**BEFORE THE STATE CORPORATION COMMISSION
OF THE STATE OF KANSAS**

In the Matter of the Application of	)	
Kansas Gas Service, a Division of ONEOK, Inc.	)	
For Approval of a Hedge Program for Gas	)	Docket No. 05-KGSG-580-HED
Purchased for the Winter Heating Season.	)	GAS

STAFF MEMORANDUM IN SUPPORT OF STIPULATION AND AGREEMENT

COMES NOW the Staff of the State Corporation Commission of the State of Kansas ("Staff" and "Commission", respectively) and files its Memorandum in support of the Stipulation and Agreement filed by Kansas Gas Service, a Division of ONEOK, Inc. (Kansas Gas Service), Staff, and Citizens' Utility Ratepayer Board (CURB) on March 18, 2005.

1. On March 18, 2005, Kansas Gas Service, Staff and CURB (Joint Movants) entered into a Stipulation and Agreement in this matter and filed their Joint Motion for an Order Approving Stipulation and Agreement.

2. In support of the Stipulation and Agreement entered into and filed by Joint Movants, Staff incorporates by reference the Memorandum prepared by Dr. John Cita, Chief of Economic Policy and Planning, dated March 23, 2005, which is attached hereto as Attachment 1.

Respectfully submitted,

Otto A. Newton

Otto A. Newton #8760
Assistant General Counsel
Kansas Corporation Commission
1500 SW Arrowhead Road
Topeka, KS 66604
(785) 271-3157

VERIFICATION

STATE OF KANSAS)
) ss.
COUNTY OF SHAWNEE)

Otto A. Newton, being duly sworn upon his oath deposes and states that he is an Assistant General Counsel for the State Corporation Commission of the State of Kansas, that he has read and is familiar with the foregoing pleading and that the statements contained therein are true and correct to the best of his knowledge, information and belief.

Otto A. Newton

Subscribed and sworn to before me this 23rd day of March, 2005.

PAMELA J. GRIFFETH
Notary Public - State of Kansas
My Appt. Expires 08-17-2007

Notary Public

Attachment 1

MEMORANDUM

To: Chair Brian Moline
Commissioner Robert Krehbiel
Commissioner Michael Moffet

From: John Cita

Date: March 23, 2005

RE: Staff's Discussion and Evaluation of Kansas Gas Service's 2005/2006 Gas Hedge Program and Support for the Joint Motion Seeking Approval of the Unanimous Stipulation and Agreement (S&A), Docket No. 05-KGSG-570-HED.

Background and Cumulative Performance of the Program

Kansas Gas Service's (KGS) Hedge Program Application for the coming 2005/2006 winter season represents the eighth such application. For the last five years the basic components of the Hedge Program have largely remained the same. The relatively small changes in program design that have been made, as well as those changes currently proposed, are basically evolutionary in nature.

The objective of the program has been a constant throughout its existence: reduce the *volatility* of (COGR) customers' monthly bills by guarding against unanticipated price spikes. In that regard the program has been an unqualified success. The financial payoffs of derivatives arranged and purchased through the program have served to offset and, thus, reduce the price volatility embedded in the (spot) gas price indices. And, as an added benefit, KGS's Hedge Program has provided the COGR customers a positive net savings. As of the current date, the *cumulative net savings* from the program are approximately $19M.[1] I would remind the Commission that Staff generally expects the cumulative net savings from KCC approved hedge programs to be near zero in the *long run*. In short, hedging is about reducing price risk, that is, price volatility; it is not about creating speculative profits and, thus, savings for retail customers. Yet, it is somewhat remarkable that after seven years the KGS Program has such a significant surplus.

[1] For last winter the Program ended in the red. The net cost of KGS's options was approximately $7M, yielding a payoff of about $3.7M. KGS's swaps yielded a gain of nearly $1.3M. Thus, on the $7M spent for risk coverage, KGS's program provided revenue offset of about $5M. Considering the weather in Kansas was slightly warmer than normal, those are unexpectedly good results. Part of what explains the "good results" are the large payoff on December derivatives. It is possible that an unintentional misreporting of gas storage information during late November 2004 contributed to the size of those payoffs. That simply shows Hedge Programs are designed to guard against all unexpected events, including misreporting of storage quantities.

The Currently Proposed Program

The currently proposed program is identical to last year's Commission approved program,[2] but for two things: 1) the cost of the hedge program will be presented as a separate line item on customers' monthly bills and 2) the annual budget amount is *up to* \$13.3M, compared with \$7.3M last year. Each of these proposed changes warrant some discussion and explanation.

Unbundling the Hedge Charge

In previous years, KGS has included the Hedge Program cost as part of its cost of gas. In short, the costs of the Hedge Program were bundled/combined with its gas (and upstream transport) costs. Accordingly, the cost of the Hedge Program was included at part of KGS's COGR price. With next year's program, the cost of the hedge program would be recovered through an unbundled, volumetric charge of about \$0.94/MMBtu. As usual, that charge would be collected over the low-volume summer months, April through October. By making this change, KGS's Program will be consistent with the other Hedge Programs approved by the Commission. Furthermore, by having an unbundled charge for the Program, it is generally easier to measure and assess customers' acceptance of the program.

Increasing the Maximal Annual Budget

No doubt, this proposed change would be significant. However, it is Staff's position that the proposed budget increase is very much in line with other cost increases, namely the cost of natural gas. Moreover, given the sample results obtained through the 2004 Summer Focus Group surveys, we have evidence that suggests gas utility customers may be both willing and able to spend more on hedging than what was spent in the past.

For about the last five years, the approved Hedge Program budgets (including KGS's) were based on a \$1/month/customer assessment formula. With the currently proposed budget, the assessment would be about \$1.75/month/customer, or about \$21/year/meter. Based on the Focus Group results, about 89% of surveyed customers indicated that spending \$21/year *or more* would be "reasonable." In fact, the sample average amount of money deemed reasonably spent on hedging was \$42.20/year. While Staff agrees the proposed increase from \$12 to \$21 per year is significant, the higher amount may yet be conservative compared with the amount of risk protection customers are actually willing and able to pay for.

During the 1999/2000 winter, or about five years ago, the average price of gas was \$2.45/MMBtu. The current, average price forecast for next winter is \$8.31. Furthermore, an at-the-money call option for January 2006 is currently priced at \$1.18/MMBtu. While we do not have access to historical call price information, it is likely at-the-money calls for the 1999/2000 winter were nowhere near \$1.18.

---

[2] Last year's Program was designed and implemented in accordance with parameters set forth in a unanimous Stipulation and Agreement approved by the Commission on March 19, 2004, Docket No. 98-KGSG-475-CON.

So there are two considerations here: 1) hedge program budgets have been roughly constant for the last five years, with no adjustments for inflation and 2) winter gas prices have nearly tripled in five years which necessarily implies higher cost options.

In order to cover approximately two-thirds of KGS's flowing, winter gas requirements, while maintaining a significant proportion of downside risk for the COGR customers, which is a preference revealed through the survey results, it is Staff's position that the requested budget increase is reasonable. For this next winter, based on current forecasts, if a reasonable level of price risk protection is to be provided it appears the necessity of increasing the allowed hedge program budget is inescapable.

Finally, if market conditions change, KGS may end up spending far less than the maximally allowed amount. In the past there have been some years when KGS spent less than the allowed amount. Of course, granting permission to spend up to $13.3M does not mean all of that amount will be spent, however, at this time it does seem likely that the entire budget would be spent.

<u>One Other Change</u>

KGS requested a slight change in the procedure used to implement its hedge programs. Previously, program implementation has been achieved through annual applications. Under the proposed agreement, all recognize the program's status as a "permanent" program. Starting after this year, KGS would not file a new Application to effectively re-start the program for the coming winter. Rather, KGS would simply meet with Staff and interested interveners to discuss any proposed changes in the program. (These meetings have been a standard component of KGS's implementation process starting with the first Hedge Program. Typically the meetings occurred after Applications were filed. Hereafter, the only difference in the process would be KGS not submitting a new Application each year.) The Commission will still have full oversight over any proposed changes in the Program, including whether the program should be continued.

<u>Summary and Recommendation</u>

KGS has consistently designed and implemented a reasonable and well performing Hedge Program. KGS has and continues to base its program design on the preferences of its customers as revealed by results of two separate Focus Group survey efforts. The proposed program for next winter is identical to last winter's program, except the proposed budget for the new program is larger by $6.1M and customers will now see on their monthly bills exactly what the Hedge Program costs them.

While Staff fully recognizes the proposed budget increase is significant, given current gas price forecasts, Staff sees the proposed increase as reasonable if KGS's COGR customers are to continue receiving the same level of protection from price spikes. Any time price transparency is improved, such as with the unbundling of the Hedge Program charge, there is a better foundation for consumers making economically efficient decisions. Whatever the customer responses to seeing the hedge charge, we will simply have more evidence by which to determine the appropriate size of the hedge budget. For the reasons stated in this memorandum, it is Staff's opinion the Commission could find the proposed S&A to be consistent with the public interest. As usual, should any Commissioner have any questions regarding the S&A or the Hedge Program itself, my staff and I are here to provide answers.

Cc: Don Low

VERIFICATION
05-KGSG-580-HED

STATE OF KANSAS)
) ss.
COUNTY OF SHAWNEE)

John Cita, being duly sworn upon his oath deposes and states that he is Chief of Economic Policy and Planning for the State Corporation Commission of the State of Kansas, that he prepared the foregoing Memorandum and is familiar with the content thereof and that the statements contained therein are true and correct to the best of his knowledge, information and belief.

John Cita

John Cita

Subscribed and sworn to before me this 23rd day of March, 2005.

PAMELA J. GRIFFETH
Notary Public - State of Kansas
My Appt. Expires 08-17-2007

Pamela J. Griffeth
Notary Public

My Appointment expires:

August 17 2007

CERTIFICATE OF SERVICE
05-KGSG-580-HED

I hereby certify that a true and correct copy of the foregoing Staff Memorandum in Support of Stipulation and Agreement was placed in the United States Mail, postage prepaid, on this 23rd day of March, 2005, properly addressed to:

John P. DeCoursey
Walker Hendrix
Kansas Gas Service,
a Division of ONEOK, Inc.
7421 W. 129th Street
Overland Park, KS 66213-5957

David Springe
Niki Christopher
Citizens' Utility Ratepayer Board
1500 SW Arrowhead Road
Topeka, KS 66604-4027

Otto A. Newton
Assistant General Counsel