

STATE OF MICHIGAN
BEFORE THE MICHIGAN PUBLIC SERVICE COMMISSION

In the matter of the application of)	
SEMCO ENERGY GAS COMPANY for a gas)	
cost recovery reconciliation proceeding for the)	Case No. U-14402-R
12-month period ended March 31, 2006.)	
_____)	

At the January 29, 2008 meeting of the Michigan Public Service Commission in Lansing, Michigan.

PRESENT: Hon. Orjiakor N. Isiogu, Chairman
Hon. Monica Martinez, Commissioner
Hon. Steven A. Transeth, Commissioner

ORDER

History of Proceedings

On June 15, 2006, SEMCO Energy Gas Company (SEMCO) filed an application for authorization to reconcile its gas cost recovery (GCR) revenues for the 12-month period ended March 31, 2006, pursuant to 1982 PA 304 (Act 304), MCL 460.6h *et seq.* See, MCL 460.6h(12). SEMCO filed testimony and exhibits in support of its application. The company seeks approval to roll a total overrecovery of \$262,810 (inclusive of interest) into its 2006-2007 plan year.

A prehearing conference was held on September 7, 2006, at which time Administrative Law Judge Daniel E. Nickerson, Jr. (ALJ) granted leave to intervene to Attorney General Michael A. Cox (Attorney General) and the Residential Ratepayers Consortium (RRC). The Commission Staff (Staff) also participated.

On April 24 and 25, 2007, the ALJ held evidentiary hearings. Testimony and exhibits were presented by SEMCO, the RRC, and the Attorney General, and were bound into the record. Briefs and reply briefs were filed by SEMCO, the Attorney General, and the RRC. The Staff presented no evidence and filed no briefs. The record consists of 273 pages of transcript and 50 exhibits admitted into evidence.

The ALJ issued a Proposal for Decision (PFD) on November 5, 2007. Exceptions to the PFD were timely filed by the RRC and the Attorney General. SEMCO and the Staff did not file exceptions. Replies to exceptions were timely filed by SEMCO.

The Attorney General's Proposed Disallowance

The Attorney General seeks a disallowance of \$2.4 million. The Attorney General argues that SEMCO made winter gas purchases above planned amounts. The Attorney General contends that SEMCO should have increased its storage withdrawals in the winter and made these purchases in the summer, thereby saving \$2.4 million. The Attorney General argues that there was no need for increased purchases because January was warmer than normal, and February was only 1% colder than normal, thus actual gas requirements were below the planned requirements. SEMCO counters that the January and February purchases were necessary to meet the planned peak demand requirements and that, simply because a peak day did not occur during these two months does not mean that the plan could be ignored. SEMCO also points out that storage withdrawals cannot be made on a moment's notice, as they are always subject to delivery constraints.

The ALJ recommends rejection of the Attorney General's proposed disallowance. The ALJ found that the plan established projected average and peak day demands, and that if SEMCO had limited January and February supplies to only the amount necessary to serve the average demand there would have been significant shortfalls. The ALJ also noted that the actual purchases for

peak demand were less than those included in the plan. Base load purchases were also lower than plan levels. The ALJ found these to be reasonable and prudent responses to the drop in GCR demand. The ALJ further found that, with respect to storage withdrawals, the warmer than normal January was, of course, not known about until it actually occurred, and the Attorney General's argument impermissibly relies on hindsight.

In his exceptions the Attorney General again contends that SEMCO imprudently purchased more gas in January and February 2006 than was approved in its GCR plan, and the purchases were not justified by weather, storage, or gas requirement issues. Pointing out that no peak days occurred in January or February, the Attorney General argues that SEMCO's purchases amounted to excess gas, especially in light of the warm January that did not require even the planned daily average amount of gas. The Attorney General also argues that issues of storage capability are irrelevant to a reconciliation case.

In reply, SEMCO contends that ignoring the potential for a peak day would leave the company without adequate supply to serve customers on a peak day. 2 Tr 71-72. SEMCO contends that its purchases cannot be fairly characterized as "excess" because they were built into the company's GCR plan, and SEMCO notes that, in the plan case, the Attorney General did not challenge the peak day forecast. Moreover, the company's actual purchases made to meet the forecasted peak day were less than the planned purchases due to the weather conditions. SEMCO argues that an attack on its actions on the grounds that no peak day occurred and weather was warmer than normal constitutes impermissible hindsight.

The Commission affirms that planning to meet peak day requirements is reasonable. The Commission adopts the findings and recommendation of the ALJ regarding the Attorney General's proposed disallowance. In this case, SEMCO formulated a reasonable GCR plan for meeting peak

day requirements, and prudently adjusted that plan when warmer than normal weather materialized. The Commission finds that SEMCO's January and February baseload purchases were reasonable and prudent.

The RRC's Proposed Disallowances

The RRC sought a total disallowance of approximately \$3.2 million, arguing that SEMCO failed to properly use historical pricing information to guide its early, winter, and monthly purchases.¹ In general, the RRC condemns purchases made using a fixed New York Mercantile Exchange (NYMEX) price and a fixed basis. The RRC argues that the benefits of a diverse purchasing strategy are not an excuse for achieving less-than-optimal results.

SEMCO fills 6% of its monthly supply requirements through early purchases (those made prior to the bid week applicable to each month). The objected-to purchases were made using a fixed NYMEX and fixed basis price. The RRC compares the actual price of these purchases to the cost had the purchases been made using the NYMEX close or the Index, and posits that the early purchases were \$530,131 more expensive than if they had been made using the NYMEX close, and \$1,177,341 more expensive than if made using the Index. SEMCO responds that it could not have had knowledge of the Index close at the time that it was placing the early purchase orders; to which the RRC replies that by February 2006 SEMCO could have known that its early purchases had been priced higher than the Index close in eight out of ten of the preceding months. The RRC recommends a disallowance of \$757,248 based upon "known and available data" for the January to March 2006 period. PFD, p. 14.

¹The RRC initially objected to the summer term purchases as well, but dropped the objection. PFD, p. 18.

SEMCO responds that it has achieved pricing diversity by securing supply throughout the year and at various times of the month through a variety of pricing options including monthly NYMEX settlement pricing, Index pricing, and negotiated fixed pricing.

The ALJ recommends rejection of the RRC's proposed early purchase disallowance. The ALJ found that SEMCO's early purchases were reasonably made and were part of SEMCO's use of a disciplined and diverse purchasing strategy to attempt to even out the uncertainties associated with gas purchases. The ALJ found that the RRC failed to establish the existence of a trend with respect to these purchases and relied on hindsight in calculating the proposed disallowance. The ALJ found that the standard of performance advocated by the RRC could not reasonably be expected, and that it was not imprudent of SEMCO to fix 6% of its basis prices with the early purchases.

In its exceptions, the RRC points out that SEMCO did not describe its early purchase method in the plan case, thus it is not possible to say whether the actual purchases conformed to the plan. The RRC contends that its recommended disallowance does not rely on hindsight because it is limited to the January to March time period and relies on knowledge that was available to SEMCO by January 2006, such as the fact that during April to December 2005 early purchases "made at NYMEX were more expensive than Index in 6 of those 9 months." RRC exceptions, p. 4. The RRC argues that it is not necessary to show a trend, and that the small percentage of early purchases does not necessarily make them reasonable.

In reply, SEMCO argues in favor of diversity in supply and pricing mechanisms. SEMCO points out that it achieved supply diversity by making use of monthly and term purchases, withdrawals from on-system and leased storage, and peaking services; and it achieved pricing diversity by making use of the monthly NYMEX settlement price, the first of the month Index

price, and negotiated fixed prices, and by purchasing at various times of the year and the month. SEMCO contends that there is no way to know in advance in any given month whether the NYMEX will outperform the Index or vice versa, making it impossible to rely on trends. SEMCO argues that the information available to the company at the time of its early and term purchases justified the continuation of the purchasing strategy that was built into its plan.

With respect to early purchases, specifically, SEMCO argues that Act 304 does not require that every type of purchase to be made during the plan year be described in minute detail. SEMCO supports the ALJ's finding that the 6% early purchases were part of a disciplined and diverse gas purchasing strategy. SEMCO points to the lack of a trend (which the RRC concedes), and notes that the RRC simply prefers alternative procurement strategies. SEMCO notes that in any given month – whatever the result of the previous months – there is a 50% chance that the NYMEX will outperform the Index, and vice versa. SEMCO points out that at the time that its early purchases were made the company knew that: (1) early purchases had performed well in 2004-2005; (2) early purchases would allow the company to hedge the price of a small portion of monthly purchases against late month surges in the NYMEX; (3) market data could be used to trigger early purchases when a downward trend appeared in the NYMEX; and (4) there is always historical variance in the relative performance of the NYMEX and the Index.

Turning to winter term purchases, the RRC seeks a disallowance of \$1,087,897. The RRC again compares the actual prices paid to what the purchases would have cost if made based upon the NYMEX close or the Index. The RRC characterizes SEMCO as having a “fascination with NYMEX and Basis.” 2 Tr 189. The RRC argues that SEMCO should enter into fixed price contracts with various suppliers or rely on pricing that is based upon the Index, but should decrease its reliance on the NYMEX plus a fixed basis. The RRC contends that SEMCO's winter

term purchases were \$479,982 more expensive than if SEMCO had used the NYMEX close, and \$1,087,897 more expensive than if SEMCO had used the Index.

SEMCO again responds that the RRC has failed to show an established trend and to avoid the use of hindsight. SEMCO points out that each type of purchase is linked to a distinct and unrelated market risk: early purchases mitigate potential spikes in the NYMEX during bid week, and winter term purchases mitigate potential supply shortages during cold weather. SEMCO points out that the Staff has encouraged utilities in recent years to increase their level of fixed price term supplies in order to stabilize price and supply.

The ALJ recommends rejection of the RRC's winter term purchase disallowance because, again, the RRC did not establish a price trend that could have been relied upon by SEMCO to support deviating from its plan, and the RRC's arguments rely on hindsight. The ALJ found that SEMCO showed that it compared the basis bid against the actual bid data for the previous winter and determined that the price was favorable. The ALJ noted that fixed prices stabilize price and supply which, in addition to achieving a low price, are important goals. Hurricanes Katrina and Rita had made the marketplace extremely volatile and SEMCO achieved some mitigation of the volatility by use of fixed term purchases.

In its exceptions, the RRC argues that the company should have seen that a fixed, negotiated basis combined with NYMEX pricing would achieve poor results in comparison to available alternatives. The RRC contends that it was unreasonable for SEMCO to rely on the NYMEX for pricing of gas supplies.

In reply, SEMCO points out that the natural gas market was extremely volatile at the time that these purchases were made, and the term purchases succeeded in stabilizing price and supply during those months. SEMCO maintained the option to either trigger a fixed price or allow the

price to settle at month's end, and, when triggering fixed prices, did so because the price was favorable when compared to actual bids in previous winters. SEMCO argues that it would have been imprudent to follow the RRC's recommended method of making only Index-based spot purchases during the winter of 2005-2006.

The RRC recommends a disallowance of \$1,320,069 for monthly purchases made by SEMCO from October 2005 through March 2006. The RRC again compares the fixed prices used by SEMCO to the NYMEX close and the Index. The RRC argues that a trend of volatility emerged after the two hurricanes that should have indicated to SEMCO that the Index would outperform the NYMEX, that this information was available to SEMCO at the time, and should have caused the company to adjust its monthly purchases.

In response, SEMCO notes that the NYMEX outperformed the Index for half of the April-September period including three of the prior five months, and that any trend between these two markers had reversed itself three times in the prior six months.

The ALJ recommends rejection of the RRC's proposed monthly purchase disallowance, noting that these monthly purchases were made during a time period of challenging events and that SEMCO made a prudent decision in continuing to execute its plan.

In its exceptions, the RRC argues that SEMCO acted unreasonably in making "only 16 of the 41 monthly purchases" in the October 2005 to March 2006 time period at Index, despite Index prices being more attractive than NYMEX prices. RRC exceptions, p. 14.

In reply, SEMCO argues in favor of its strategy of using a blend of NYMEX and Index based purchases for monthly purchases, since, in any given month, one might outperform the other. SEMCO again points out that whether the Index falls in relation to the NYMEX can only be known with hindsight. SEMCO notes that 39% of its monthly purchases (16 out of 41) were made

at the Index price, which does not indicate total reliance on the NYMEX. SEMCO maintains that making all purchases at the Index price would result in a potentially dangerous lack of diversity in the portfolio.

Gas supply decisions are judged based on the known and reasonably foreseeable circumstances existing at the time that the decisions were made, and not on the results of the decisions. December 19, 1991 order in Case No. U-9173-R, p. 26; May 10, 1996 order in Case No. U-10444-R, p. 6; March 12, 2003 order in Case No. U-13060-R, p. 26. “Act 304 does not hold utilities to a standard of omniscience or perfect performance, but rather to a standard of reasonableness and prudence.” February 5, 1997 order in Case No. U-10640-R, p. 10.

The RRC did not present any evidence to rebut SEMCO’s testimony regarding its decision-making process and the information that the company took into consideration at the time of its purchasing decisions.

The ALJ recommends that the Commission adopt SEMCO’s proposed reconciliation plan. The Commission agrees and adopts the findings and recommendations of the ALJ. While the RRC concedes that there is no such thing as a trend with respect to the month-by-month comparison of the performance of the NYMEX relative to the Index because any given month can differ from the previous month, the RRC maintains that the company should have changed its early, term, and monthly purchase strategies. The Commission disagrees. SEMCO had a reasonable and prudent plan in place and was correct to follow that plan, adjusting for the warmer than normal January by purchasing less baseload gas for that month. The Commission does not agree that SEMCO should have abandoned reliance on the NYMEX or on any fixed pricing, as such action would have been unreasonable and imprudent. The RRC has been able to establish the fact that the Index outperformed the NYMEX during much of the relevant time period only through

hindsight. The Commission is not persuaded that any of the RRC's proposed disallowances should be adopted.

Finally, the Commission finds that it has jurisdiction under 1909 PA 106, MCL 460.551 *et seq.*; 1919 PA 419, MCL 460.51 *et seq.*; 1939 PA 3, MCL 460.1 *et seq.*; 1982 PA 304, MCL 460.6h *et seq.*; 1969 PA 306, MCL 24.201 *et seq.*; and the Commission's Rules of Practice and Procedure, 1999 AC, R 460.17101 *et seq.*

THEREFORE, IT IS ORDERED that SEMCO Energy Gas Company's application for authorization to reconcile its gas cost recovery revenues for the 12-month period ended March 31, 2006, is granted.

The Commission reserves jurisdiction and may issue further orders as necessary.

Any party desiring to appeal this order must do so in the appropriate court within 30 days after issuance and notice of this order, under MCL 462.26.

MICHIGAN PUBLIC SERVICE COMMISSION

Orjiakor N. Isiogu, Chairman

By its action of January 29, 2008.

Monica Martinez, Commissioner

Mary Jo Kunkle, Executive Secretary

Steven A. Transeth, Commissioner