to funding energy assistance for its most vulnerable customers.
- Third, Laclede is willing to remove off-system sales revenues from base rates and once again include them in the GSIP.
- Fourth, Laclede is willing to reinstitute an overall cap on the amount it may retain under the GSIP – a cap that will also apply to off-system sales revenues.
- Fifth, the Company is proposing that language be added to the provisions of 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.

- Finally, and perhaps most importantly given the events of this past winter, Laclede is willing to significantly alter that component of its GSIP proposal which relates to the gas supply commodity component of its gas costs 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 is willing to commit to obtaining a minimum level of fixed-price instruments for this coming winter. For future periods, the Company is also agreeable to implementing 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. In connection with this proposal, the Company is also willing to subject its remaining procurement decisions to a subsequent prudence review.

Q. Why is the Company willing to make these modifications?

A. For two reasons. First, it is abundantly clear, as the Commission itself has recognized by its prior extensions of the GSIP, that the Plan has enabled the Company to achieve significant net benefits for its customers. Although some of the witnesses for Staff and Public Counsel have suggested, or simply assumed, a lack of such benefit in their rebuttal testimony, they have offered no substantive analysis in support of their views. Indeed, as Mr. Jaskowiak's surrebuttal testimony demonstrates, these unsubstantiated claims simply ignore the evidence from Case No. GT-99-303 which 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. Since then, these actions, as well as others, have generated additional net benefits of at least $19 million, and we are confident that the GSIP will continue to benefit customers in the future if it is allowed to operate. In view of these benefits, the Company believes it is critical for our customers that the GSIP be allowed to continue and we are willing to make whatever reasonable accommodations are necessary to permit that to happen.

Second, there is no denying the fact that 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 Mr. 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. 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. 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 we have acknowledged by proposing the kind of reasonable modifications that should eliminate any concerns over whether such a course of action is appropriate.

<u>Reduction and Equalization of Company's Share of GSIP Benefits</u>

Q. Turning to the specific modifications you previously summarized, would you please describe the Company's proposal to equalize the sharing percentages applicable to what it may retain under the GSIP?

A. Yes. 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%. 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. Under our proposed modification, 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.

Q. Compared to the retention percentages in the existing GSIP, does this represent a reduction in the overall share of GSIP benefits that may be retained by the Company?

A. Yes, 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. 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. Expressed as a percentage, 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. I should add that this reduction in the Company's share of GSIP benefits does not take into account the additional, financial impact of our proposal to devote a significant portion of our remaining 35% share to Dollar-Help. I will discuss that proposal later in my testimony.

Q. *Why is the Company willing to reduce its share of GSIP benefits by such a significant amount?*

A. Both Mr. Sommerer for the Staff, as well as Mr. Busch for Public Counsel, have proposed that the Commission establish new or increased baseline levels for all of the components of the GSIP. Mr. Sommerer also proposes reductions in the percentage share that the Company may retain in connection with most of these components. The end result of both of these approaches is to virtually eliminate any possibility that the Company will share in any savings under the GSIP and increase the likelihood that it will lose money on its efforts to generate such savings for its customers.

Q. Do you agree that such modifications are appropriate?

A. No. For reasons I will discuss later in my testimony, I believe it is fundamentally inappropriate to "rebase" these items. And even if it were not, it is clear that the baselines being proposed by Staff and Public Counsel are unreasonable given current market conditions. I also believe that the same considerations argue against any reduction in the sharing percentages applicable to these components. Despite these fundamental differences, however, the Company has nevertheless developed a proposal that gives substantial recognition to Staff's and Public Counsel's position on this issue by permitting a significant reduction in the overall share of benefits that may be retained by the Company under the GSIP. The Company's proposal should accordingly be adopted by the Commission.

Q. Does the adoption of uniform sharing percentages serve any other purpose?

A. Yes. In the past, the GSIP has wrongly been criticized on the grounds that the different retention percentages for its various components may give the Company an inappropriate incentive to structure its transactions so as to take advantage of the higher sharing opportunities afforded by some components. Indeed, it is clear that Staff's and Public Counsel's respective proposals in this case to afford similar sharing treatment to the Company's capacity release and off-systems sales revenues has been prompted by this very kind of concern. 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.

Contribution of Company GSIP Earnings to Dollar- Help

Q. In addition to reducing its overall share of GSIP benefits, you also indicated that the Company was willing to contribute a significant portion of its GSIP earnings to funding energy assistance for low-income customers. Please explain this proposed modification and why the Company is making it.

A. In the event the Commission approves the 35% sharing retention percentages and other modifications proposed by the Company in this proceeding, Laclede would agree to contribute 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.

Q. *What impact would this proposal have on the level of energy assistance available for low-income customers?*

A. 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. For illustration purposes, however, the analysis performed by Mr. Jaskowiak shows that had this modification 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.

Q. Would implementation of this proposal also result in a further reduction in the amount of earnings ultimately achieved by the Company as a result of the GSIP?

A. Yes. The Company's commitment to contribute 1/7 of its share of the benefits achieved under the GSIP would obviously reduce by some additional amount the level of earnings that could ultimately be realized by the Company pursuant to the Plan. 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.

Q. Why is the Company proposing to contribute a share of its GSIP earnings to help fund the energy assistance efforts of Dollar-Help?

A. As discussed more fully 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. Laclede's proposal in this case is therefore a natural extension of the Company's traditional commitment in this area. As to why we chose Dollar-Help as the organization for distributing these funds, we simply believe, for the reasons discussed by Mr. Moten, that 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.

Q. Is this proposed modification also designed to address concerns raised by Staff and Public Counsel in their rebuttal testimony?

A. Yes. Both Staff and, to a lesser extent, Public Counsel have raised concerns over 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. 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.

Q. Do you agree with this concern?

A. While I have heard this concern voiced by Staff and Public Counsel, I have not been able to confirm that it is actually shared by our customers. To the contrary, the reports I have received 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. In fact, the only circumstances under which I could foresee any adverse reaction of this nature would be in those situations where consumers were misled into believing that they have not received significant net benefits as a result of the Commission's innovative efforts in this area.

Nevertheless, I do agree 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. 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 will 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 -- a result that should be particularly helpful in the higher cost environment we face today.

Treatment of Off-System Sales Revenues

Q. Why is the Company proposing to remove off-system sales revenues from base rates and reincorporate them as a component of the GSIP?

A. As I previously mentioned, both Staff and Public Counsel have expressed concern that the varying treatment afforded these two items (i.e., one 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 I do not believe this has actually occurred, the Company understands why this differing treatment could engender such concerns. Moreover, Laclede has always believed that PGA rather than rate case treatment is more appropriate for items like off-system sales revenues that are extremely volatile from one year to the next. The Company therefore supports Staff's recommendation, as set forth at page 18 of Staff witness Sommerer's rebuttal testimony, that off-system sales revenues be removed from base rates by temporarily increasing gas costs by the $900,000 that was imputed for this item in Laclede's last rate case. However, for the reasons discussed elsewhere in my testimony and in the surrebuttal testimony of Mr. Jaskowiak, the Company does not agree that the Company's ability to retain a share of such revenues should be subject to a baseline, let alone the ones proposed by Staff and Public Counsel in their rebuttal testimony.

Preservation of Cap and Acceptance of MRT Proposal

Q. Please describe the fourth modification the Company is willing to make to its GSIP proposal in order to address the concerns raised by Staff and Public Counsel.

A. At the time it filed its tariffs and direct testimony in this proceeding, the Company proposed elimination of two temporary measures that had been added to the GSIP when it was extended by the Commission for a fifth year. These included elimination of the provision which imposed an overall $9 million cap on the amounts that could be retained by the Company for the fifth year of the program and the provision which excluded from GSIP consideration any rate discounts that might be negotiated by the Company in the interim with its largest pipeline supplier, Mississippi River Transmission Corporation ("MRT").

Q. Has the Company reconsidered its position on these issues?

A. Yes. At page 18 of his rebuttal testimony, Staff witness Sommerer proposes that the current $9 million cap be maintained for the GSIP. Mr. Busch also makes a similar recommendation at page 22 of his testimony. In response to these recommendations, the Company is willing to agree to the continuation of an overall cap on the amount it may retain under the GSIP. I should note, however, that at the time this cap was established, off-system sales revenues had been completely excluded from GSIP consideration. In light of Staff's recommendation that such revenues once again be included in the GSIP, I would recommend that the cap be raised from $9 million to $10 million to account for the addition of off-system sales.

Q. To put the amount of this earnings cap in perspective for the Commission, could you please quantify what a $10 million cap means as a percentage of the Company's overall gas costs?

A. Based on current gas costs, a $10 million cap would limit the Company's earnings to an amount equivalent to about 2% of its overall gas costs.

Q. What is the Company's position regarding the exclusion of MRT discounts?

A. At page 16 of his rebuttal testimony, Staff witness Sommerer has presented a new alternative for the treatment of MRT discounts. It is my understanding that under the alternative approach recommended by Mr. Sommerer, the Company would be permitted to retain a share of such discounts if the resulting rates are below the contract rates that MRT is charging Laclede and the discounts achieved by Laclede are not being made available by MRT on a system-wide basis. In my view, Mr. Sommerer's alternative proposal for determining whether such discounts should be recognized is not unreasonable and is clearly preferable to an outright exclusion. The Company would therefore have no objection to modifying the GSIP to incorporate this concept.

Task Force Reopener

Q. Please explain the fifth modification the Company is proposing to make to its GSIP proposal.

A. At page 32 of his rebuttal testimony, Staff witness Schallenberg suggests 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. I certainly agree with Mr. Schallenberg that the work of the gas cost recovery task force could ultimately have some bearing on the structure and future of GSIP. However, I do 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 Mr. Schallenberg's concern and still permit the implementation of a multi-year incentive plan.

Q. Please explain what you mean.

A. The GSIP, as proposed by the Company, already contains a provision that permits any party to recommend modifications to the GSIP in the event there is a significant change in conditions. Laclede believes that 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 an opportunity for hearing, to adopt recommendations from the task force that are inconsistent with the GSIP or its provisions. 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 Mr. Schallenberg.

Treatment of Gas Supply Commodity Costs

Q. You previously indicated that the final modification proposed by the Company relates to the treatment of gas supply commodity costs. Why is the Company proposing a modification relating to this element of its GSIP proposal?

A. It is clear from a review of the testimony submitted by both Staff and Public Counsel that concerns regarding the treatment of gas supply commodity costs is driving many of their recommendations. And this is clearly one of the most critical and perhaps most problematic issues facing market participants and the Commission. Given the events of this past winter, the Company certainly recognizes the need to develop a workable approach that will foster greater bill stability through the use of fixed price instruments. Indeed, that is precisely why the Company made its Fixed Price Plan the centerpiece of its GSIP renewal request. Before a constructive solution in this area can be found, however, it is very important that there be an accurate understanding of the circumstances and reasons which actually contributed to the results experienced this winter. For if we don't know what the problem is, we're very unlikely to find the correct solution.

Q. Do you believe that Staff and Public Counsel have accurately explained why the Company did not place a greater reliance on fixed price instruments this past winter?

A. No, I do not. Both the witnesses for Staff and Public Counsel have suggested, now that the winter is over and we all know what happened, that the Company did not utilize fixed price instruments because of inherent flaws in the GSIP. In particular, they cite the GSIP provision that shields the Company from prudence reviews so long as it acquires gas supply costs at a benchmark level that changes with monthly movements in the indexed price of gas. They wrongly suggest that such a provision gave the Company a disincentive to obtain fixed price instruments by creating the prospect that the Company would lose its protection from a prudence disallowance if the fixed price turned out to be higher than this benchmark. They also point to the fact that the purchase of fixed price instruments was never triggered by the GSIP's existing fixed price component since market prices never declined to the five year average price that the component mandates before such purchases may be made. According to Staff and Public Counsel, it was a combination of these so-called flaws in the GSIP that led to the absence of fixed price protection. The historical record, however, indicates something quite different.

Q. Please explain.

A. The chief reason that Laclede did not purchase fixed price instruments last winter was because Staff and Public Counsel were, themselves, never willing to move beyond a reliance on historical prices for purposes of determining whether and when fixed price instruments should be purchased and endorse a more market-responsive standard for making such determinations. It is true that the fixed price component of the GSIP, which was proposed by Laclede in 1999, relied on an historical, five-year average of gas prices to determine when fixed price financial instruments should be purchased. Staff's "incentive proposal" at the time, however, was also based on the use of historical gas prices. What matters though is not what the parties may have used in 1999 to address the purchase of fixed price instruments but how they reacted in 2000 when there was a radical increase in the market price for both natural gas and financial instruments -- a change in market conditions that made it increasingly unlikely that an historical price benchmark would serve to trigger the purchase of such instruments.

Q. Did this change in market conditions cause Staff or Public Counsel to reevaluate whether a more market responsive standard should be used to facilitate the purchase of fixed price instruments instead of an average of historical prices?

A. Not from what I have been able to determine. To the contrary, at the very time market prices were increasing to levels substantially above the historical averages, Staff and Public Counsel entered into an incentive plan agreement with Missouri Gas Energy ("MGE") that, once again, would have triggered the implementation of a fixed price only if that price was at or below a historical average of gas prices. And even though this agreement contained explicit provisions permitting the parties to recommend increases in the trigger price in response to changing market conditions, Staff and Public Counsel were apparently unwilling or unable to ever make such a recommendation, notwithstanding the continuing escalation in market prices.

Q. During this same time period, did Laclede make an effort to establish a more market-responsive standard for the use of financial instruments?

A. Yes. As it became evident that there had been a fundamental shift in the market, Laclede made a filing with the Commission in which it requested authorization to take a number of steps that were designed to facilitate the effective use of financial instruments in the changed market environment. Specifically, in response to these market conditions, Laclede requested authority in July of last year to increase the level of funding for the purchase of call options under its Price Stabilization Program and to decrease the volumes covered by the Program. Laclede also requested the authority to use costless collars and fixed priced instruments that were more reflective of market prices. Ultimately, the parties were only able to agree on an elimination of the volume requirement under the Program.

Q. Are there other examples of Staff's reluctance to endorse standards that would permit the use of market-responsive financial instruments?

A. Yes. Late last summer, Staff also opposed MGE's request to make adjustments to its hedging program that were designed to permit the purchase of financial instruments in the higher cost environment that existed in the market at that time. Instead, Staff took the position that MGE should simply take whatever action it believed was appropriate subject to a subsequent prudence review. In addition, Staff opposed both a continuation of Laclede's Price Stabilization Program this past winter as well as most of the adjustments that Laclede had proposed to make to the Program in response to the higher cost environment for financial instruments that exists now versus when the Program was originally approved.

Q. What conclusions do you believe should be drawn from these developments?

A. In light of this history, I think it is inappropriate and unfair to suggest that it was the structure of the GSIP that was primarily responsible for the fact that the Company did not rely on fixed price instruments this past winter. Instead, it was tied far more closely to the Company's inability, despite its efforts, to obtain any assurances, or even indications, that moving away from historical prices and using market-responsive financial instruments would be deemed acceptable. To the contrary, the message that was being repeatedly sent to the Company was that historical prices remained the standard favored by both Staff and Public Counsel and that any effort by the Company to utilize more market-responsive instruments would have to be done at its own peril. Having sent that message, neither Staff nor Public Counsel is in a tenable position to attribute the results of last winter to the GSIP or any other factor that, as the historical record demonstrates, could have been easily resolved by their simple endorsement of the measures that Laclede was proposing in advance of the winter to permit the use of fixed price instruments.

Q. But couldn't the Company have simply locked in prices notwithstanding Staff's and Public Counsel's reluctance to endorse such a course of action?

A. No. As both Staff and Public Counsel appear to recognize, had the Company done so it would have faced the possibility of a significant disallowance had November and December turned out to be warmer, rather than colder, than normal and prices subsequently plummeted below the fixed price. And this is a risk that the Company would have faced regardless of whether it had a GSIP or not. What Staff and Public Counsel have not done, however, is give the Commission a sense of the true magnitude of that risk. But as the price changes last winter and even this spring continue to demonstrate, the dollar differences between a locked-in price and the ultimate market price for any significant portion of an LDC's requirements can be huge. Indeed, in the space of a few short months, the dollar differences attributable to these price changes can easily exceed tens of millions of dollars and ultimately dwarf, by two-fold or more, an LDC's net income for the entire year. Under such circumstances, the risks associated with such activities for a gas-only LDC, without reasonable assurances regarding prudence reviews, are of a magnitude that could jeopardize the Company's very viability as a going concern.

Q. But can't the Company rely on the prospect, as Public Counsel witness Meisenheimer suggests at page 20 of her rebuttal testimony, that the prudence of its actions will ultimately be judged based on whether it acted reasonably given the circumstances that existed at the time such action was taken?

A. While I believe that the Commission would attempt to apply this standard in a fair manner, as it has in the past, I know from past experience that parties, as well as regulators, can have substantially different views on what is "reasonable" under any given set of circumstances. And in light of some of the hindsight analysis that Staff recently presented in support of its proposal to terminate our Price Stabilization Program, I have serious reservations regarding whether all parties will properly apply this standard. Indeed, Staff's analysis in that proceeding was the very antithesis of the Commission's prudence standard in that it completely ignored the information and circumstances that the Company was operating under at the time it made its decision, focusing instead on what the outcome could have been based on perfect hindsight.

Q. In light of these considerations, what approach would you recommend to address gas commodity costs?

A. Certainly, the Experimental Fixed Price Plan ("EFPP") outlined in our tariff filing and direct testimony would have established the kind of clear standards that I believe are necessary to facilitate the use of fixed instruments. I also recognize, however, that while the EFPP is more market-responsive than the current fixed price component of the GSIP, there is some validity to Staff's and Public Counsel's concern that it may not trigger for this winter. To address these concerns and still provide the Company with reasonable assurances, Laclede is willing, for this winter only, to commit 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. 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. 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.

Q. How would this modified version work?

A. 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. For convenience and ease of administration, however, the determination of gains and losses would be made by reference to the NYMEX settlement price for the month that the futures contract was purchased. In addition, the Company would absorb 10% of any losses associated with the use of such instruments up to a total amount of $1 million.

Q. Would the Company also be permitted to retain 10% of any gains?

A. Only to the extent such retention could be accommodated within the overall earnings cap of $10 million that I discussed earlier.

Q. Why is the Company proposing to limit the gains it could retain and the losses it would be required to absorb in connection with this fixed-price mechanism?

A. To the extent Public Counsel's proposal envisions exposing Laclede to unlimited gains and losses associated with the purchase of such instruments, it would make it impossible for the Company to risk purchasing any meaningful level of these instruments for its gas requirements. As I indicated earlier, 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. That is not a risk that the Company can or should be asked to take.

Q. Would the Company be required to procure fixed price instruments for a specific volume of its gas requirements?

A. No. Rather than impose a specific volume requirement, the Company proposes that a range of required volumes be established with a minimum of 10 Bcf and a maximum of 25 Bcf.

Q. Why is the Company proposing that a range be established for the required volumes?

A. 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 required to fix a minimum amount of its volume requirements. When combined with the 40% of normal winter supplies covered by the financial instruments purchased under the Company's Price Stabilization Program, a 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. 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%. Either of these scenarios, or any scenario in between, would afford customers with significant price protection this winter 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.

Q. Is there any other reason why the Company has proposed a range?

A. Yes. Both Mr. Schallenberg for the Staff and Ms. Meisenheimer for Public Counsel have discussed in their testimony 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. They have also noted, as have I, the risks faced by the Company in the absence of any clear standards regarding the possible financial consequences associated with using fixed price instruments. The Company's proposal attempts to reconcile 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. At the same time, such an approach gives 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.

Q. With this modification, would the Company be subject to prudence reviews?

A. As I indicated previously, the Company is proposing to eliminate the commodity portion of its gas procurement benchmark, together with the provision that protects the Company from prudence reviews depending on how well it performs in comparison with that benchmark. With that elimination, the Company would be subject to prudence reviews relating to any issue involving its gas supply costs other than the level and cost of the financial instruments procured by the Company and the amount of demand costs incurred by the Company to reserve gas supply. The latter would continue to be subject to the RFP-determined benchmark, as modified to reduce the Company's sharing percentages of gain or losses to 35%.

Q. Do you have any concluding comments regarding the Company's proposed modifications?

A. As I indicated previously, the Company has made a serious effort to modify its proposal in order to address, in a reasonable manner, the concerns and recommendations made by Staff and Public Counsel in their rebuttal testimony. I believe that the end result 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 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 our customers' bills. Finally, for the reasons discussed below, I believe it represents the only workable incentive plan that has been presented in this proceeding.

RESPONSE TO PROPOSALS OF STAFF AND PUBLIC COUNSEL

General Comments

Q. Do you have any general comments regarding the proposals submitted by Staff and Public Counsel in their rebuttal testimony regarding an incentive plan for Laclede?

A. Yes. Although the Company has made a concerted effort to adjust its GSIP in order to address the concerns and recommendations that have been presented in Staff's and Public Counsel's testimony, I have to say that I am disappointed by the overall direction and nature of those recommendations. As I indicated in my direct testimony, the parties agreed more than a year ago when they recommended an extension of the GSIP that they would participate in a "good faith effort to negotiate and implement a mandatory fixed rate trigger for gas supply commodity costs, on the understanding that the overall objective will be to develop a mutually acceptable and workable multi-year incentive program." While I recognize that the parties were free to propose alternative courses of action in the event they were unable to achieve this objective, it is disturbing how little relationship there is between this goal and the approaches finally recommended by Staff and Public Counsel.

Q. Please explain what you mean.

A. In contrast to the Company's proposal in this case, there is nothing in either Staff's or Public Counsel's recommended approaches that would trigger any acquisition of fixed price instruments for any portion of the Company's gas supply requirements. In light of the events of last winter, and some of the assertions made in their rebuttal testimony, it is amazing to me that neither Public Counsel nor Staff have proposed any mechanism that would provide such a trigger for at least some of the Company's requirements. Moreover, rather than propose a workable, multi-year incentive program, Staff and Public Counsel have proposed to either eliminate any workable incentive feature at all for various elements of the Company's gas costs or to implement modifications that virtually ensure that the Company can only lose money on its merchant function. In short, they have failed to propose anything that could reasonably be deemed a workable incentive program. And in addition to opposing the only workable incentive program that has been presented in this proceeding, Staff has also proposed that such a program be limited to only one year rather the multi-year arrangement originally envisioned by the parties.

Q. What is the basis for your statement that Staff and Public Counsel have failed to propose workable incentive plans in this proceeding?

A. Even in those instances where they have not opposed an incentive mechanism outright for certain elements of the Company's gas supply costs, Staff and Public Counsel have proposed to establish benchmarks or baselines that would effectively deprive the Company of any 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 rebuttal 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. 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. 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.

Q. What would be the overall impact of these proposals on the Company were they to ever be implemented?

A. 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.

Q. Why do you say that?

A. As pointed out in the rebuttal testimony of Mr. Glenn Buck, the Company is already incurring a significant level of unrecovered costs relating to its performance of the merchant function under which it purchases, stores and sells gas on behalf of its smaller customers. In the last year alone, these unrecovered costs have been conservatively estimated at nearly $5 million. Notably, a substantial portion of these costs 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. 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 anywhere from $5 million to $8 million in unrecovered gas costs from the start, both parties would also propose that the Company be exposed to the risk of even greater losses as a result of potential disallowances from future prudence reviews. I can't begin to conceive of any business that would willingly submit to providing services under these kind of punitive and patently uneconomic conditions.

Q. But isn't the Company compensated for these risks by the earnings it receives from distributing gas to customers?

A. No. As I indicated previously, and as Mr. Buck's analysis also shows, even with the income realized by the Company as a result of its efforts under the GSIP, it has still not been able to earn its authorized returns in three out of the last four fiscal years. 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. 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. And now they 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. 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 provide the financial resources required to provide utility service.

Q. You also indicated that the Company would have to re-evaluate its future merchant role for the sake of its customers in the event the recommendations made by Staff and Public Counsel were to be adopted. What did you mean by that?

A. As the Commission may know, Laclede has on numerous occasions questioned whether customers would receive any benefits from a further unbundling of our natural gas services that would permit all customers to purchase their gas supplies from alternative suppliers in a deregulated market. And we continue to believe that the current structure, which authorizes and provides the Company with incentives to pursue gas cost savings on behalf of all of its customers, still makes the most economic sense for customers. Above all else, however, it is critical to the health and welfare of our customers and the economic fabric of our state that customers continue to receive natural gas service when they need it. Laclede has always made that its highest priority and it has consistently delivered on its commitment over the years to make certain that these critical services are available. Given some of the proposals that have been submitted by Staff in the past, and the proposals that have been presented in this case by both Staff and Public Counsel, it is clear to me that they are unwilling to recognize the economic realities of what it takes to perform this function. Accordingly, if their views were to prevail, I have reluctantly concluded that consumers, as a whole, might be better off under an unregulated market structure that would at least come closer to eliciting the financial resources required to ensure the future availability of these critical resources.

Response to Baseline/Benchmark Recommendations

Q. Aside from their adverse, financial impact on the Company, are there any other reasons why the Commission should reject the proposals by Staff and Public Counsel to establish new or higher baselines for various components of the GSIP?

A. Yes. While the Company has significantly modified its sharing percentages under the GSIP in an effort to accommodate the concerns underlying these proposals, and therefore believes no further adjustments are appropriate in any event, it also has serious conceptual and factual objections to the propriety of these recommendations. The factual ones, which demonstrate why these proposals are unrealistic in light of current market conditions, are addressed by Mr. Henning and Mr. Jaskowiak in their surrebuttal testimony. I will address why the proposals are also conceptually inappropriate as a matter of policy and simple fairness.

Q. Please continue.

A. 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. According to Public Counsel witness Busch, this ensures that the Company will only be rewarded if it continues to achieve ever greater levels of savings and ensures that the Company will not be rewarded for "business as usual."

Q. What's wrong about such an approach?

A. To begin with, such an approach is really nothing more than a method for ensuring that all incentive programs will inevitably be terminated. Contrary to Public Counsel witness Busch's claim at page 20 of his rebuttal testimony, it is simply not possible for Laclede or any other LDC to achieve ever greater levels of savings and revenues through the management of their gas supply and transportation assets. 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. 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.

Q. Why should the Commission conclude that the specific rebasing proposals made by Staff and Public Counsel will produce such a result in this case?

A. Because if it was 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. Since it has operated under the GSIP for nearly five years now, Laclede has had every incentive to achieve as significant a level of savings and revenues through the management of its gas supply assets as it could without endangering reliability or taking unwarranted risks. And I can assure the Commission that we have done so. Indeed, when Mr. Busch notes 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 serves 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.

Q. But why then should the Company continue to be permitted to share in savings and revenues at levels that are no greater than what it has been achieved under the GSIP to date?

A. Because in an ever changing competitive marketplace, nothing is ever permanent and nothing can ever be taken for granted. Savings and revenues achieved today, can be gone tomorrow absent constant efforts to maintain them. Under such circumstances, it is misguided in the extreme 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. Under many circumstances, particularly in a tightening market like we face today, the most exceptional manifestation of superior performance can be to simply retain what you have already achieved. 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. Indeed, to see the flaws in the approach recommended by Staff and Public Counsel, one only has to consider whether any salesperson who works on commission would be willing to do so if they had to constantly beat their best historical performance to receive any compensation.

Q. Isn't the rebasing approach recommended by Staff and Public Counsel consistent with how revenues and expenses are determined in a general rate case proceeding?

A. No. 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. 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. And the proposed retention percentages recommended by Staff are significantly lower than that. I should note that this tradeoff between retention percentages, and whether or how high a baseline should be set, has previously been recognized by the Commission as well. 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 period. 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. For all of these reasons, I would urge the Commission to reject their recommendations.

<u>Response to Staff's "Possible" Incentive Plan</u>

Q. Have you reviewed the "possible" incentive plan that Staff witness Schallenberg has presented in his rebuttal testimony?

A. Yes, I have.

Q. Do you believe it provides a basis upon which the Commission could establish an incentive plan in the future?

A. No. As it is currently structured, I would not even consider it an incentive plan.

Q. Why is that?

A. 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. 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.

Q. How so?

A. 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. For example, LDCs have different customer growth rates from year to year because of demographic considerations that they cannot influence. Some LDCs are also exposed to significantly greater variations in weather temperatures than other LDCs. 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. Staff's proposed mechanism completely fails to distinguish or correct for these differences. Moreover, 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. 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. Once again. Staff's proposal does nothing to account for these differences.

Q. Can you determine how profound an impact these differences can have 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?

A. While I believe it can be significant, there is no way to precisely answer that question without full access to the procurement plans, operational characteristics and results achieved by each LDC. And this again illustrates another major flaw in Staff's approach. 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.

Unfortunately, the need for such access would potentially bring with it its own set of adverse consequences by eroding any competitive advantage LDCs can achieve by maintaining a certain degree of confidentiality regarding their gas procurement strategies. 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.

Q. Are there other reasons why you believe Staff's possible incentive plan is unworkable?

A. Yes. According to Mr. Schallenberg the plan would only permit LDCs to retain a share of the gas cost savings they achieve in those instances where the delivered cost of gas has declined from the previous year. In effect, such a proposal would completely eliminate any incentives when they are needed most, namely, in a rising market. Moreover, it would create the very kind of "perverse incentives" that Staff is always criticizing other incentive plans for. 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. 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. For all of these reasons, it is clear to me that Staff's possible incentive plan is completely unworkable and far more likely to retard rather than promote its asserted goals.

Response to Staff's Recommendations on Gas Procurement Reviews

Q. Have you also reviewed Mr. Schallenberg's proposals regarding a new process for evaluating the gas procurement plans and strategies of Missouri LDCs?

A. Yes. And as a general matter, I am 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, Staff's proposal raises fundamental questions regarding how involved Staff or the Commission should be in the gas acquisition strategies of LDCs. Moreover, I also have reservations regarding the feasibility of conducting such an elaborate review process within the time constraints suggested by Mr. Schallenberg and do not, in any event, believes such a review process is necessary for any portion of the Company's gas costs that are subject to incentives. 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.

Q. Does this conclude your surrebuttal testimony?

A. Yes.