BEFORE THE STATE CORPORATION COMMISSION
OF THE STATE OF KANSAS

In the Matter of the Application of Aquila, Inc., d/b/a Aquila Networks-KGO, for Approval of an Accounting Order to Permit Aquila, Inc., d/b/a Aquila Networks-KGO to Recover Amounts Necessary to Expend in Order to Establish and Maintain a Gas Hedge Ceiling Price for the 2005-2006 Heating Season.	Docket No. 05-AQLG-616-HED

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 Aquila, Inc., d/b/a Aquila Networks-KGO (Aquila), Staff, and Citizens' Utility Ratepayer Board (CURB) on June 7, 2005.

1. On June 7, 2005, Aquila, 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 herein by reference the Memorandum prepared by Dr. John Cita, Chief of Economic Policy and Planning, dated June 7, 2005, which is attached hereto as Attachment 1.

Respectfully submitted,

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

VERIFICATION
05-AQLG-616-HED

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 7th day of June, 2005.

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

Notary Public

My appointment expires: august 17, 2007

Attachment 1

MEMORANDUM

To: Chair Brian Moline
Commissioner Robert Krehbiel
Commissioner Michael Moffet

From: John Cita

Date: June 7, 2005

RE: Staff's Discussion and Evaluation of Aquila'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-AQLG-616-HED.

Background and Recent Performance of the Program

Aquila Networks-KGO's ("KGO") Gas Hedge Program Application for the coming 2005/2006 winter season represents the fourth such application. Except for the allowed budget amount, KGO's Hedge Program has remained largely unchanged since its inception.

Throughout its existence, the primary objective of KGO's Hedge Program has been a constant: reduce the *volatility* of its (PGA) customers' winter month bills by guarding against unanticipated price spikes. In that regard the program has been an unqualified success. Over the years the financial payoffs of derivatives arranged and purchased through the program have served to offset and, thus, reduce the price volatility embedded in KGO's gas purchase prices. And, as an added benefit, from time to time, hedge programs can provide customers with a positive net savings. However, in the case of KGO's Hedge Program, for each of its first three years the program has finished in the red. Yet even though the net revenues have not been positive, in each of the first three years KGO's Hedge Program generated revenues that served to offset (i.e., reduce) a significant proportion (about 60%) of the program cost. Thus, using the insurance analogy, through its Hedge Program KGO has filed claims (i.e., settled derivatives) that yield payments totaling about 60% of the total premiums paid (i.e., total program cost). Again, 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*. That's equivalent to saying, in short, hedging is about reducing price risk, that is, price volatility; hedging is not about creating speculative profits and, thus, net savings for retail customers.

The Currently Proposed Program

The currently proposed program is basically identical to last year's Commission approved program,[1] but for two things: 1) the annual budget amount is capped at $2.3M, compared with a cap of nearly $1.3M last year and 2) the program status changes from effectively being "pilot" to "permanent." These proposed changes warrant some discussion and explanation.

1) 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 recent cost increases, namely the increased 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.[2]

From the start, KGO's approved Hedge Program budgets 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 survey customers deemed reasonably spent on hedging was $42.20/year. While Staff agrees the proposed increase from $12 to $21 per year is significant, this increase may yet be conservative compared with the amount of risk protection customers have indicated they may be willing and able to pay for.

During the first winter covered by KGO's Hedge Program (the 2002/2003 winter) the average price of gas was $5.28/MMBtu, which includes the large spike that occurred March 2003. The current, average price forecast for next winter is $8.24. Furthermore, an at-the-money call option for January 2006 is currently priced at about $1.18/MMBtu. While we do not have access to historical call price information, it is likely at-the-money calls for the 2002/2003 winter were far less than the current price of $1.18. So there are two considerations here: 1) KGO's hedge program budgets have been roughly constant for the last three years, with no adjustments for inflation and 2) winter gas prices have nearly doubled in three years which necessarily implies higher cost call options and, thus, a higher cost to hedge.

In order to cover approximately two-thirds of KGO'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

[1] Last year's Hedge Program was designed and implemented in accordance with parameters set forth in a unanimous Stipulation and Agreement approved by the Commission on April 30, 2004, Docket No. 04-AQLG-659-HED.

[2] During the summer of 2004, the KCC's jurisdictional natural gas utilities, in a cooperative effort and with the assistance of a consultant, conducted a series of four Focus Group sessions. The purpose of those sessions was to conduct customer surveys by which to (statistically) evaluate customer preferences over various hedging program strategies and budget levels. While the sample sizes were small, Staff believes the evidence obtained is still meaningful as an indication of what customers generally want from a utility-sponsored hedge program and what they are willing and able to pay for those programs.

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, KGO may end up spending far less than the maximally allowed amount. Granting permission to spend up to $2.3M does not mean that the entire amount will be spent, however, at this time it does seem likely that the entire budget would be spent.

2) Program Status

KGO has agreed to 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, KGO would not file a new Application to effectively re-start the program for the coming winter. Rather, KGO would simply meet with Staff and interested interveners to discuss any proposed changes in the program. (These meetings have been a standard component of KGO'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 KGO not submitting a new Application each year.) The Commission will still have oversight over any proposed changes in the Program, including whether the program should be continued.

Summary and Recommendation

KGO has consistently designed and implemented a reasonable and well performing Hedge Program. KGO 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.[3] The proposed program for next winter is effectively identical to last winter's program, except the proposed budget for the new program is larger by about $1M.

While Staff fully recognizes the proposed budget increase as significant, given current gas price forecasts, Staff sees the proposed increase as reasonable if KGO's PGA customers are to continue receiving the same level of protection from price spikes that they have received in the past.

Finally, the proposed S&A in this docket is nearly identical to the S&A the Commission just approved in Docket Numbers 05-KGSG-580-HED and 05-ATMG-617-HED. Accordingly, the Hedge Program KGO proposes to implement for next year is nearly identical to the Hedge Programs the Commission has already approved for KGS and Atmos.

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 available to provide or obtain the answers.

[3] The first Focus Group effort occurred during the late Fall 2001.

VERIFICATION
05-AQLG-616-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 7th day of June, 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-AQLG-616-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 7th day of June, 2005, properly addressed to:

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