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In the Matter of the Third Prudence Review of Costs Subject to the Commission-Approved Fuel Adjustment Clause of KCP&L Greater Missouri Operations Company.	File No. EO-2011-0390

HAROLD STEARLEY, Presiding,
DEPUTY CHIEF REGULATORY LAW JUDGE.

STEPHEN M. STOLL,
COMMISSIONER.

Staff Exhibit No. 397
Date 10-29-12 Reporter KF
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can be done. It's just it's a lot easier to buy gas locally. And so we don't take physical delivery.

Q. Okay. So hedge is used solely to protect the natural gas price of where you're buying it here locally, the local distributor?

A. Yes.

JUDGE STEARLEY: Okay. Thank you. Any other questions from the Bench?

(No response.)

JUDGE STEARLEY: All right. Any recross based on questions from the Bench?

MR. FISCHER: Yes, Judge. Oh, I'm sorry.

JUDGE STEARLEY: We'll get to redirect in just a few minutes.

MR. THOMPSON: No recross.

JUDGE STEARLEY: Now you may redirect.

MR. FISCHER: Okay. Thank you, Judge. I jumped ahead here.

REDIRECT EXAMINATION BY MR. FISCHER:

Q. Let's go to Judge Stearley's questions there at the end and make sure I understand what you're saying. He was asking how often you settle. Do you recall that?

A. Yes.

Q. Would you explain whether you wait 'til the

monthly settlement date to deal with these natural gas futures contracts?

A. Generally we do.

Q. Okay. Would you explain that -- how that process works and how that -- because you're dealing with an hourly electric price, how that would be important?

A. Well, generally the settlement is the sale price of the contract. The purchase price varies continuously throughout the day and across the whole time that the contract's been traded. So the purchase price of August 2009 gas has been varying for almost seven years continuously. So the purchase price is whenever you bought it at -- whatever price you bought it at. It varies.

The settlement price is the point at which the NYMEX brings to a close that futures contract, and if you will, it's essentially a touch point of where the futures market and the cash market come together. They essentially have to converge at some point for the whole thing to work. And that settlement price is that point of convergence where futures and cash come together, and that's why it is a single price.

It's used a lot of times in analysis, but it is the average of the last 30 minutes of trading on the exchange for that contract.

Q. But the electric prices vary hourly throughout the month; is that right?

A. Yes, they do.

Q. Well, how does a monthly natural gas settlement help you hedge the hourly prices?

A. Well, it comes back to, one, you've got multiple pieces happening. One as I was referring to, on the purchase side your price is moving on gas just like the electricity price is moving. It's moving all the time.

The settlement, what you're looking for when you make a hedge is you've bought a futures, you've sold a futures, and the gain or loss from that is what I'm referring to as this bucket of money. That bucket of money is then used to offset whatever was happening in the cash or the physical market.

So if I can go to my Schedule WEB-9, I think it's a little easier to talk from a picture. On Schedule WEB-9, which is part of my surrebuttal, I illustrate how this works with real numbers. And what you see in essentially the cell that I call B1, which is under the column labeled physical market, you see where it's showing that GMO needed 982,000 megawatt hours. It needed that for August. Well, that's what it needs on average. And then to offset that need, it went out to the futures

market and bought 793 contracts of natural gas. So those two volumes are essentially equivalent, 982,000 megawatt hours versus 793 contracts. We had a need. We bought a futures contract.

Then it comes time when we actually really do need that electricity, so we go out and first we would sell the futures contract. That happens right at the end of the month before. And you can see on the column that I labeled C under futures market, it says sell. That's saying we sold 793 contracts at a value of $4.34, and we have a loss of $14 million, which this is roughly equivalent to the 14.8 that everybody's been referring to.

On the physical market side, you see that we come in, we buy electricity, but we're buying at a price much lower than what we thought we were going to have to pay. So we experienced a real gain of $12.8 million. That's how they work. They sync up with each other.

Q. So is that a real world example of what I was talking about in the opening where the gains and losses offset each other?

A. Yes. These are real GMO numbers. They don't exactly sync to the 14.8 because I took out some of the more complicated hedges, but this is what we're looking at. It's showing how the offset and how you buy

one, sell the other, and then you reverse it.

Q. Would that roughly equate to the $1.80 that Mr. Thompson was referring to per megawatt hour or not?

A. Well, if you only looked at the futures side, you get to the $1.80 or something like that, but if you recognize both sides of the hedge, there is really no adjustment.

Q. Well, did you do an analysis of that $1.80 effectively and whether that was a reasonable cost for the insurance that you were buying to cover the risk of the electric price spikes?

A. I did. But if you'd like to go back to the one schedule that Mr. Thompson gave me from Ms. Mantle's testimony, that would be an easy place just to even eyeball it without even going into my own testimony of schedule where it's --

Q. That's Schedule 9, I believe.

A. This one (indicating).

Q. Yes.

A. In the lower right-hand corner you'll see it refers to total purchases and it says total purchases, the dollar cost was on average $26.86. Well, $1.80 of $26 is less than 10 percent. And where I live, sales tax is almost 9 percent. So what's a reasonable amount to pay for this insurance? Industry rule of thumb, as long as

you're less than 30 percent, you've done well. We've done very well.

Q. At the time of settlement, has the company decided whether it will purchase power in the following month or whether it will generate electricity?

A. No.

Q. Okay. I'd like to go to Exhibit No. 7 that the Staff put in front of you that had the NYMEX natural gas contract settlement price chart or graph. Do you have that?

A. Yes. Is that the one labeled Schedule WEB-12?

Q. Yes. Mr. Blunk, where on that chart did Katrina happen?

A. Katrina was in '05, wasn't she? I don't remember exactly.

Q. What happened in August of 2008 where the spike began, if you know?

A. I'm sorry. I'm not remembering the event.

Q. Okay. Do you recall if the Commission's natural gas price volatility mitigation rule was adopted after the Katrina event?

A. Well, the Commission issued a joint report that was following, I believe it was Katrina and Rita, and that was -- the report came out in 2006 because they have

a picture of it on the front cover.

Q. Do such events affect electricity or natural gas prices?

A. Yes.

Q. In what way?

A. Well, for example, the hurricanes, they led to a spike in the price of natural gas, and since natural gas is the primary on the margin fuel, if your primary on the margin fuel is going up, then the market price for electricity is going to follow it. And natural gas is always the cause, a primary cause for what's driving the price of electricity in Southwest Power Pool.

Q. Would you expect that if Katrina hit the natural gas fields in New Orleans, that that would affect your margin on electricity cost?

A. Oh, it definitely would. It definitely would, because it would so impact the price for natural gas that it's going to in turn, since that is primary -- the fuel for the on-peak power in Southwest Power Pool, it's going to drive up the price for electricity.

Q. Did you expect Katrina to hit New Orleans?

A. Well, not before 2005.

Q. Do you expect the hurricane to hit New Orleans this year?

A. I don't personally, no.

Q. Do you think it's wise to have some insurance in case electricity prices would spike for some reason?

A. Yes.

Q. You were asked a question about your direct testimony on page 17, and you were asked to read into the record, I think, the first sentence regarding simply to liquidate or liquidity?

A. Yes.

Q. Would you explain what that reference relates to?

A. Putting it in context, this is testimony from Case No. ER-2007-0004, and it is testimony referring to why GMO would choose to use cross hedges as opposed to trying to use an electric forward contract to hedge price risk. It's also worth noting that that testimony was in a case that first introduced GMO's fuel clause.

But liquidity is the reason why you would choose to cross hedge instead of just signing a contract with another electricity provider. If you just sign a contract with another electricity provider, you'd still get price insurance, but getting out of that contract should your volume change, you're going to have to sell, shall we say, at a loss because that other person, they don't -- it's not a good secondary market. So you have to

pay a consequence to get out of the contract.

Q. Would you turn to the next page of your testimony that continues to discuss that topic.

A. Yes.

Q. Are there other reasons listed there that would suggest that using natural gas futures contracts rather than these other financial tools makes good sense?

A. Yes, there are. I mean, liquidity is a very big one. The natural gas market, it trades a factor of, I don't know for sure, like 30 times the actual volume of gas. It's very liquid. You can easily get in. You can get out. Basically no penalty for doing that. There is credit party risk. If I signed or if the company signed a bilateral contract with another counter party, we'd have to worry about their credit risk.

The futures exchange, when you purchase a futures contract, your counter party is technically the exchange itself or the NYMEX. The NYMEX is guaranteed by the clearing members, and the clearing members include a large number of very financially strong institutions, large banks, large players in the industry. They have and have maintained very high credit ratings.

Another value is simply the volume you can deal in. If I use NYMEX futures, we can take a very small bite. For example, one contract is the equivalent of

nearly 1,000 hours of electricity. And if we did a bilateral contract, I probably couldn't fine tune it.

Maybe take a larger quantity or lesser quantity. Again, if we had to adjust the volumes, which we do have to adjust volumes from time to time, making that adjustment if it's a contract, a bilateral contract, as the buyer, I'm essentially going to pay a price to make the change. On the futures exchange, I mean, the broker fee in this stuff is insignificant, so there's no penalty.

Q. If you're going to use financial instruments to hedge your electricity price risk, do you know of any better financial instrument than the natural gas futures NYMEX?

A. No, not for what we're dealing with.

Q. Does any of this discussion that you have here on page 17 or 18 suggest that the company isn't hedging to protect customers?

A. The purpose of our hedging program really is to protect customers. The fuel clause, the customer is the one that bears the energy market risk. So all the hedging is for the benefit of the customer. There is no benefit to the company of any of this hedging. There is no benefit to the company.

Q. So you're indifferent whether you -- if the Commission says don't cross hedge anymore, what would be

the company's response?

A. We would probably stop hedging, hedging altogether. There's no -- the company has no benefit from employing this hedging program. It is strictly for the benefit of the customer.

Q. Does the company -- does Kansas City Power & Light Company, to your knowledge, hedge in Kansas?

A. No. We do not hedge in Kansas because in Kansas KCPL has a fuel clause. Again, when there's a fuel clause in place, the hedging is for the benefit of the customer. There is no benefit to the company for a hedge program. There's no motive, no benefit, no reason to do it.

Q. But again, do yo know if Katrina's going to hit again this year?

A. No, I do not if Katrina or Rita's going to hit.

Q. Mr. Thompson asked you a number of questions about the Kase program and the Hedge Model and Easy Hedge. Do you recall those?

A. Yes.

Q. Would you explain to Commissioner Stoll and Judge Stearley just how this Kase program works, in layman's terms?

A. Yes. Probably the easiest thing to do is

talk from a picture again. I guess this is Schedule 9, my graph. It's a little easier to see from the picture. In general, what the Kase hedge program is doing is it is creating a moving average. Is there a way I can draw, draw a picture?

JUDGE STEARLEY: Well, we could use the ELMO. Have you got some paper perhaps he could draw on and display it up there?

MR. FISCHER: Mr. Blunk, if you'd go to the machine over here, we'll give you a piece of paper, and I believe the Judge in his magic can project it onto the wall.

JUDGE STEARLEY: We'll see about that.

MR. FISCHER: Or if you want to put that on there and draw on that, that will work, too.

THE WITNESS: Okay.

MR. FISCHER: Judge, can you see this from your vantage point?

JUDGE STEARLEY: I can. It's a little gray, but we can see it.

BY MR. FISCHER:

Q. Go ahead, Mr. Blunk. Please explain your answer.

A. You've seen this chart. You've seen the line which it was essentially the market price for gas,

and while these are monthly prices, we assume these are daily because we track this daily.

What I've drawn, if you will, I've drawn kind of a thick line that kind of follows more like the moving average. So the middle line, which kind of goes through the middle, from the Kase hedge program we would consider something about where the prices are more or less at as a normal price.

If it's just moving a little bit today or tomorrow, you might not do anything. But if a price gets outside of a range, so, for example, it would cross this line, we'd say prices are running away. We need to have done something to protect ourself. Under the Kase hedge program, it would say you probably should buy a few caps, unless you don't need gas in that period. It's really looking out and saying prices that spike like that, that spike is only going to last six, maybe nine months. And if it's not going to come in and affect you, don't do anything. Just ride it out.

On the other hand, we would come in and this is saying, oh, well, that's probably a very opportunistic price. We want to buy into that. We want to take a little bite, buy into it, take another bite, buy into it and see if prices go down and continue to ride them down.

So if you think of it as a high price zone, a low price zone and a middle zone, in the middle zone where it's just kind of like normal day-to-day stuff, you might not place any hedges because it does cost money to place a hedge. But it it's going high, you're going to do things to protect yourself. If it's going low, you're going to take advantage of that opportunity and you're going to ride it down.

Q. Mr. Blunk, is the Kase program then market insensitive?

A. No. It's very market sensitive. It is giving a lot of consideration to the market. In fact, the Kase program -- well, going back to the joint report of -- you might not have a copy of it, but in 2006 there was a report done by -- it's called the Joint Report on Natural Gas Market Conditions, PGA Rates, Customer Bills and Hedging Efforts of Missouri's Natural Gas Local Distribution Companies.

I referred to it in my testimony. That report identified things that it thought were important in a hedging program. One of them was that it needed to give consideration and have flexibility to react to markets, and the Kase hedge program does that. In fact, of the various bullets that that report identifies, the Kase program lines up best of any program that I know of.

Q. Do you still exercise professional judgment even though you have Kase?

A. Yes, we do. Those lines that I drew, those are based on statistics, and they tell us this might be a good time to trigger. Just because we have a trigger doesn't mean we'll go out and place a hedge.

We are in constant consultation with Kase, who is the provider of the program, and every time we have a trigger, we talk to them, because that -- the triggers are statistical. I mean, it's kind of like any kind of test, you might get a false reading. So we discuss with them their interpretation and is that consistent with what we know about the market based on things we read in the marketplace and what we're knowing about the market.

Q. Are you trying to outguess the market?

A. If I could truly outguess the market, I might not have to be in this seat.

Q. When prices for natural gas plummet like they did during this period, what do you typically expect would happen with electricity spot prices?

A. It will follow the gas prices down.

Q. Is that a bad thing for consumers?

A. Oh, no. Oh, no. In fact, that's what we saw and I showed in my Schedule WEB-9 was that the price of gas came down on the futures side, the price of

electricity came down on the cash or physical market side.

Q. If Katrina or Rita or something like that had hit during this period, would you have expected natural gas prices to have fallen?

A. Oh, no. No. If a major hurricane had gone through -- gone through the gas-producing region of the Gulf like Katrina and Rita did, it would have driven gas prices up.

Q. From the shareholder perspective, assuming that you have an FAC in place, do you care if a Katrina hits?

A. As a share -- well, from the company's perspective, its risk goes through the fuel clause, so no. As a ratepayer, I'm a GMO ratepayer, I do care.

Q. You care very much?

A. I do.

Q. Okay. Talking about the Kase program, how does Kase differ from a cost averaging program perhaps like a one-third program?

A. Under the one-third program, and that's probably -- the market neutrality portion of the one-third program versus Kase, under that market neutrality piece, what Aquila was doing was -- and I'll exaggerate to illustrate the point. I don't know the exact pieces of it. But it's like as if on the second Tuesday of every

month they bought 1/12 of whatever the requirement was, and whatever the market was, they triggered on that, which is why Mr. Hyneman referred to it as a very rigid program, and it was. The way that was implemented, if it was the second Tuesday of the month, you did what you had to buy.

Under the Kase program, it doesn't give consideration to that. It's looking at what's happening in the marketplace? Are prices trending up or are they trending down? And depending which way they're going affects what acts you will take. It will affect the level of action you will take.

So the two are very different in that the, what we've referred to as the one-third program being market neutral is very rigid, very, very locked in, but Kase is not.

Q. Would you explain under the Kase program when you would typically make decisions on when to hedge or whether to hedge and how that would work?

A. The Kase hedge program as we're employing it looks out up to three years, which again is consistent with what the recommendations in the joint report said. The joint report said you should look out three years or more. We're looking out three years.

Most of our hedges are not placed three years in advance. Only if -- you remember I showed when

the prices are low, it's in the low price zone, and when they are really low prices, then we'll look out three years and we'll place them. If they're high prices, we don't want to lock into those for a long time.

So on average, it looks like that Kase triggers -- and this is simple average over what's happened. It's not a way to read the rules, but just on average, based on what's happened, we tend to place hedges about 11 to 12 months out. That's an average.

Q. Could you build a power plant in 11 or 12 years, a coal plant like Iatan 2?

A. 11 or 12 years?

Q. I mean 11 or 12 months?

A. No. No, we could not build a coal-fired power plant in 11 months.

Q. Are you likely to be able to secure significant amounts of capacity for 11 months out?

A. You couldn't construct it that quick, no.

Q. If the company had built generation, natural gas or otherwise as suggested by Mr. Thompson, would the company continue to hedge as it does today?

A. Yes, and I discussed that in my prefiled testimony. If the company had built gas-fired generation or, as Ms. Mantle kind of implies, purchased Aries, which is now known as Dogwood, we would have employed the same

hedges. We probably would have had the exact same hedge volume. We would have used Kase. We would have had exactly the same hedge adjustment. It would look just exactly the same to the ratepayer, except for the cost of capital, which cost of capital does not go through the fuel clause.

Q. And that's because that's a natural gas fired plant?

A. Yes.

Q. Okay. When you make the decision to hedge your expected purchased power, do you know at that point what your generation fleet is and do you have any control about what that generation fleet, how that's going to change in 12 months?

A. No. I don't have control over as I make the hedge program, no.

Q. So as a decision-maker, under the circumstances that you know at the time, you know what the generation is, what your capabilities are?

A. Yes.

Q. And what your spot purchased power requirements are likely to be?

A. Yes. We have projections of those things. We know what our capacity is, our fleet is, and we projected what we think are fuel requirement is and what

we think we will then supplement it with out-of-the-market purchases are.

Q. Going back to your Schedule WEB-9 that you referred to earlier, the real life example of what the physical market gain was and what the futures market loss was.

A. Yes.

Q. There is under that table a dollar offset ratio of 109.6 percent?

A. Yes.

Q. What does that show?

A. That 109.6 percent is dividing the 14 million by the 12.8 million. And what that is showing is how well did the actual hedges that were placed in the futures market, how well did they project the risk that we had in the physical market. And at 109.6 percent, that suggests this is a very good hedge. The guidelines established consistent with a variety of parties, and we've referenced several of them, implement -- well, not implementation, but accounting firms and applying FASB's rules, commodity futures trade exchange, they are all suggesting that anything between an 80 percent and either 120 or 125 percent represents a good hedge, and that fits very nicely inside that bound.

Q. But isn't that a hindsight review? You

knew what happened now?

A. Oh, yes, this is hindsight. We know exactly what happened at this point.

Q. When you put in these hedges, did you know what was going to happen?

A. No, we did not know. We had to rely on historical correlation analysis.

Q. That's what you relied on, correct?

A. Yes.

Q. When natural gas prices are falling like they did in this case, would you expect to have some losses in the hedging program or not?

A. If you're only looking at the derivative side, yes.

Q. Is that necessarily a bad thing from your perspective?

A. No. It just simply could be indicating the hedge worked as designed, because when you put a hedge in place, you are essentially saying I'm going to lock into a price, and the way you lock into a market that you cannot control or you can't get a contract for is you go to the futures market, and the two are moving in parallel. So all the gains I have on one side will offset the losses on the other or all the losses on the other will offset the gains. The issue is, at the end of the day, you're coming

to essentially a net zero.

Q. Well, if natural gas prices are going the other way, would you expect -- and they're skyrocketing, like apparently they did in October of '08 and then again in October of 2010 --

A. Yes.

Q. -- what would you expect electric prices to be doing?

A. They also would skyrocket.

Q. Now, on the derivative side, what would you expect in your hedging program?

A. The natural gas futures contracts would have a significant gain. In other words, we'd make a lot of money there. That would fill my little bucket of money that I keep referring to, and I can then use that bucket of money to offset what's happened on the cash or the physical market for electricity. I've got all this, if you will, this insurance proceeds to help pay for this now higher price electricity.

Q. Well, since you had all those gains, is that a good thing?

A. I don't know if you'd say it's good or bad. It's -- you need to take the two, and the two of them wash each other out.

Q. So the company's indifferent, is that what

you're saying?

A. Yes. Doesn't matter to the company.

Q. The Staff seems to suggest -- well, strike that.

Gas prices that are the low level today, the $2, $3 range, would you still recommend the Commission continue to hedge or not?

A. Oh, yes. Yeah. The Kase program is going to help us exercise how we do that, but we're looking at historically low gas prices, and as a buyer, I'm looking if I want to lock something in, I want to lock in low prices. So this is really an optimal time to be hedging. I would want to continue the program that would allow us to lock in these lower prices, and how far we can carry them in the future remains to be seen, but this is -- this is a good time to be hedging, good time to be placing hedges, which is consistent with how our program works. Identifies these low prices and we'd be placing hedges.

MR. FISCHER: Judge, I think that's all I have. Thank you very much.

JUDGE STEARLEY: All right. That concludes redirect. You may step down, and thank you for your testimony, Mr. Blunk.

We are at about 11:35. Do the parties wish to start the next witness testimony or do you want to