Exhibit No.: _____

Issue(s): Natural Gas Prices
Witness/Type of Exhibit: Busch/Surrebuttal
Sponsoring Party: Public Counsel
Case No.: ER-2001-672

SURREBUTTAL TESTIMONY

OF

JAMES A. BUSCH

Submitted on Behalf of the Office of the Public Counsel

UtiliCorp United Inc.

Case No. ER-2001-672

January 22, 2002

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BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of the tariff filing of UtiliCorp United Inc., ("UtiliCorp") to implement a general rate increase for retail electric service provided to customers in the Missouri service area.	)))))	Case No. ER-2001-672

AFFIDAVIT OF JAMES A. BUSCH

STATE OF MISSOURI	)	
	)	ss
COUNTY OF COLE	)	

James A. Busch, of lawful age and being first duly sworn, deposes and states:

1. My name is James A. Busch. I am the Public Utility Economist for the Office of the Public Counsel.

2. Attached hereto and made a part hereof for all purposes is my surrebuttal testimony consisting of pages 1 through 11 and Schedules JAB-SR-1 and JAB-SR2.

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

James A. Busch

Subscribed and sworn to me this 22nd day of January, 2002.

BONNIE S. HOWARD
MY COMMISSION EXPIRES DEC 03 2005
NOTARY SEAL
NOTARY PUBLIC
COUNTY OF MONITEAU
STATE OF MISSOURI

Bonnie S. Howard, Notary Public

My commission expires May 3, 2005.

SURREBUTTAL TESTIMONY

OF

JAMES A. BUSCH

CASE NO. ER-2001-672

UTILICORP UNITED, INC

Q. Please state your name and business address.

A. My name is James A. Busch and my business address is P. O. Box 7800, Jefferson City, MO 65102.

Q. Are you the same James A. Busch who filed direct and rebuttal testimony in this case?

A. Yes I am.

Q. What is the purpose of your surrebuttal testimony?

A. The purpose of my surrebuttal testimony is to address the rebuttal testimony of UtiliCorp witness Mr. John W. McKinney.

Q. According to Mr. McKinney's rebuttal testimony, what is UtiliCorp's proposed methodology for establishing natural gas prices in this rate case?

A. On page 22, lines 16 and 17, and page 24, lines 6 and 7 of his rebuttal testimony, Mr. McKinney confirms that UtiliCorp is proposing to true-up the price of natural gas to actual prices paid for the 12-months ended January 31, 2002.

Q. What would the price of natural gas be based on the 12-months ended January 31, 2002?

A. As indicated in my rebuttal testimony, the 12-months ended January 31, 2002 average for natural gas based on NYMEX (New York Mercantile Exchange) closing prices is $3.654 per MMBtu.

Q. What is UtiliCorp's reasoning for basing the price of natural gas in this rate case on the most recent 12-months prices?

A. Mr. McKinney argues on page 25, lines 2 and 3 of his rebuttal testimony that UtiliCorp "should be allowed to recover the cost it paid for natural gas to produce electricity," during the past 12 months.

Q. How much did UtiliCorp "under-recover" during the year 2001?

A. UtiliCorp has not provided that information in its testimony.

Q. Is it possible that UtiliCorp did not recover its cost in regard to natural gas during 2001?

A. Yes.

Q. Is it possibly, that in years when natural gas costs were lower, that UtiliCorp recovered more than its costs with regard to natural gas costs?

A. Yes.

Q. Please explain.

A. For electric firms, a price for natural gas is built into the ultimate rate charged by the company to its customers. In years when the price of natural gas is below the built in price, the electric company may "over-recover" its natural gas costs. In years when the price is above the built in price, the electric company may "under-recover" its natural gas costs. Therefore, since the prices of natural gas between

the years of 1996 – 2001 were generally low, it can be assumed that UtiliCorp "over-recovered" its natural gas costs.

Q. Did UtiliCorp, at any point when it "over-recovered" its natural gas costs, propose a mechanism to give back the excess revenues it might have collected?

A. Not that I am aware of.

Q. Are there other factors that need to be considered when determining the harm, if any, to the Company if natural gas prices were higher than expected?

A. Yes. In the fuel run that is used to help determine the ultimate electric rates that are charged to consumers, a price for natural gas is assumed along with an assumed amount of natural gas that will be used. There are also other factors such as coal prices and volumes, purchased power contracts, spot purchases, and fuel oil that is considered when establishing electric rates. When the price of natural gas is higher then the assumed price, the Company may switch between fuels to lower the reliance on the more expensive input while taking advantage of relatively lower prices in other inputs. Further, the price of natural gas may have gone up when usage of natural gas was low due to the time of the year. This would diminish the effect the higher natural gas prices had on the utility. Therefore, just because the price of one input resource has gone up in the short-term, other factors may also change to insulate the Company from harm.

Q. What is the current 12-month futures strip price for natural gas?

A. Based on the January 17, 2002 close, the 12-month futures strip is $2.54 per MMBtu.

Q. Briefly describe some key market fundamentals for natural gas.

A. Currently, the biggest factor in the natural gas market is the abundance of storage that remains in the market. As of the week ended January 11, 2002, there was 2,529 Bcf (Billion Cubic Feet) of natural gas in storage nationwide. This is more than 1 Bcf greater than the same period last year and reflects a storage level of 77% of capacity. Further, this storage level is approximately 25% greater than the 5-year average storage level of approximately 2,000 Bcf.

Another key market fundamental is the weather. There are no major forecasts for a significant cold spell in the near future across the United States. The weather, coupled with the high storage levels, is keeping pressure on the price of natural gas to remain steady or fall somewhat.

Q. Should the Commission adopt UtiliCorp's proposal of taking the last 12-month actuals to determine natural gas prices on a going forward basis?

A. No. Establishing the proper price for natural gas in this rate case, or any rate case, on a simple 12-month average is inappropriate. The 12 months chosen could have prices that are artificially or unrealistically high compared to a more normal range of natural gas prices, or artificially or unrealistically low compared to a more normal range of natural gas prices. In the course of 12 months, short-term fluctuations in the market can cause the price to move substantially away from normal prices. An extremely cold winter, an extremely warm summer, a hurricane, or unusually low storage levels, are but a few factors that can affect the price of natural gas in the short-term, causing prices to jump higher than normal. If the 12-months chosen include these types of events, the price that is ultimately

used in the establishment of rates will not be representative of more normal natural gas prices.

Q. What is a "normal" range for natural gas prices?

A. In today's market, natural gas prices fluctuate within a normal range between $2.00 and $4.00 per MMBtu.

Q. Does the time frame that UtiliCorp proposes to use include any one-time factors as described above?

A. Yes. The period that UtiliCorp proposes to use begins with February 2001. As we all remember, the prices for natural gas in the winter of 2000/2001 were the highest on record, due to extremely cold weather in November and December and unusually low storage levels. Therefore, the prices at the beginning of UtiliCorp's proposed period are unrealistically high compared to current market conditions and above those that should be reasonably anticipated in the foreseeable future. This can be seen by Schedule JAB-SR1. This schedule is a chart showing NYMEX prices all the way back to 1990. As can be seen in this chart, a majority of the month's prices fall in the range from $1.75 to $3.00 per MMBtu. The major exceptions on the high end of the price scale are the months of December 1996 and January 1997 and the price run-up of 2000/2001 that began in early May of 2000.

Q. Is UtiliCorp's proposed methodology and anticipated price appropriate?

A. No. UtiliCorp's proposed price, based on NYMEX closing prices, is about $1.00 above current prices. UtiliCorp has a very active trading operation. If UtiliCorp was awarded a price of nearly $1.00 above current costs, UtiliCorp could merely

enter into various long-term fixed price contracts to guarantee extra profit, holding all other factors constant, which I described in my rebuttal testimony. Further, UtiliCorp's ability to hedge against adverse natural gas price movements should help insulate it from any potential future price movements.

Q. Do you have any information regarding UtiliCorp's potential use of financial instruments to hedge against adverse price movements?

A. Yes. Attached to my surrebuttal testimony as Highly Confidential Schedule JAB-SR2 are UtiliCorp's responses to Public Counsel Data Requests (DRs) Nos. 624 and 636. These DR responses indicate the strategy that UtiliCorp has begun to incorporate into its purchasing activity for natural gas. It indicates that for the year 2001 the Company had started to use financial instruments to protect against price movements and that it may already be hedging for the year 2002.

Q. On page 23, lines 12 and 13, Mr. McKinney criticizes your methodology by stating that it appears to have been selected to produce a low price and thereby minimize cost recovery. Please comment.

A. My methodology was selected to produce a reasonable price for natural gas in this rate case. My methodology, unlike UtiliCorp's, was not selected to recover any excess costs from previous periods. The price of natural gas is volatile, meaning the price can move dramatically up and down in short periods of time. My methodology tries to account for this volatility by examining historical prices that have been realized and averaging those prices with current market prices.

Q. Mr. McKinney claims that you have changed your methodology from the Empire rate case. Did you change your methodology?

A. No. Mr. McKinney has mischaracterized my testimony in Case No. ER-2001-299. As I stated on page 3, lines 3 and 6 of my direct testimony in that case, "I utilized this hybrid approach of **historical and future** data in recognition of the volatility of the natural gas market. I believe it is important to use **both historical and future** information to arrive at the appropriate natural gas cost to build into rates." (emphasis added) Further on page 2, lines 15 – 17 of my direct testimony in that case I state, "**In this case,** I believe that the price of natural gas that should be included for the purpose of reflecting proper fuel costs should be based on a four-year average of natural gas prices." (emphasis added) It is clear that my methodology is to incorporate both historical and future prices.

Furthermore, when testimony was being written for the Empire rate case, in late March of 2001, the price of natural gas was still higher than more normal levels as it was coming off the record prices of January 2001, plus storage levels were low. At the time I wrote my testimony, it was uncertain whether or not prices would be stabilizing over the next 12 months or so. Therefore, I utilized a four-year average that included a 24-month futures strip. In this case, since natural gas prices have come back to more normal levels, I felt it was more appropriate to use the 12-month futures strip.

Q. Why is a 12-month futures strip more appropriate than a 24-month futures strip in this case given the current market for natural gas?

A. A futures strip, or for that matter any futures price, is merely a price where one party is willing to buy a commodity today for future delivery and another party is

willing to sell a commodity today for future delivery at a price determined today. The information that is available in the market today will change tomorrow, which means that prices will change in the future. When looking at the futures market, the prompt month (the month immediately following the current month) is the most "reliable." This means that the information used by the market to determine what the futures price is today is closer to the actual market fundamentals that will determine the ultimate price for that month. As you move further away from the prompt month, the "reliability" of the futures as a "predictor" drops. Therefore, a 12-month futures strip will generally be more reliable than a 24-month futures strip at gauging where prices may be in the foreseeable future.

Also, the number of open contracts is greatest in the months nearest to the current month. By the time you get to 13 – 24 months from the current month, there are very little open contracts. This means that there are not a lot of transactions taking place in the market for delivery in those months. This lack of transactions mean that any price set today for a futures contract in those months is more unreliable.

Q. Are you arguing that a futures strip alone is a good predictor for natural gas prices?

A. Not at all. A futures market establishes a price today that parties will be willing to buy or sell natural gas for on a future date based on the fundamentals of today. Since the fundamentals are constantly changing, the futures price is constantly

changing. This can be seen by the volatility associated with the natural gas futures market.

Further, the fact that I average the futures strip with historical prices should indicate that I do not believe that the futures strip alone should be used to establish the price of natural gas for purposes of this rate case. The reason that I average the historical prices with the futures strip is to try to determine a price that is reasonable. When only one or the other, historical data or futures data, is used, a price could be obtained that is unrealistically high or low compared to current market conditions. A relatively common saying in financial markets is that "the past is no indicator of future performance" meaning that if an historical look results in prices around $1.75 per MMBtu and there has been a fundamental shift in the market, the $1.75 price could be unrealistically too low. Conversely, if the price for natural gas was unusually high for reasons that are no longer in affecting the market, a look at the past may provide a price that is too high.

The same argument holds true if reliance is weighted solely on the futures market for determining natural gas prices. Short-term phenomena such as hurricanes, intense cold spells, unusual storage numbers, or other factors, could cause the futures strip to move dramatically away from "normal" levels, only to fall back when the short-term factor is gone.

In this rate case, I am trying to establish an appropriate price for natural gas to be used in the fuel run to help determine the electric rates for this Company. Therefore, I must analyze all available data, historical prices, futures prices, and current market conditions, to determine what price of natural gas is the most appropriate for this rate case. There is not one time frame that can be utilized in a cookie-cutter approach to determine what that price should be in all cases. However, my technique is the most appropriate considering the volatile nature that is inherent in the natural gas market.

Q. Should natural gas be treated like other expenses such as payroll?

A. No. Payroll and other expenses are generally less volatile then natural gas prices. It is unlikely that any expense that the Company has changes as dramatically in such a short time frame as the price of natural gas. Due to this volatility, the appropriate price of natural gas to use can not be determined in the same way as payroll or other expenses. It is essential that factors outside of a narrow 12-month focus be considered when establishing the appropriate price level.

Q. What could happen if current market conditions were completely ignored when establishing the appropriate natural gas price to help set rates?

A. Current market conditions need to be evaluated to ensure that a price is not set too low such that the Company does not have a reasonable opportunity to acquire natural gas near the price that is built into rates. On the other hand, the price of natural gas can not be set so high that the Company can make excess profits, holding all other factors constant, by merely locking in natural gas for the future

because current prices are substantially below the price used in establishing rates. I described this problem in my rebuttal testimony.

Q. Mr. McKinney, in his rebuttal testimony, claims that you omitted 2001 prices from your calculation because those prices were too high. Is that an accurate characterization of why you omitted those prices?

A. No. I used historic prices through December 2000 to align my methodology with the test year. I utilized the 2002 12-month strip because that was the nearest 12-month strip going forward.

Q. What would be your result if you updated your methodology to include the 24 months ended January 2002 plus the current 12-month futures strip?

A. If I updated my methodology to current numbers, and still used my methodology of replacing the months with prices over $5.00 per MMBtu and was 50% greater than the next highest monthly price with that months next highest price, my methodology would result in a price for natural gas of $2.90 per MMBtu.

Q. Does this conclude your surrebuttal testimony?

A. Yes it does.

OFFICE OF PUBLIC COUNSEL

UtiliCorp United, Inc.
Case No. ER-2001-672
Historical NYMEX Prices

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
January		$ 2.046	$ 1.695	$ 2.003	$ 2.022	$ 1.639	$ 3.448	$ 3.998	$ 2.309	$ 1.765	$ 2.344	$ 9.978	$ 2.555
February		$ 1.538	$ 1.046	$ 1.634	$ 2.470	$ 1.416	$ 2.340	$ 2.986	$ 2.001	$ 1.810	$ 2.610	$ 6.293	
March		$ 1.395	$ 1.249	$ 1.906	$ 2.418	$ 1.428	$ 2.746	$ 1.780	$ 2.286	$ 1.666	$ 2.603	$ 4.998	
April		$ 1.391	$ 1.418	$ 2.224	$ 1.981	$ 1.566	$ 2.779	$ 1.807	$ 2.300	$ 1.852	$ 2.900	$ 5.384	
May		$ 1.350	$ 1.596	$ 2.758	$ 2.076	$ 1.672	$ 2.214	$ 2.122	$ 2.262	$ 2.348	$ 3.089	$ 4.891	
June	$ 1.557	$ 1.336	$ 1.685	$ 2.119	$ 1.851	$ 1.757	$ 2.361	$ 2.346	$ 2.017	$ 2.226	$ 4.406	$ 3.738	
July	$ 1.510	$ 1.167	$ 1.517	$ 1.918	$ 1.966	$ 1.532	$ 2.646	$ 2.145	$ 2.358	$ 2.262	$ 4.369	$ 3.182	
August	$ 1.426	$ 1.195	$ 1.939	$ 2.121	$ 1.789	$ 1.385	$ 2.322	$ 2.161	$ 1.942	$ 2.601	$ 3.820	$ 3.167	
September	$ 1.428	$ 1.420	$ 1.987	$ 2.401	$ 1.484	$ 1.575	$ 1.853	$ 2.515	$ 1.672	$ 2.912	$ 4.618	$ 2.295	
October	$ 1.555	$ 1.800	$ 2.743	$ 2.066	$ 1.406	$ 1.644	$ 1.828	$ 3.346	$ 2.031	$ 2.570	$ 5.310	$ 1.830	
November	$ 1.970	$ 1.772	$ 2.499	$ 2.155	$ 1.683	$ 1.772	$ 2.652	$ 3.266	$ 1.972	$ 3.092	$ 4.541	$ 3.202	
December	$ 2.380	$ 1.987	$ 2.332	$ 2.385	$ 1.661	$ 2.241	$ 3.901	$ 2.577	$ 2.149	$ 2.120	$ 6.016	$ 2.316	

SCHEDULE JAB-SR2

HAS BEEN DEEMED

HIGHLY CONFIDENTIAL

IN ITS ENTIRETY.