BEFORE THE MINNESOTA PUBLIC UTILITIES COMMISSION

Gregory Scott	Chair
Edward A. Garvey	Commissioner
Marshall Johnson	Commissioner
LeRoy Koppendrayer	Commissioner
Phyllis A. Reha	Commissioner

In the Matter of An Investigation into UtiliCorp United Inc.'s 1998-99 Gas Purchasing Practices

ISSUE DATE: August 12, 2002

DOCKET NO. G-007,011/CI-01-295

ORDER ACCEPTING AND ADOPTING ALJ'S REPORT

PROCEDURAL HISTORY

On September 1, 1999, Peoples Natural Gas Company (Peoples) and Northern Minnesota Utilities (NMU) (collectively the Companies), Divisions of UtiliCorp United Inc. (UtiliCorp or the Company), filed their annual automatic adjustment reports and annual true-up filings for the period July 1,1998, through June 30, 1999.[1]

In the period between February and May of 2000, the Department of Commerce (DOC) and the Companies submitted comments, reply comments and supplemental reply comments. At this time, the DOC recommended disallowing rate recovery of approximately $3.4 million of gas costs related to UtiliCorp's use of fixed-price commodity gas purchases. The disallowed rate recovery represents the excess cost of the fixed gas purchases over index-prices for the 1998-99 reporting period.

On March 12, 2001, the Commission issued its ORDER ACTING ON GAS UTILITIES' 1999 ANNUAL AUTOMATIC ADJUSTMENT REPORTS AND OPENING INVESTIGATION and its NOTICE AND ORDER FOR HEARING. Specifically, the Commission opened an investigation into the reasonableness of UtiliCorp's[2] purchase of fixed-price gas supplies during

[1] Pursuant to Minn. Rules part 7825.2810, subp. 1 & 2 and Minn. Rules, part 7825.2910, subp. 4

[2] UtiliCorp purchases fixed-price gas on behalf of its Minnesota utilities, Peoples and NMU. The cost of fixed-price gas at issue was allocated by UtiliCorp to Minnesota ratepayers who were served by Northern Natural Gas Pipeline (NNG) system. Peoples' ratepayers are served by three different pipeline systems and pay different rates on that basis. NMU's ratepayers are served by four different pipeline systems, including NNG, and pay one average rate. UtiliCorp allocates a portion of its fixed-price gas supplies to each of the states it serves that use the NNG system.

the 1998-99 reporting period and whether the cost difference between the fixed-price supplies and index-priced supplies should be recovered in rates. The Commission referred the matter to the Office of Administrative Hearings for contested case proceedings.

On February 25, 2002, the Administrative Law Judge (ALJ) issued his Findings of Fact, Conclusions, Recommended Order and Memorandum in this matter. The ALJ recommended that the Commission accept the purchased gas adjustment filings by the Companies for the 1998-99 heating season. Further, the ALJ recommended that the Commission find that UtiliCorp's hedging policy and its implementation were neither imprudent nor unreasonable during that time. The ALJ did not recommend a disallowance for either Peoples or NMU.

On March 18, 2002, UtiliCorp and the DOC submitted exceptions to the ALJ's report. On March 28, 2002, the parties submitted replies.

This matter came before the Commission on July 11, 2002.

FINDINGS AND CONCLUSIONS

I. Summary of the Issue

Peoples and NMU filed their 1998-99 annual automatic adjustment reports and annual true-up filings for the period July 1, 1998 through June 30, 1999. The DOC recommended that UtiliCorp not be permitted to recover \$2.357 million of the cost of natural gas bought during the 1998-99 reporting period.

The DOC challenged as unreasonable and imprudent the way in which UtiliCorp implemented its policy to hedge the risk of price fluctuations in natural gas by purchasing a mix of fixed-price gas supplies, index priced gas supplies and gas for storage during the relevant period.

The DOC challenged UtiliCorp's decision to purchase enough natural gas through fixed-price contracts and for storage to meet approximately 47% of its expected, normal winter heating season demand for the 1998-99 heating season. The DOC believed the Company should have reevaluated its policy before the 1998-99 heating season and should have purchased, through fixed contracts, not more than 43% of its expected, normal winter heating season demand. The DOC argued that the smaller percentage was more prudent given that the supply of natural gas was much greater in 1998 than in the previous year.

The DOC also challenged as unreasonable UtiliCorp's reliance on weather forecasts of a colder than usual winter for 1998-99 to establish its fixed gas purchasing target at 47%.

II. Summary of ALJ's Report

The ALJ concluded that UtiliCorp had the burden of establishing that the rates it charged regulated customers were fair and reasonable. The ALJ concluded that in order to meet that burden, the

Company had to establish that its policies and practices used to purchase natural gas sold to customers were reasonable and prudent.

The ALJ made the following additional conclusions:

- that UtiliCorp's policy of hedging its purchases of natural gas by acquiring between 40% and 50% of anticipated normal winter heating needs for 1998-99 was not unreasonable or imprudent;

- that it was not unreasonable or imprudent for UtiliCorp to include expected heating season demand for interruptible customers in its calculation of normal expected winter demand in its hedging program;

- that UtiliCorp's implementation of its hedging policy for the 1998-99 heating season was not unreasonable or imprudent.

The ALJ recommended that the Commission accept the purchased gas adjustment filing by Peoples and NMU for the 1998-99 heating season and conclude that the hedging policy and its implementation were neither imprudent nor unreasonable during that time.

Specifically, the ALJ's Findings of Fact and Memorandum included, among other things, the following;

- UtiliCorp's policy called for purchasing between 40% and 50% of its gas supply needs through fixed contracts for the 1998-99 heating season. Because the weather forecast predicted a colder than normal winter, UtiliCorp targeted its 1998-99 winter purchasing goal at the higher end of the 40%-50% range (47%). These fixed rate purchases were made during the months of March through August in a manner to dollar cost average them in the non-heating season. The total fixed-price purchases amounted to slightly less than 50% of UtiliCorp's normal expected requirements.

- While there may be an honest disagreement whether the Company should have hedged a smaller percentage of its expected normal demand for 1998-99, the Company's decision to continue to implement its hedging policy using a dollar cost averaging strategy was not unreasonable or imprudent.

- The purpose of a hedging strategy is to lock in natural gas supplies for the next heating season at a fixed-price to minimize the affect on ratepayers of swings that occur in the market price. It is not necessarily a cost minimization strategy. When utilities use a hedging strategy, regulated customers will not fully benefit from a sudden drop in prices during the heating season, nor will they experience sharp price increases if the market price suddenly increases.

- While the DOC established that there were indicators during 1998 showing that the supply of natural gas was more robust relative to demand than during 1997, the DOC did not establish that UtiliCorp's failure to re-evaluate the market and lower the quantity of fixed-price gas to be purchased was either unreasonable or imprudent.

- UtiliCorp's decision to purchase volumes of fixed-price gas at the higher end of its hedging range for 1998-1999 was based on forecasts of a colder than normal winter. This was not unreasonable.

- UtiliCorp's decision to implement its hedging strategy using dollar cost averaging for 1998-99 without conducting a new analysis of the natural gas market was also not unreasonable. Had UtiliCorp lowered the targeted % amount of supplies that it would hedge in hopes that it had properly assessed changes in the market, it would have been acting contrary to the stated purpose of a hedging program, which is to lock in the price for a portion of natural gas that will be needed so that customers are not subject to swings in the market price for natural gas.

- UtiliCorp's implementation of a dollar cost averaging strategy of purchasing volumes of gas was reasonable because it minimized the risk of changes in the market.

- It was reasonable for the Company to consider the forecast for a colder winter and to choose to purchase at the higher end of its range in order to hedge more gas in the event of upward price spikes due to a colder winter. The Company could have analyzed storage and other market data and concluded that index gas prices would be lower during the heating season but its strategy of trying not to outguess the market was also reasonable. The Company's dollar cost averaging of its fixed gas purchases minimized the risk of changes in the market.

III. Exceptions to the ALJ's Findings of Fact, Conclusions, Recommended Order and Memorandum

A. DOC

Exception 1:

The DOC believed that UtiliCorp performed no meaningful review of its hedging policy of the previous year before making fixed-price purchases for the 1998-99 period nor did UtiliCorp perform any updated analysis for the 1998-99 period. The DOC argued that the Company's failure to evaluate current market conditions was unreasonable.

Exception 2:

The DOC argued that UtiliCorp's failure to assess current market conditions in order to establish the percentage of fixed-price gas to buy was contrary to its own purchasing policy and was not shown by the Company to be reasonable.

Exception 3:

The DOC argued that it was unreasonable for UtiliCorp to include the needs of interruptible customers in determining its normal winter requirements. The effect of including the interruptible volumes inflated the Company's system-wide normal winter requirements. UtiliCorp did not provide a reasonable basis for including them and not doing so was unreasonable.

Exception 4:

The DOC argued that it was unreasonable for UtiliCorp to have selected a purchasing target at the high end (47percent) rather than the low end (40 to 43 percent) of its range when supply (relative to demand) was significantly greater than the preceding year.

It also questioned why the Company gave such weight to long term weather forecasts in the face of indications of significant supply (over demand) conditions. The DOC argued that the company did not show it was reasonable to rely on long-range weather forecasts to adjust its target upward.

Exception 5:

The DOC believed that UtiliCorp exceeded its stated 47 percent target with no explanation and that it was unreasonable for UtiliCorp to do so. The DOC believed that the total fixed-price purchases were 57.519 percent of normal winter requirements. The Company offered no evidence of any circumstances under which it would be reasonable to exceed its range.

Exception 6:

The DOC argued that UtiliCorp has failed to demonstrate that it purchased fixed-price gas in accordance with its plan to purchase 47 percent of system-wide normal winter requirements. The record evidence, it argued, showed that the Company purchased 57.519 percent of system-wide normal winter requirements in fixed-price gas. Since UtiliCorp has not shown that it purchased fixed-price volumes in accordance with the plan, it is unreasonable to impose on Minnesota ratepayers the higher costs, over index costs, associated with fixed-price volumes in excess of 47 percent (or even 43 percent) of its system-wide normal winter requirements.

Exception 7:

The DOC agreed with the ALJ's recommendation that avoids the adoption of a minimum requirements standard. The DOC argued that the record did not sufficiently develop a minimum requirements standard and there was no support in the record for the ALJ's conclusion in his Memorandum that " ...A minimum requirements standard would not result in smaller volumes of gas being hedged."[3] The DOC argued that cost recovery or denial should not be based on whether UtiliCorp's fixed volumes were less than the minimum requirements of Peoples' or NMU's ratepayers.

B. UtiliCorp's Exceptions

UtiliCorp argued that the Commission should accept the ALJ's Report. It raised a few concerns that certain findings could be misinterpreted if read out of context.

It also argued that the ALJ should not have discounted evidence presented on other utility hedging activities (ALJ Memorandum p.12). UtiliCorp argued that such information was relevant as to whether UtiliCorp acted reasonably and the Commission should recognize that in its findings.

UtiliCorp, at oral argument before the Commission, withdrew its exceptions to the ALJ's report.

IV. UtiliCorp's Reply to DOC's Exceptions

UtiliCorp argued that it did evaluate the actions taken during its first year of hedging and also evaluated whether hedging continued to be reasonable. It determined that hedging continued to make sense and that overall market conditions were still in balance. Further, it recognized that for 1997-98, the company started the hedging program too late to dollar cost average by purchasing its supplies over the normal five month purchasing season. In contrast, the Company was able to engage in dollar cost averaging for its 1998-99 gas supplies.

UtiliCorp, based on its concerns that a colder winter could increase price volatility, targeted 47 percent of its normal system-wide NNG requirements for hedging. The DOC would have set the Company target at no more than 43 percent. The Company argued that this was a matter of judgment and the DOC, using after-the -fact reasoning, has drawn too precise a line between reasonable and imprudent behavior.

Further, in response to the DOC's claim that the Company gave "overriding weight" to the prediction of a colder winter than normal, UtiliCorp argued that selecting 47% rather than 45% (the midrange) was a reasonable exercise of judgement. Further, UtiliCorp argued that the weather is the single most important and unpredictable variable affecting demand. Weather is important because it changes demand too quickly for supply to respond, causing temporary shortages with resulting price spikes. A colder than normal winter, all else being equal, would have resulted in greater price volatility, with price spikes.

UtiliCorp, in response to the DOC's statement that the Company hedged 57.519 percent of its NNG normal requirements, stated that the DOC's assertion is false. It is based solely on one exhibit which sums the total fixed-price purchases and the total injections into storage. The later include both volumes injected into storage for hedging purposes and those volumes injected into storage because of operational requirements. UtiliCorp stated that the document in question

[3] ALJ's Recommendation at 12.

demonstrates that UtiliCorp actually hedged 46.988 percent of its normal requirements.

UtiliCorp argued that interruptible sales volumes were properly included in the determination of normal requirements because interruptible sales customers take gas during normal usage conditions. These customers have their gas supplies interrupted only at times of peak demand, when gas supplies or pipeline constraints will not permit them to receive service. They may go an entire season without being interrupted. They are not interrupted each time that demand reaches normal usage levels. The gas supplies purchased to serve interruptible customers are included with the gas supplies to serve firm sales customers. The Company provides sales service to both firm and interruptible customers during normal usage conditions so it is necessary to purchase gas supplies for all sales customers during normal demand. For this reason, UtiliCorp included all sales volumes used during normal conditions to determine its normal requirements.

V. Commission Action

The Commission concurs with, accepts and adopts the ALJ's findings, conclusions and recommendations on this matter. They are well developed, thoughtful, and supported by the weight of the evidence. The parties presented expert witnesses offering differing opinions about the significance of events in the market for natural gas and the appropriate responses by utilities. The ALJ was in the best position to determine issues of credibility of witnesses and the Commission will defer to the ALJ's determinations on these issues.

The ALJ concluded that UtiliCorp's gas purchasing decisions for 1998-1999 were reasonable and prudent citing a definition of reasonableness articulated by the Minnesota Supreme Court:

> Reasonableness is a concept of some flexibility and moderation, not exclusivity; a determination that one course of conduct is reasonable is not a determination that any other course is unreasonable.[4]

The Commission agrees with the ALJ that the Company's conduct meets this standard of reasonableness.

The Commission recognizes that there may be some disagreement as to the Company's gas purchasing decisions for this time period but the Commission agrees with the ALJ that UtiliCorp's gas purchasing decisions were logical, based on known relevant facts, and were reasonable.

Since the Commission agrees with the ALJ that there was nothing unreasonable in UtiliCorp's implementation of its hedging policy for the 1998-99 reporting period, the Commission will permit NMU and Peoples to recover from their regulated customers all costs incurred for the purchase of fixed-price gas supplies during the 1998-1999 reporting period. Further, the Commission will accept Peoples' and NMU's 1998-99 annual automatic adjustment reports and true-up filings in the relevant docket.

---

[4] Application of Peoples Natural Gas Co., 389 N.W. 2nd 903, 908 (Minn. 1986).

ORDER

1. The Commission adopts and incorporates herein the ALJ’s report consisting of the ALJ’s Findings of Fact, Conclusions, Recommended Order and Memorandum.

2. Peoples and NMU shall each recover from their regulated customers all costs incurred for the purchase of fixed-price gas supplies during the 1998-1999 reporting period.

3. Peoples’ and NMU’s 1998-99 annual automatic adjustment reports and true-up filings in Docket No. G,E-999/AA-99-1095 are hereby accepted.

4. The decision in this docket shall not impede the Commission’s decision making ability in Docket G007,011/CI-01-501, *In the Matter of an Investigation into UtiliCorp’s Gas Supply Services Department.*

5. This Order shall become effective immediately.

BY ORDER OF THE COMMISSION

Burl W. Haar
Executive Secretary

(S E A L)

This document can be made available in alternative formats (i.e., large print or audio tape) by calling (651) 297-4596 (voice), (651) 297-1200 (TTY), or 1-800-627-3529 (TTY relay service).