Missouri Public Service Commission

Natural Gas Roundtable Discussion Group
Record of Proceedings

Properly Structured Incentive Plans

October 26, 2001
State Information Center
Jefferson City, Missouri

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Secretary/Chief Regulatory Law Judge
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General Counsel

MEMORANDUM

TO: Natural Gas Roundtable Discussion Group

FROM: Warren Wood WW

SUBJECT: Record of Proceedings

DATE: November 8, 2001

Thank you for attending the Commission's Natural Gas Roundtable session on **Properly Structured Incentive Plans** held in Jefferson City, Missouri on October 26, 2001. As promised, please find attached a bound compilation of the materials presented.

Our desire is to make these meetings as informative, beneficial, and effective as possible. Any ideas or suggestions you may have to help us toward that end are always appreciated. Feel free to contact me at (573) 751-2978 or e-mail me at wwood@mail.state.mo.us with any comments. We look forward to your attendance and active participation at future roundtable meetings.

Attachment

Table of Contents

Warren T. Wood, PE
Energy Department Manager
Missouri Public Service Commission Staff

Mr. Wood is the manager of the MoPSC's Energy Department with responsibilities over Missouri's regulated natural gas and electric utilities. Prior to coming to the MoPSC, Mr. Wood was a consulting engineer with Black & Veatch Architects / Engineers. Mr. Wood has worked extensively on the design of coal fired, single and combined cycle combustion turbine, and nuclear power plants.

Since coming to the MoPSC in 2000, Mr. Wood has spent much time responding to concerns from the general public and legislators on the energy price spikes observed in the 2000-01 winter. This has involved speaking at numerous public meetings and testifying before a legislative committee, the Governor's Energy Policy Task Force, and Missouri's Attorney General. One of his primary responsibilities over the past few months was acting as the Chair of the MoPSC's Natural Gas Commodity Price Task Force. This task force investigated what factors led to the dramatic increases in customer's bills last winter and developed options on how to improve the natural gas costs recovery process in the future.

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Properly Structured Incentive Plans

Natural Gas Roundtable Discussion Group
October 26th, 2001 - 1:00 to 4:00 PM
State Information Center, Interpretive Center, Room 139
600 West Main, Jefferson City, MO

12:30 Registration

1:00 Opening Remarks & Introductions
Warren Wood, Energy Department Manager, MoPSC Staff

1:15 Presentation by NRRI on Incentive Plans
Kenneth Costello, Senior Institute Economist, National Regulatory Research Institute (NRRI), Ohio State University
Objectives & Structures of Incentive Plans

1:50 Break

2:00 Responses of Panelists
The following panelist will respond to the information provided by NRRI and provide their thoughts on properly structured incentive plans and how to implement them:

Barb Meisenheimer, Chief Economist, Office of the Public Counsel
Scott Glaeser, Manager Natural Gas Supply & Transportation, Ameren Energy Fuels & Services Company
Kenneth Neises, Senior Vice President – Energy & Administrative Services, Laclede Gas Company
Bob Schallenberg, Utility Services Division Director, MoPSC Staff
Doug Micheel, Senior Public Counsel, Office of the Public Counsel
Warren Wood, Energy Department Manager, MoPSC Staff

3:00 Open Discussion/Question Period for All Participants

What are the likely objectives/goals of an incentive plan?
What are the likely internal mechanics of an incentive plan?
What kind of incentive plans do we see in the natural gas industry?
What kind of outcomes should we be wary of?
What are the next steps toward implementation?

3:50 Closing Remarks

4:00 Adjourn

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Ken Costello

Senior Institute Economist
National Regulatory Research Institute
Ohio State University

Mr. Costello received B.S. and M.A. degrees from Marquette University and completed some doctoral work at the University of Chicago. Mr. Costello previously worked for the Illinois Commerce Commission, the Argonne National Laboratory, Commonwealth Edison Company, and as an independent consultant.

Mr. Costello has conducted extensive research and written widely on topics related to the energy industries and public utility regulation. His research has appeared in books, technical reports and monographs, and scholarly and trade publications. These publications include the *Cato Journal*, *Electricity Journal*, *Energy Journal*, *Energy Law Journal*, *Public Utilities Fortnightly*, *Regulation*, *Resources and Energy*, and *Yale Journal on Regulation.*

Mr. Costello has also provided training and consulting services to the countries of Argentina, Bolivia, Canada, the Central and Eastern European countries, China, Costa Rica, Egypt, India, Japan, the Newly Independent States, and Russia.

Mr. Costello's recent areas of research include measuring the benefits of gas-customer choice programs, electric industry restructuring, pricing rules for utility-affiliate transactions, "code of conduct" rules, hedging programs for gas utilities, and interregional coordination of electric transmission organizations.

Barbara Meisenheimer
Office of the Public Counsel
Jefferson City, Missouri

Barbara Meisenheimer has been with the Missouri Public Counsel since 1996. She serves as a Chief Economist providing testimony and technical support in the representation of ratepayers of public utilities before the Missouri Public Service Commission and the Courts. Her primary areas of responsibility are telecommunications and natural gas.

Ms. Meisenheimer received her Bachelor of Science degree in Mathematics from the University of Missouri-Columbia. She has completed the comprehensive exams for a Ph.D. in Economics from the same institution with emphasis in the areas of Quantitative Economics, and Industrial Organization.

Ms. Meisenheimer has actively participated in State and National forums addressing telecommunications and gas policy issues. She has served on Missouri's Adaptive Telecommunications Equipment Program Advisory Committee, the Telecommunications Roundtable Agenda Committee. At the national level, Ms. Meisenheimer served on the FCC's North American Numbering Council as a representative of the National Association of Utility Consumer Advocates. She also serves as a staff member to the Federal Communication Commission's Universal Service Joint Board. Ms Meisenheimer has testified and supervised testimony on gas supply incentives design issues. Most recently she has participated in the Commission's Natural Gas Commodity Price Task Force.

Scott A. Glaeser
Manager, Natural Gas Supply And Transportation
AmerenEnergy Fuels And Services Company
sglaeser@ameren.com

Scott A. Glaeser is manager, Natural Gas Supply and Transportation, for AmerenEnergy Fuels and Services Company where he is responsible for the natural gas supply for Ameren's affiliates including AmerenUE, AmerenCIPS, and Ameren Generating Company.

Glaeser joined AmerenUE in 1991 as a natural gas fuel buyer in the Fossil Fuels Department. In March of 1998, he became a supervising engineer of Gas Supply under Ameren Services Company and was promoted to manager of Gas Supply later that year. Glaeser has extensive industrial end-user energy experience having worked for National Steel Corporation in the energy management area from 1987 to 1991.

Glaeser earned his bachelor's degree in mechanical engineering from the University of Missouri at Rolla.

Biography of Kenneth J. Neises

Kenneth J. Neises is Senior Vice President of Energy & Administrative Services of Laclede Gas Company, St. Louis, Missouri. He was elected to this position in March 1998. He joined Laclede in 1983.

Prior to joining Laclede, Mr. Neises was a partner in the law firm of Debevoise and Liberman in Washington, D.C. where he represented clients involved in natural gas, electric, airline and telecommunications businesses.

Mr. Neises is a graduate of Creighton University and the Georgetown University Law Center.

Mr. Neises is a member of the American Bar Association, the District of Columbia Bar Association, the Missouri Bar Association, the St. Louis Metropolitan Bar Association and the Federal Energy Bar Association.

Bob Schallenberg
Utility Services Division Director
Missouri Public Service Commission Staff

Bob is a 1976 graduate of the University of Missouri at Kansas City with a Bachelor of Science degree with a major emphasis in Accounting. In November 1976, Bob successfully completed the Uniform Certified Public Accountant (CPA) examination and received his CPA certificate. In 1989, Bob received his CPA license to practice in Missouri.

Bob has worked for the Commission for nearly 25 years. Bob began employment with the Missouri Public Service Commission as a Public Utility Accountant in November 1976. He remained on the Staff of the Missouri Public Service Commission until May 1978, when he accepted the position of Senior Regulatory Auditor with the Kansas State Corporation Commission. In October 1978, Bob returned to the Staff of the Missouri Public Service Commission and remained to this date.

In October 1997, Bob began to work in his current position as Division Director of the Utility Services Division of the Commission. This group has primary responsibilities in the areas of accounting, auditing, depreciation, and finance. This group conducts regulatory, financial, and management audits on both a formal and informal basis. Bob is actively involved in several reviews of the Agency's practices to find opportunities to improve the efficiency and effectiveness of the Commission operations.

Bob has filed and given testimony before the Commission and the Federal Energy Regulatory Commission. Bob has been a participant in prudence reviews and the related legal proceedings. Bob has been involved with many of the incentive or alternative regulatory plans that have been implemented here in Missouri. These endeavors span the electric, natural gas, and telephone industries.

Doug Micheel
Office of the Public Counsel
Jefferson City, Missouri

Doug Micheel has been with the Missouri Public Counsel for 9 years. He is the Senior Public Counsel responsible for natural gas.

Mr. Micheel received his Bachelor of Arts degree in Political Science from Kansas State University. Mr. Micheel received a J.D. from Creighton University School of Law.

Mr. Micheel has actively participated on the Natural Gas Committee for the National Association of Utility Consumer Advocates. He has participated in State and National forums addressing gas policy issues. Most recently Mr. Micheel participated in the Commission's Natural Gas Commodity Price Task Force.

BRENDA WILBERS

Education

Undergraduate: Lincoln University, Jefferson City, MO
B.S. in Business Administration, 1985

Graduate: University of Missouri-Columbia
Master of Public Administration, 1996

Energy and Environmental Experience

Energy Policy and Analysis Program Director
Department of Natural Resources
Outreach and Assistance Center - Energy Center
Jefferson City, Missouri
July 1999 – present
Energy policy analysis and development; energy-related legislation; utility industry restructuring; state energy program grants and reporting; energy emergency planning; energy price and supply issues; strategic planning

Environmental Policy Analyst
Department of Natural Resources
Department Director's Office
September 1997 -- July 1999
Environmental policy analysis; interagency coordination of issues; federal and state legislative analysis; liaison with Upper Missouri River Native American tribes; transportation policy review

Intergovernmental Affairs Planner
Department of Natural Resources Energy Center
December 1991 – September 1997
State utility industry restructuring – consumer and energy policy issues; state affordable housing issues; division legislative liaison; federal and state legislative analysis and state fiscal impact statement; intergovernmental coordination of energy policy issues

November 1988 – December 1991
Performance Auditor
Committee on Legislative Research - Oversight Division
State legislative policy analysis and fiscal impact statements; program reviews

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Missouri Public Service Commission
Natural Gas Roundtable on Properly Structured Incentive Plans
October 26th 1:00 to 4:00, State Information Center

Good afternoon and thank you for coming to this Natural Gas Roundtable on Properly Structured Incentive Plans. The events of last winter and the recent recommendations of the PSC's Natural Gas Commodity Price Task Force make this is an important and timely discussion. The task force's recommendations and testimony in numerous cases clearly state that properly structured incentive plans may provide opportunities for improving how the customers of natural gas utilities are served. For that reason, I am very excited to hear the presentations that are lined up for today, starting with our keynote speaker, who we were very fortunate to be able to have come to this roundtable:

Ken Costello
Senior Institute Economist
National Regulatory Research Institute

As shown in the agenda, we will follow the presentation by Ken Costello by a panel discussion focused on responses to the information presented by NRRI and the panelist's thoughts on incentive plans and how to implement them. Our panelists for today's discussion are:

Barb Meisenheimer, Chief Economist, Office of the Public Counsel
Scott Glaeser, Manager Natural Gas Supply & Transportation, Ameren Energy Fuels & Services Company
Kenneth Neises, Senior Vice President – Energy & Administrative Services, Laclede Gas Company
Bob Schallenberg, Utility Services Division Director, MoPSC Staff
Doug Micheel, Senior Public Counsel, Office of the Public Counsel
Warren Wood, Energy Department Manager, MoPSC Staff

Before going any further, I want to clarify that Incentive Plans are not a new concept in the State of Missouri. In fact, since MGE's first plan in case GO-94-318, we've seen a number of incentive plans with different structures. These incentive programs have primarily focused on providing an incentive for LDCs to reduce cost associated with specific components of performing the merchant function. Individual incentives have been believed to contribute to overall cost mitigation in the area of gas procurement.

Some have suggested, however, that ultimately an incentive program should only reward the LDC's efforts in the event that the overall delivered cost of gas falls below some benchmark performance. Some have suggested that these benchmarks may be based on historic performance, expected price or costs, and/or comparisons to other LDCs. The common attributes to Missouri's Gas Supply Incentive Plans (GSIPs) have been gas commodity price benchmarks, capacity release sales, off system sales, transportation discounts, and/or pipeline mixes.

As I noted earlier, GSIPs started in Missouri with Missouri Gas Energy's plan in case no. GO-94-318. MGE has also had a number of other plans, one of which continues in a limited form.

Laclede also has a history of GSIPs. The first of their GSIPs was GR-96-193 – which was approved in a stipulation as part of that rate case. Since then a number of GSIP cases have taken place with the most recent one expiring within the last month.

Another GSIP currently in place is AmerenUE's and it continues by a stipulation that will end it in May of 2002.

The state has also seen a number of Price Stabilization Plans (PSPs). In the winters of 1995-96 and 1996-97, AmerenUE had a limited experimental program with a sharing grid.

Following the 1996-97 winter, a generic PGA docket (the one that went to 2 PGA changes per year) was followed by more standard PSPs, without incentives, being in place the winters of 1997-98 and 1998-99 for our 3 largest LDCs.

The most recent PSP was Laclede's, which included 2 incentive features - price protection and overall cost reduction. This program was in effect for 3 years and will end after the winter.

For one reason or another, these incentive plans have ended, or are scheduled to shortly. I hope that everyone here today will avoid the temptation to debate these cases again and instead focus forward on what can be done to implement incentive plans based on as many of the principles that are going to be discussed today as possible.

One of the primary factors that led to this roundtable being focused on properly structured incentive plans is the fact that this concept was strongly supported by the Natural Gas Commodity Price Task Force. The final report of this group includes a summary of the objectives that any properly structured incentive plan should have. I would have gone through these points as part of my opening remarks but understand that Barb Meisenheimer of OPC, who was actually one of the authors of this section of the task force's report, will cover these bullets in her remarks when we go to the panel discussion.

With that said, I'm honored to introduce our keynote speaker:

Kenneth Costello

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nrri

PROPERLY STRUCTURED INCENTIVE PLANS

Ken Costello
Senior Institute Economist
THE NATIONAL REGULATORY RESEARCH INSTITUTE

Roundtable Discussion Group
Natural Gas
Jefferson City, Missouri
October 26, 2001

TOPICS

- Rationale for incentive plans (IPs)
- Objectives/goals of IPs
- Basic mechanics of IPs
- Features of good IPs
- Kinds of IPs for local gas distribution companies
- Pitfalls to avoid
- Incentives and risk management
- Summary

RATIONALE FOR IPs

- Asymmetric information where the utility has better knowledge of (1) its opportunities to control costs, and (2) market conditions, than its regulator
- Deviation of a utility's goals and public interest goals
- Transitory mechanism (for emerging competitive activities) versus permanent mechanism (for natural monopoly activities)

RATIONALE FOR IPs - continued

- Perception of traditional regulation as flawed in eliciting good performance
  - "fully distributed cost"prices to consumers
  - **Limited utility profits and risks**
  - Rigid prices
  - **Cost-plus-type contract**
  - **High information costs for regulators**
- For example, standard PGAs not conducive to maximum cost-efficiency performance by a utility (what would be good for consumers may not be worth the effort for the utility to pursue)

OBJECTIVES/GOALS

- Overriding goal of creating consumer benefits
- Problem of prevailing regulatory incentives (via rate of return regulation and standard PGAs): weak incentives for a utility to control costs and take additional actions that could benefit consumers
- Implies that an IP, while allowing a utility to increase its profits, should have the end result of benefiting consumers

OBJECTIVES/GOALS – continued

- Thus the desirability of a "win-win" outcome ("the invisible hand of Adam Smith")
- The requirement, for example, of consumer benefits from improved cost efficiency (i.e., the utility redistributing some pre-specified portion of cost savings to consumers)

OBJECTIVES/GOALS - continued

- Objectives may include
  - Improving cost efficiency
  - Improving price efficiency
  - Moderating price volatility
  - Promoting fairness
  - Preventing a decline in reliability/quality
  - Increasing a utility's revenues (for example, for off-system services and capacity release), and crediting a portion back to consumers

WHAT DIFFERENT GROUPS WANT FROM IPs

- Consumers: lower prices, no deterioration of service, more stable prices (?)
- Utilities: greater profit opportunities, compensation for increased market risk
- Regulators: "win-win"
- Society at large: more efficient utility industry

POTENTIAL BENEFITS

- Stronger incentives for a utility to be cost efficient
- Consumer benefits from a "win-win" outcome
- Resource savings from the elimination, or scaling down, of prudence reviews
- More efficient and fair risk-sharing of a utility's decisions and the outcomes from those decisions

BASIC MECHANICS OF IPs

- Primary features
  - Targeted area
  - Benchmark or standard of performance (with an optional "dead band")
  - Sharing parameter
  - "Distortion mitigation" component (optional)

BASIC MECHANICS - continued

- Discussion
  - Targeted area should be one for which (1) costs are non-trivial, (2) performance is measurable, and (3) utility management has some control
  - The benchmark can represent the expected performance of a utility absent the added incentives, or the "average" performance of a selected group of gas utilities

BASIC MECHANICS - continued

- Sharing of benefits between consumers and the utility
- Added incentives strong enough to elicit better management performance but constrained to limit a utility's financial exposure or ability to earn very high profits

BASIC MECHANICS - continued

- Illustration: Cost-sharing mechanism

$$C_f = (g)\, C_a + (1 - g)\, C_b, \quad \text{or}$$
$$C_b + g\,(C_a - C_b)$$

where

C_f	=	purchased gas costs flowed through to consumers
C_a	=	actual purchased gas costs incurred
C_b	=	benchmark established by the regulator
(1-g)	=	% of cost savings utility retains
g	=	% of cost savings passed on to consumers

BASIC MECHANICS - continued

Cost Savings = $C_b - C_a$ *

Incremental profit to the utility ($[1 - g][C_a - C_b]$) = share of cost savings the utility is allowed to retain

NOTE: In traditional (cost-plus) regulation,

$$C_f = C_a$$

(purchased gas adjustment clause, subject to a prudence review)

* assumes $C_a < C_b$

BASIC MECHANICS - continued

- Numerical Example
  - Applying the formula $C_f = C_b + g(C_a - C_b)$, where C_a = \$5 million and C_b = \$5.4 million
    - When g = 0, $C_f = C_b$ = \$5.4, utility profits = \$0.4, consumer benefits = \$0
    - When g = 0.5, C_f = \$5.2, utility profits = \$0.2, consumer benefits = \$0.2
    - When g = 0.75, C_f = \$5.1, utility profits = \$0.1, consumer benefits = \$0.3
  - The above example assumes that actual cost savings were \$0.4 million (i.e., the difference between the actual costs and the "benchmark" costs)

BASIC MECHANICS – continued

- Observations
  - Price-cap-type mechanism as a special case where "g" equals zero (i.e., $C_f = C_b$)
  - Cost-plus-mechanism as a special case where "g" equals one (i.e., $C_f = C_a$)
  - Higher values for "g" weaken the utility's incentive to control costs – e.g., a value of .5 (.75) means that 50% (75%) of the cost savings returned to consumers, but also 50% (75%) of the costs in excess of the benchmark allocated to consumers

BASIC MECHANICS - continued

- No single or simple rule for determining the optimal value of "g": equity and economic efficiency important factors, as well as legislative statutes and judicial interpretations of those statutes
- Setting an incorrect benchmark complicates measuring the actual cost savings and the actual benefits to consumers and utility shareholders – e.g., a too high "benchmark" cost inflates the cost savings and the reward to the utility

FEATURES OF A GOOD IP

- Positive incremental actions on the part of the utility – no "gaming," no "free rider"
- Utility receiving higher revenues for doing something positive (e.g., lowering total system-wide costs) – no distortive outcomes
- Symmetric-like rewards and penalties (e.g., expected rewards equal, or at least closely related to, expected penalties)

FEATURES OF A GOOD IP - continued

- Most of the benefits distributed to consumers with modest gains to shareholders
- Tolerance for "benchmark" error – e.g., setting of a "dead band" range within which no price adjustment is made
- Positive long-term outcomes
- "Win-win" outcome (positive-sum game)
- Subject to modifications in response to changed conditions
- Commitment by the regulator

IPs FOR THE NATURAL GAS INDUSTRY

- Price caps for distribution service
- Price caps for commodity gas
- Gas-procurement, cost-sharing incentives
- Revenue sharing for capacity brokering, interruptible sales, off-system sales
- Sharing of storage benefits
- Targeted DSM incentives
- Profit or earnings sharing
- Targeted service-quality incentives

PITFALLS OF IPs

- General
  - The wrong benchmark
  - Distorted sharing mechanism
  - Perverse incentives

PITFALLS OF IPs - continued

- Reasons why an IP may not benefit, or only marginally benefit, consumers
  - Excessive spending on non-targeted activities, allowing the utility to earn a higher reward (perverse incentives)
  - Decline in reliability/quality of service
  - No incremental effect on a utility except for receiving a reward (a zero-sum game)

PITFALLS OF IPs -- continued

- Earnings volatility increasing a utility's cost of capital
- Rewards too small to elicit change in utility behavior
- Inflexible incentive system resulting in distortions as technological and market conditions change (e.g., static "benchmark" not reflecting market conditions on a going forward basis)

PARTICULAR CONCERNS TO REGULATORS

- Effect on small (core) customers
  - Price
  - Reliability/quality of service
- How do consumers benefit when the utility earns higher profits?
- What happens if the utility earns unexpectedly high or low profits?

CONCERNS TO REGULATORS - continued

- How do we know whether an IP is working as intended?
- Setting the parameters
- Regulators intolerant of IPs not shown to have benefited consumers

INCENTIVES AND RISK MANAGEMENT

- Objectives of gas procurement and risk management
  - Reasonable gas costs
  - High reliability
  - More stable gas costs (new)
- Effect of standard PGAs
- Certainty of recovering hedging costs
- Distribution of hedging gains
- Prudence standards (how do they differ?)
  - Gas procurement
  - Risk management

INCENTIVES AND RISK MANAGEMENT -- continued

- Effect of targeted gas-procurement IPs
- An argument for establishing separately (1) an IP specifically for procurement (the purchasing of physical gas), and (2) guidelines for risk management involving financial derivatives

SUMMARY

- Primary objective of IPs: **make it in the utility's interest to provide benefits to consumers**
- Need to look carefully at the structure or mechanics of an IP – several pitfalls to avoid
- Need to conduct an *ex post* evaluation
- Important for regulators to be able to modify or terminate an IP in place – but not in an ad hoc or arbitrary fashion
- Good IPs share common features
- A menu of generic IPs from which to choose

SUMMARY -- continued

- Finally, a 4-step process in implementing an IP
  - Reaching agreement that an IP should be implemented
  - Developing the general features or structure of an IP
  - Resolving the implementation issues ("the devil is in the details")
  - Modifying or terminating the IP when supported by *ex post* information

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Properly Structured Incentives

Barbara Meisenheimer
Missouri Office Of The Public Counsel

Scope Of Issues Considered

- Can Properly Designed Incentives Address The Concerns Of Various Stakeholders; Upward Price Volatility, Energy Efficiency, Risk Of Prudence Disallowance and, Disincentives In The Current System
- Goals and Objectives Of A Properly Designed Incentive Mechanism

Scope Of Issues Considered

- Targeted Incentives Focused On Cost Reduction In Natural Gas Purchasing vs. Performance Based Regulation In The Form OF Bill Caps Or Rate Caps
- Specific Incentives Geared Toward Gas Cost Reductions and Energy Efficiency
- Expanded Information Exchange

Task Force Incentive Recommendations

4.a) Targeted incentive programs that are properly structured in accordance with the principles set forth on pages 50 through 57 of the task force report should be utilized in the gas cost area;

Task Force Incentive Recommendations

4.b) Performance Based Regulation (PBR), with rate or bill caps, as described on pages 46 through 50 of the task force report, should not be implemented in the gas cost area at this time;

Task Force Incentive Recommendations

4.c) The Commission should pursue incentive measures for encouraging energy efficiency that make financial sense for the utility and the consumer;

Task Force Incentive Related Recommendations

4.d) An expanded exchange of information by LDCs with Staff and OPC relating to procurement plans and strategies should be pursued in an effort to reduce disincentives in the gas cost area.

Task Force Incentive Recommendations

- The principles adopted by the Task Force are generally consistent with Mr. Costello's observations.

Task Force Recommended Incentive Plan Principles

- Incentives should be targeted to areas of operation in which the LDC's actions have a meaningful impact in reducing costs, enhancing net revenues, or in providing other benefits that are in the customers interest, such as energy efficiency programs.

Task Force Recommended Incentive Plan Principles

- Additional profit from an incentive plan should only be awarded for cost reducing or net revenue enhancing actions by the LDC, and efficiency gains in excess of those that the LDC should reasonably be expected to undertake absent the incentive.

Task Force Recommended Incentive Plan Principles

- Incentive mechanisms may be an effective tool when the level of compensation required by the LDC, for engaging in cost reducing actions does not exceed the net benefit consumers receive for the level of cost reductions that can be reasonably anticipated to result.

Task Force Recommended Incentive Plan Principles

- Incentives should be structured to allow the LDC sufficient flexibility to respond to changing market conditions.

Task Force Recommended Incentive Plan Principles

- Incentives should be structured to promote a portfolio targeted at mitigating overall cost or improving energy efficiency.

Task Force Recommended Incentive Plan Principles

- Incentives should be structured to ensure that consumers receive benefits by aligning rewards to the LDC with outcomes desirable to consumers.

Task Force Recommended Incentive Plan Principles

- Incentives should be structured to align the risk to the LDC with the risk faced by consumers in an effort to ensure that consumers are made no worse.

Task Force Recommended Incentive Plan Principles

- Baselines should be considered for components of the incentive plan where inherent levels of performance exist. Factors relevant to establishing a particular baseline may include historic performance, changing market conditions, comparisons to similarly situated firms, or desired public energy policies.

Task Force Recommended Incentive Plan Principles

- Consumers have expressed a strong preference for more stable natural gas prices. In the area of procurement, incentives should be targeted toward stabilizing prices by mitigating upward price volatility.

Task Force Recommended Incentive Plan Principles

- An incentive mechanism should allow a relatively lower reward to the LDC when information linking the LDC's actions with beneficial outcomes cannot be clearly verified and a relatively higher reward to the LDC when information linking the LDC's actions with beneficial outcomes can be clearly verified. Even if provided at lower levels, however, the case for utilizing incentives as opposed to prudence reviews may be strongest where a link exists but it is difficult or costly to evaluate the precise extent of the link.

Task Force Recommended Incentive Plan Principles

- Incentives should be structured to avoid creating a situation where the firm's management has less incentive to perform efficiently from either a customer or shareholder perspective.

Task Force Recommended Incentive Plan Principles

- The total incentive package should be structured to ensure that when individual components are implemented together they do not produce undesirable results.

Task Force Recommended Incentive Plan Principles

- No Consensus On The Form of The Gas Purchasing Incentive Plan
  - Focus On Rewarding Outcomes
  - Focus on Rewarding Actions
- Recommendation For Further Investigation Of Potential Energy Efficiency Incentives
- Recommendation For Expanded Exchange Of Information By LDCs With Staff and OPC

Public Counsel's Concerns

- Properly structured plan that produces net consumer benefit
- Weigh the benefits of an incentive plan with all the cost including increased risk
- To avoid perverse incentives it needs to be a complete plan not piece-meal.
- Reward superior performance not just ordinary management; The firm must face symmetrical risk and reward.

5b

natural gas - electric generation - price

AmerenUE

Presentation to MPSC Natural Gas Roundtable

October 25th, 2001

Scott Glaeser
Manager
Natural Gas Supply & Transportation
AmerenEnergy Fuels & Services

natural gas - electric generation - price

Gas Supply Incentive Plans

AmerenUE Strongly Supports Gas Supply Incentive Plans for LDCs in Missouri

natural gas - electric generation - price

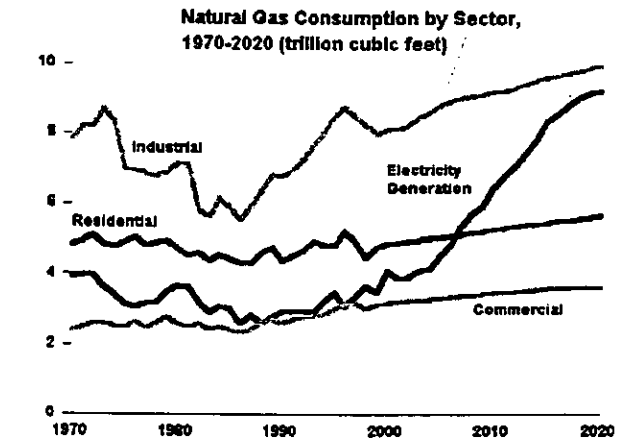
Gas Supply Incentive Plans

The Primary Goal is to Align the Interests of Customers and LDCs to Share Risks and Rewards

- Significant Demand Growth for Natural Gas will Increase Price and Basis Volatility in Future
- Risks to Gas Supply Function will Only Increase in Future
- LDC Earnings in Rates Do Not Reflect Risk Associated with Gas Sales Function

natural gas - electric generation - price

Market Risk Factors



Data from Energy Information Agency (DOE)

natural gas - electric generation - price

Traditional Regulation

- Stifles Risk Taking and Creativity in Gas Supply Function
- Regulatory Time Lag to Resolve Issues
- Physical and Financial Markets Evolving Faster and Becoming More Complex
- Scope of ACA Prudence Audits has Broadened, Consuming Significant Resources

natural gas - electric generation - price

Gas Supply Incentive Plans

Benefits for Customers and LDCs

- Most Efficient Method to Attain Best Gas Price for Customers
- Economic Incentives to Assume Greater Risks, Aggressive Strategies, Creative Transactions
- Equitable Sharing of Benefits and Risks
- Greater Resources Devoted to Gas Supply
- Retain & Attract Experienced Gas Professionals
- Reduced Regulatory Burden

natural gas - electric generation - price

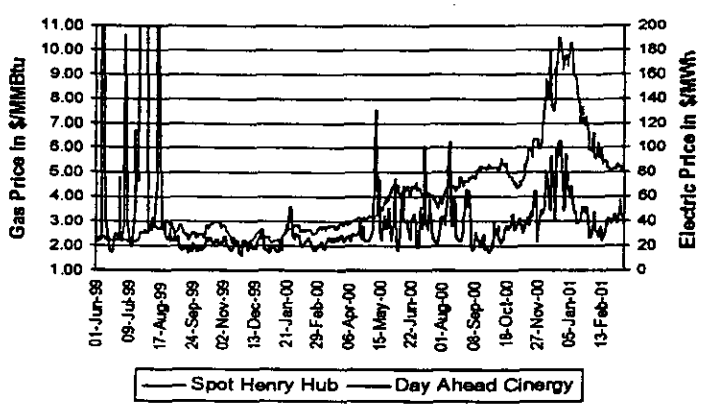
Issues for Proper GSIP

- Compatibility of GSIP and Risk Management
- Appropriate Use of Financial Instruments
- Establishing Equitable Benchmarks
- Extreme Market Price Spikes
- Implementation Timing

natural gas - electric generation - price

Market Price Risk

Comparison of Spot Gas to Daily Cinergy



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STATEMENT OF KENNETH J. NEISES
SENIOR VICE PRESIDENT-ENERGY AND ADMINISTRATIVE SERVICES
LACLEDE GAS COMPANY

NATURAL GAS ROUNDTABLE PANEL
JEFFERSON CITY, MISSOURI
OCTOBER 26, 2001

Laclede appreciates this opportunity to participate in this roundtable on properly structured incentive plans.

Laclede has five years experience operating under a gas supply incentive plan. On three separate occasions, the Commission found that plan to be in the public interest. Nevertheless, last month, the Commission terminated the program on the ground that it did not strike "the proper balance between the ratepayer and shareholder".

Since I have testified on a number of occasions before this Commission in support of incentive plans, my position is on the record and well known. Suffice it to say that Laclede believes that incentive plans can and indeed have produced significant net benefits for our customers. It is our hope that a new plan can be put in place promptly for all gas distributors and consumers in this State. But, I do have a number of concerns that I wish to share with you today.

At the outset, I wish to emphasize that Laclede intends to take the Commission at its word when it said that it is interested in developing a "well-designed" gas supply incentive plan. I am concerned, however, that one of the reasons the Commission gave for terminating our plan was that Laclede made money under the plan, and, in the Commission's view it was never the purpose of the plan to produce

earnings that could be included in the Company's earnings program. If the Commission's idea of a "well-designed" incentive plan is one under which the Company can make no money, then there is no basis upon which we can proceed. After all, the very purpose of an incentive plan is to give utilities a financial reward in return for producing financial benefits for their customers.

A major concern we have regarding this effort to develop a new incentive plan is that we are not certain of the willingness of Staff and Public Counsel to compromise and make concessions. Over the past five years, Laclede has made numerous concessions in the hope of addressing their concerns. Indeed, in our last request for extension, we proposed modifications that would have substantially reduced the amounts that the Company could have earned under the program. But these proposals were all met with vigorous opposition. The counter-proposals that we did receive simply demanded too much from us. In the end, if there is nothing meaningful in the plan for the company, it is not worth our participation.

There are several concepts that we simply have to overcome if we are to develop a properly structured gas supply incentive plan. First is the belief that if the shareholders benefit, the program must be bad for customers. Commissioner Murray rejected this concept in her dissent to the Commission majority opinion terminating our plan last month, and it must be rejected by all parties if we are to make any progress. There is such a thing as a win/win situation. Equally misguided is the concept that all incentives must place the Company's earnings at risk. I believe that rewards for superior performance that are not coupled with a risk of

non-recovery of gas costs are entirely appropriate. The incentive structure that Laclede had in its incentive plan for transportation discounts operated in this fashion and I believe produced substantial benefits for our customers. Finally, a concept which I believe we must also overcome is the idea that benchmarks must constantly be rebased to meet achieved levels of performance. Expectations of continuous cost reduction are simply unrealistic. Once the cost reductions reach optimum levels, incentives should not be discontinued. They are needed to insure that the optimum levels are maintained on an ongoing basis.

Laclede is also concerned that Staff and Public Counsel may expect natural gas distribution companies in this State to take on even more risk than they now have in the recovery of their gas and non-gas costs. While we certainly are willing to assume measured risk in performing our gas supply responsibilities, and thereby produce benefits for our customers and shareholders alike, there is a limit to how much risk we can assume. We are already at risk for over 50% of our non-gas costs due to weather. And, in recent years, the Commission has adopted policies at the urgings of Staff and Public Counsel that make it exceedingly difficult for natural gas distribution companies to earn their authorized returns. Recovery of significant gas costs is also at risk as was demonstrated so clearly this past year. Right now, we have huge uncollectible gas costs that linger on from last winter and we have incurred significant carrying costs on gas we injected into storage in the summer of 2000 at unexpectedly high prices. While we have proposals before the Commission that would ameliorate some of these problems, it should be clear that we are not

interested in taking on significant amounts of additional risk in the recovery of gas costs through a gas supply incentive plan when, even without such a plan, we face substantial risks.

As for the components of a well-designed incentive plan, I continue to believe that all of the traditional elements should be included: gas procurement, transportation discounts, pipeline mix, off-system sales and capacity release. As for the latter two, there has been a move to include revenues derived from these transactions in base rates. However, these revenues are volatile and subject to the vagaries of the marketplace. For that reason, I believe it is unfair both to our customers and to the Company to attempt to impute assumed revenues into rates. This is particularly so since these transactions are nontraditional sources of revenue derived from out-of-state business.

Finally, I'm sure we'll hear much about comprehensive planning and reporting with the goal of improved decision making. Contrary to the picture that has been painted before this Commission, I believe that Laclede has been engaged in comprehensive planning for years and we will continue to do so. The mere fact that we have had separate programs for various components of the gas supply planning process does not mean that our planning is disaggregated. As for reporting, Laclede is not adverse to discussing the needs of the Staff and Public Counsel. However, the Company will continue to oppose reporting that is inconsistent with the features of the incentive plan that is ultimately approved. Consistent with Staff's statements in the past as to what incentive plans should accomplish, regulatory burden should

be decreased not increased. As such, a well-designed incentive plan should reduce not expand reporting requirements.

Thank you.

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Bob Schallenberg
Missouri Public Service
Commission Staff

Properly Structured Incentive Plans

Details will play the Devil
with a Properly
Structured Incentive Plan

Issues that will impact Implementation

- Objectives versus Incentive/Rewards
- Experiment versus Entitlement
- Improvement versus Redistribution

Objective versus Incentive/Rewards

- The objective of the plan can never become the achievement of the Incentive/Reward on either explicit or implicit basis.
- The objective of the plan should be perceived as a benefit by consumers and stakeholder groups.
- The objective of the plan should be expressed in measurable periodic results.
- The Incentive/Reward feature must never be a distraction to achievement of the plan's objective.

Incentive/Rewards Traps

- "Dogged pursuit of the perfect reward scheme, as Samuel Johnson might have said, represents the triumph of hope over experience".
- Rewards absolutely motivate people, but only to get the reward.
- If people do not believe in the achievement of the objective, then the reward will induce temporary compliance to "do things right", but not to "do the right thing".

Proper Incentive/Reward

- It is important that you identify all the groups that need to buy-in to program to make it work (e.g. Management, Employees, Consumers, Commission, Staff, OPC, etc.).
- All groups need to believe that the objective and expected result is an improvement or benefit.
- All groups must accept the incentive/reward feature as fair consideration in relation to objective achievement.

Incentive/Reward Purpose

- Catalyst for change in philosophy & behavior or
- Acknowledgement for accomplishment
- The definition of the purpose will allow for the development of the incentive/reward required to support plan's objective.
- Catalysts will need to address change in all necessary groups.
- Acknowledgement will need to be perceived by as worthwhile to all necessary groups

Experiment versus Entitlement

- Details need to address the flexibility of the plan to be changed or terminated.
- Agreement should be reached regarding the mechanics of the process to change or terminate.
- These features are important for buy-in and plan functionality.

Experiment

- The Plan is an experiment to produce a new improved result.
- An expected measurable result(s) should be stated that will define success or failure.
- Information needs to be gathered and disseminated to interested groups to facilitate evaluation of experiences learned from the Plan's operation.

Entitlement

- There should be the expectation that the plan can end at any time if it is no longer beneficial.
- If parties support the plan in order to continue to enjoy the Incentive/Reward, then the Plan's objective has been subjugated.
- This condition will be evidenced when the Incentive/Reward feature is consuming considerable attention.

Improvement versus Redistribution

- The Plan's objective should result in an overall improvement in the consumer's perception of their situation.
- A Plan that focuses on specific components and not the overall result runs the risk of redistributing resources from areas that can produce greater benefits.

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Comments of Brenda Wilbers
Energy Policy and Analysis Program Director
Missouri Department of Natural Resources Energy Center

The PSC Task Force endorsed the use of properly designed incentives for energy efficiency programs.

Energy efficiency helps contain energy prices by curbing demand instead of increasing supply. Balanced portfolios that address demand reduction can be designed to be good for the consumer (through lower energy costs) and the utility company (through incentives that lessen the impact of reduced profits from a reduction in sales).

Benefits include --

- Energy efficiency helps customers reduce their energy usage and utility bills. This is particularly important when energy prices are higher and more volatile.
- Long-term costs to the system may be lower by reducing the distribution companies' costs to upgrade their systems.
- Using energy efficiently provides economic value by improving the competitiveness of businesses and increasing customers' discretionary income and by preserving natural resources and reducing pollution.

The Governor's Energy Policy Task Force in its October 16, 2001 report supported implementation of the PSC Task Force Report recommendations and identified these three areas of focus:

- Encouraging energy efficiency and conservation
- Working with public utilities and private industry, and
- Protecting consumers.

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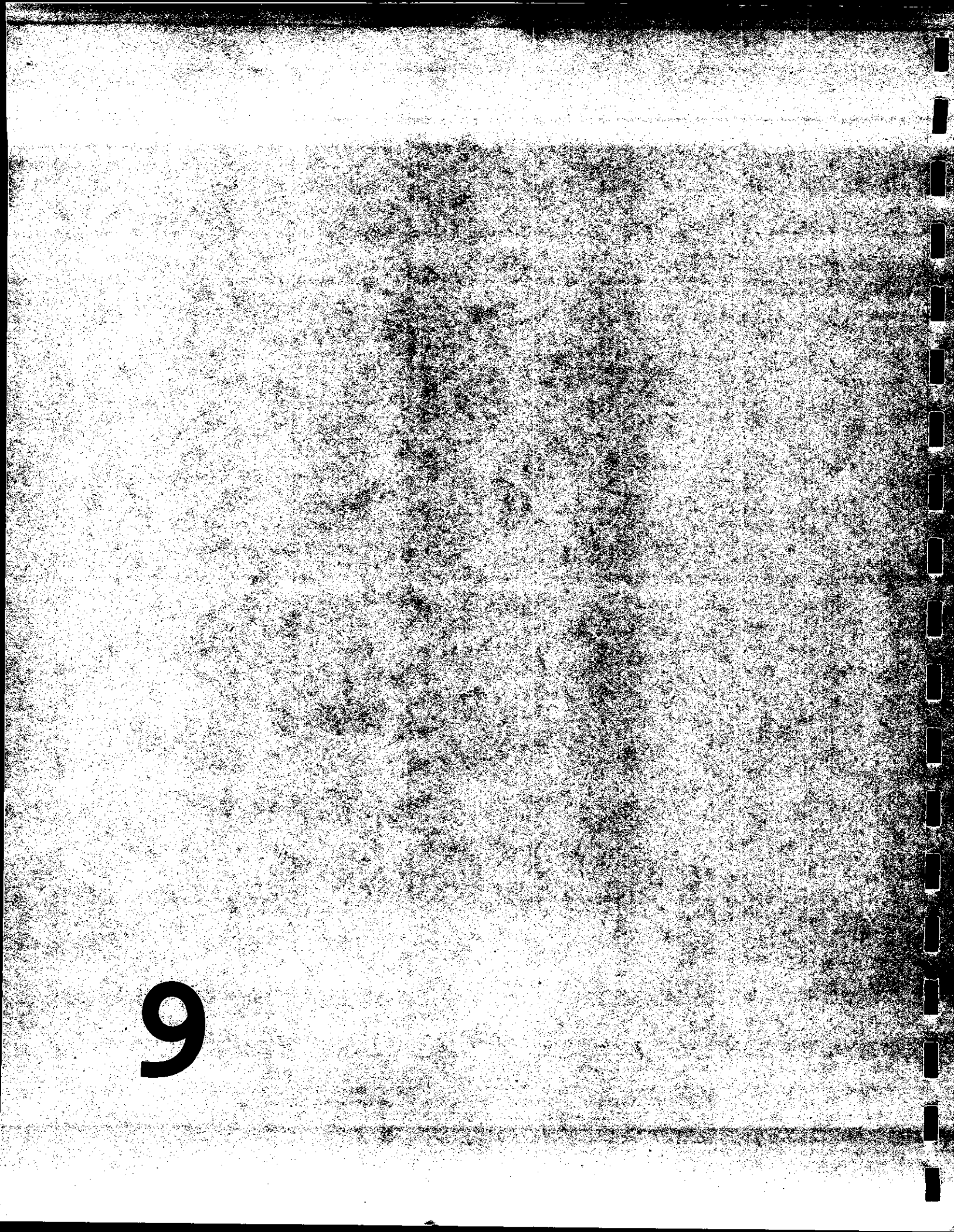

MoPSC

Natural Gas Roundtable

Properly Structured Incentive Plans

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