BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

AG PROCESSING INC A COOPERATIVE,	)	
Complainant,	)	
	)	
vs.	)	**HC-2010-0235**
	)	
KCP&L GREATER MISSOURI OPERATIONS COMPANY,	)	
Respondent.	)	

AG PROCESSING INC A COOPERATIVE
REPLY BRIEF

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ATTORNEYS FOR AG PROCESSING INC.

February 9, 2011

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I. INTRODUCTION.

A. Overall Summary of Response.

Aquila management did not fare well in its foray into competitive markets. Indeed, Aquila management did not fare well even in the regulated utility business where regulation is intended in part to act as a substitute for competition. Now GMO's initial brief offers another glimpse into the failures of Aquila. It falls to this Commission to ensure that the imprudent actions of the Aquila management, and the resulting imprudent costs, are not left on the doorstep of Missouri industries -- Missouri industries that continue to meet the test of the competitive markets that are the essence of America and the world.

Free markets are at the same time simple and sophisticated. They are Economics 101. Supply meets demand at a market clearing price. When supply is short prices go up. When prices go up demand goes down. And there is another element wholly disregarded in GMO's opening market diatribe (see GMO Initial Brief, pp. 4-6) that is intended to set the stage for the rationalization of the failed Aquila foray into natural gas hedging. When prices go up in a competitive market suppliers are incented to bring new supplies to the market. Given just a little time the market will reach a new equilibrium. Occasionally prices spike, but by definition the spikes do not persist because market participants respond, not just in theory, but in reality.

GMO creates for the Commission its own adaption of the famous children's story of Chicken Little with a cameo role for Aquila. They would have the Commission believe that the sky was falling in February, 2006. Natural gas markets were high and inevitably headed higher, they argue. In spite of no independent fundamental analysis of the natural gas market, and instead based solely on selected industry news available to everyone in the market, GMO now pens a story in which Aquila's decision makers had the hubris to believe that they could profitably bet against the market. GMO provides ***no*** evidence whatsoever from an Aquila decision maker, but instead pens a story that even with the benefit of editorial license shows Aquila to have placed bets without a reasonable basis, without a reasonable analysis of the hedge program arbitrarily initiated, and, not surprisingly, without success. The bets were cloaked in a hedge program that in their story was one of allegedly universal applicability. AGP's Initial Brief has already listed the many ways in which the steam hedge program was not what it was purported to be, for Aquila found ways to convolute and create failure even in its implementation and administration. Now the Chicken Little story laid out by GMO, Aquila’s newly minted surrogate, would have consumers pick up the tab in the fantasy that is a literal management tragedy.

It is a matter of record that GMO did no due diligence analysis of the liabilities of the hedge program.[1/] Now, having taken Chicken Little into the fold of Great Plains Energy, GMO struggles to avoid the consequences by laying the cost of Aquila’s failures onto Missouri industry that can and must survive in competitive markets.

In AGP’s Initial Brief we explained the technical failures of the hedge program. GMO’s brief, in spite of rhetoric with a contrary intent, if arguments are accepted provides a window into the naivety and incompetence that was Aquila’s management. In this reply we will not dwell on the many compounding mistakes summarized in our initial brief. Here we will focus instead on Aquila management’s failures that created

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[1/]

Q. You answered: To my understanding, they did not.
And then you were asked: In what respect did they not employ due diligence?

00305

And you answered: I don’t believe they looked at the steam hedging program as an issue to be addressed with regard to due diligence.
Do you acknowledge that being the question and answer?
A. I -- I do.

Tr. p. 304-05.

imprudently incurred costs that should be left on the doorstep of the owners, now GMO and of course Great Plains. It was, after all, the responsibility of owners to have installed a management up to the task, and to make money or to lose money based on their success or failure as managers.

Mr. Johnstone's Direct and Rebuttal Testimony clearly challenged the choices made by Aquila management. And set before the Commission the short e-mail[2/] that -- alone -- constituted Aquila management's decisional process to implement this "strategy." In response, GMO/Aquila never produced a witness to explain what was before management when the decisions were made, to speak to management's thought process or the lack of subsequent monitoring. Mr. Johnstone's characterizations of "salient omissions" and "corporate failures" were not controverted or challenged by cross-examination. What then did they do? They resort to an attack on Mr. Johnstone's credentials, but in doing so apparently forgot his years of experience as a load forecaster and system planner for Union Electric. And, they challenge AGP's unwillingness to take this lying down as "untimely." If there was an explanation, we would have seen it. If there was a defense, we would have heard it. This sort of challenge bespeaks GMO's implicit recognition that one cannot defend what is indefensible.

[2/] Exhibit 4.

B. The Natural Gas Markets.

Was the sky falling? The futures market potentially provides benefits, but at the same time adds degrees of complexity and sophistication for those that would use them. We begin with a simple truth: there are no facts about the future. Yet in February 2006 there were participants in natural gas futures markets willing to enter transactions that would inevitably, over time, be beneficial to some and costly to others. While Aquila's approach was purportedly intended only to mitigate volatility, Aquila in fact rushed into the futures markets with a program instead seeking protection from its expectation of ever increasing market prices[3/] and was so one-sided as to sell protection to others to protect them from the risk of falling prices -- at great risk to Aquila. One would think Aquila's earlier failed foray into natural gas marketing would have chastened management. It apparently did not. History repeats.[4/]

According to the story line in GMO's Initial Brief, Aquila was moved to its arbitrary actions under a Chicken Little Syndrome portrayed on pages 3 through 6. Given the syndrome as

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[3/]

BY MR. CONRAD:
Q. Now that we've been through that, Mr. Gottsch, were you asked: Well, over what period of time rising?
And did you answer: For the foreseeable future?
A. Yes.

Tr. p, 216, ll. 6-12.

[4/] "Those who cannot remember the past are condemned to repeat it." Jorge Agustín Nicolás Ruiz de Santayana y Borrás.

portrayed, GMO rationalizes the Aquila rush to capitalize on predictions of doom. Yet, there was, necessarily, always an unmentioned someone on the other side of the table making the opposite bet. Those on the other side were the counter parties. They did not buy into Aquila's Chicken Little Syndrome. Obviously so, but why not? What information did they have that Aquila did not even consider? Were they the shale gas producers? Were they merely speculators that did their homework? Should they be dismissed as hapless gamblers? If Aquila made any credible attempt to understand what would motivate the counter parties, there is no evidence of any such attempt. Rather than a reasoned analysis of the pros and cons of the market and natural gas supply and demand fundamentals, GMO offers up only its Chicken Little Syndrome to justify Aquila's rush to hedge.

One would logically ask, what was management's thought process? Was there consideration of anything beyond the naivety of the Chicken Little Syndrome offered up by GMO's brief? We will never know. The Commission will never know. GMO did not produce a responsible corporate officer, or even a manager that could have made a recommendation to the responsible corporate officer. The record is utterly devoid of such evidence. Instead GMO chose to make a run at saving revenue through Monday morning quarterbacking, and through a tale concocted from conjecture with no basis in factual analysis made by managers or officers of Aquila. What a sad fantasy in lieu of any evidence of prudent management.

We know how the story ends. The sky did not fall. The market worked its will. Natural gas prices at the wellhead were deregulated years ago so the natural gas supply market would have the price signals that would allow both producers and consumers to respond. They do. They did. Where was Aquila's mind? There is no evidence that they understood these most basic market precepts. To the contrary, there is only evidence of an imprudent and ill-timed hedge program, an execution inconsistent even with its very premise of laddered purchases, and further flawed in its implementation with no reasonable monitoring that could have minimized the financial damage of a wrong-headed start.

The one silver lining is that once the ineptitude of Aquila's management of the hedge program was revealed, AGP acted to put a stop to the hemorrhage. GMO owes AGP a debt of gratitude for putting a stop to the losses. However, AGP expects no thanks and asks nothing more than to be relieved of the burden of the imprudently incurred costs.

GMO presents the Aquila "Chicken Little" view of the market as the only view. There is no mention of a single alternative. It is well established that effective planning requires the consideration of uncertainty through analysis (the Commission's present IRP Rule in Chapter 22 and its natural gas volatility mitigation rule[5/] are examples). But Aquila apparently saw no high and low possibilities, at least not in the picture GMO chooses to paint. GMO goes on to assert that what happened

[5/] 4 CSR 240-40.018,

in reality was impossible to predict. That the future was unpredictable is fundamental. Why is that presented as news? To what extent was the development of shale gas instead a matter of economics? From another perspective, given that future reality is impossible to predict, what gave Aquila the confidence to believe in and act on only its Chicken Little Syndrome as the basis for its hedge program? GMO would have the Commission believe the rush to implement without first having a proper analysis was the act of a reasonable management.

GMO offers scant praise of Mr. Johnstone for his 20-20 hindsight and for performing the analysis that Aquila should have done before launching into this program and his pointing out that these same considerations could easily have been anticipated and avoided. Indeed, even with the benefit of hindsight, GMO has not even been able to weave a plausible story.

II. ARGUMENT.

A. Burden of Proof Revisited.

Although invited to do so by the assigned Law Judge, GMO spends but little time on the important question of the burden of proof. Perhaps this is because it recognizes the weakness of its argument. Moreover, GMO fails to distinguish between what is an rebuttable evidentiary presumption and the ultimate burden of persuasion. Having initially addressed these matters,[6] AGP will touch on them again, albeit briefly.

[6] AGP Initial Brief, pp. 5-7.

1. **The Relevant Case Law.**

GMO cites the *Associated Natural*[7] case but apparently fails to appreciate its significance. *Associated Natural* makes clear that in a case such as this where the utility has only collected rates ***subject to refund*** and later review, the burden is as it was in the original utility filing, *i.e.*, a refundable rate that is automatically passed on to steam customers by Aquila through a rider mechanism without the need to file another ratemaking case. The burden of proof remains on Aquila/GMO.

As AGP noted in its Initial Brief, the HR-2005-0450 Stipulation and Agreement directed that the complaint ***procedure*** be used to conduct a prudence review. This does not shift the burden of proof under Section 393.130.1. And, as was held in *Associated Natural*, *supra*,

> All charges for gas service must be just and reasonable. Section 393.130.1, RSMo 1994. The PSC has employed a "prudence" standard to determine whether a utility's costs meet this statutory requirement. If a utility's costs satisfy the prudence standard, the utility is entitled to recover those costs from its customers. The PSC has defined its prudence standard as follows:
>
>> [A] utility's costs are presumed to be prudently incurred. . . . However, the presumption does not survive "a showing of inefficiency or improvidence."
>
> . . . Where some other participant in the proceeding creates a serious doubt as to the prudence of an expenditure, then the appli-

[7] *State of Missouri ex rel. Associated Natural Gas Company v. Public Service Commission*, 954 S.W.2d 520, 528 (Mo. App. 1997).

> cant has the burden of dispelling these doubts and proving the questioned expenditure to have been prudent.[8/]

The ruling in *Associated Natural* was relied on in the recent case of *State ex rel. Nixon v. PSC*,[9/] judicial review of a rate case brought by Union Electric Company where the Court of Appeals held at p. 569 and again at p. 582 that the Commission properly presumed that Union Electric was prudent in its purchase until another party raised a "serious question" concerning the prudence of its expenditure. At page 586 the court stated:

> "In ratemaking cases, a utility receives the benefit of a presumption of prudence with regard to its costs until another party raises a serious doubt regarding the prudence of its expenditure. *Associated Natural Gas Company*, 954 S.W.2d at 528. When another party raises a serious doubt regarding an expenditure, the burden shifts to the utility to prove the prudence of the expenditure. *Id.*"

2. AGP Has More Than Met Its Burden; GMO/Aquila Has Failed to Meet Its Burden.

Through Mr. Johnstone's testimony as well as examination of GMO witnesses, AGP has presented "serious doubt" regarding Aquila's actions, not "mere speculation." Accordingly the presumption of prudence disappears and is completely out of this case. But AGP has done more. Although it did not have to, AGP has met a burden of proving that Aquila was imprudent, even

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[8/] *Associated Natural Gas, supra,* at 528 (internal citations omitted).

[9/] *State ex rel. Nixon v. PSC,* 274 S.W.3d 569 (Mo. App. 2009).

incompetent, in determining to implement this hedging strategy. GMO has offered not a single witness to explain or rationalize its decision. Regardless, it was GMO's responsibility to meet that burden of proof, and GMO has failed to meet that burden.

B. AGP's Original Itemized Listing of Aquila's Imprudence.

In his direct testimony, Mr. Johnstone listed six aspects that his investigation and analysis of Aquila's actions or inactions demonstrated were imprudent. These were:

- The QCA mechanism effectively mitigates the effects of fuel cost volatility and price spikes, by design and in practice. As such, the Aquila hedging program was not needed. It was imprudent to ignore the QCA and to instead incur the cost of a risky financial hedge program given the effective volatility mitigation of the QCA mechanism.

- Aquila could have easily discussed a hedge program with all six of its steam customers before implementation and should have done so. Aquila's interests in a hedge program: volatility mitigation, price protection, and price stability, all could have been subjects for discussion. Aquila's pass on the opportunity for important customer input is a management failure leading to imprudence.

- Aquila adopted a hedge program design without considering the nature of its natural gas usage as a swing fuel. Part and parcel of this problem was Aquila's forecast of natural gas requirements that was very far from the mark.

- Because of the design Aquila's hedge program, and because the forecast of natural gas usage requirements that was 2 or more times actual usage, the hedge program created volatility in fuel costs and price spikes. The effect of the program in some months was so extreme as to move prices up sharply in a down market.

- Aquila appears to have sold puts for speculative profit and that contributed to a hedge program-induced spike in the October 2006 cost of natural gas. The sale of puts was counterproductive to the volatility mitigation purpose of the hedge program. Aquila sold these puts for a profit which was the intent.

- Aquila began the hedge program on February 16, 2006 by executing all of its hedge positions for the remainder of 2006 (April through December). 2007 hedge positions were executed over several months in 2006, but not proportionally or in a manner that would have permitted adjustment or reaction to current requirements. The forecast natural gas usage requirements were immediately out of kilter with reality.

To this listing, a seventh could now be added:

- Analysis has demonstrated numerous unrebutted, uncontradicted and unexplained corporate failures and salient omissions in Aquila's process.

Through this process these points stand unrebutted and unexplained. The remainder of this reply will reinforce these points while addressing the few substantive comments that were in GMO's Initial Brief.

C. The Stipulation and Agreement in HR-2005-0450 Did Not Constitute An Agreement That Aquila Could Be Imprudent.

The Stipulation and Agreement in HR-2005-0450 was an agreed resolution of a steam rate case. As approved by the Commission, it established a mechanism through which Aquila could adjust its steam-related fuel expense (including, but not limited to natural gas costs), subject to refund, established a quarterly adjustment mechanism (QCA) through which these adjustments above or below an agreed-upon base level of fuel costs, could be passed through automatically to steam customers, established a coal performance standard, and a minimum threshold for review. It also gave Aquila "skin in the game" through an a 80/20 tracking mechanism.

First, the existence of a mechanism for after-the-fact review of Aquila's actions belies any contention that the Stipulation and Agreement was a license for Aquila to be imprudent. Indeed, reference to a hedging program in the Stipulation and Agreement, of which GMO attempts to make much, contains no language authorizing imprudence. Nor is it Commission policy that a utility may be imprudent in designing or implementing a hedging program. Nor would it be legal to establish rates on costs that did not meet the prudence test once questioned, even if the Commission, for some inexplicable and unimaginable reason, was inclined to pass on imprudently incurred costs. GMO's efforts in this regard are no more than question begging.

Second, GMO now wants to claim that AGP knew of the steam hedging program in advance and even that AGP requested Aquila's imprudent steam hedging program. This claim is plainly false. As AGP counsel stated in his opening, the Commission must be careful not to allow GMO to obfuscate what was in existence when the Stipulation and Agreement in HR-2005-0450 was presented on February 27, 2006.

GMO initially bases this defense on Mr. Brubaker's testimony. However, it cannot be disputed that Brubaker's testimony predated the Stipulation and Agreement by several months and Mr. Brubaker was not involved in the negotiations leading up to the Stipulation and Agreement.

GMO also places great stock in the on-the-record session held when the Commission was considering the Stipulation and Agreement. Examination of this transcript, however, does not support GMO's contentions. Indeed the portion cited by GMO in Exhibit 108 of the February 27, 2006 presentation reveals a significant divergence in sworn testimony between what Mr. Clemens said ***then***:

> COMMISSIONER CLAYTON: Does Aquila have a hedging program or a gas purchasing program in the steam operation which would be similar to its gas operations?
> MR. CLEMMONS: Yes.[10]

and what Mr. Clemens says ***now*** when queried by Commissioner Kenney:

> Q. And just so I'm clear, the particular date that we're talking about is prior to February 2006. Right? There was -- that was the date prior to which there was no hedging for the steam --
> A. That's correct.
> Q. -- production? Okay.[11]

So, which is it Mr. Clemens? Was there a steam hedging program on February 27, 2006? If there was, that program was something else and wasn't being implemented pursuant to the Stipulation and Agreement which hadn't yet been approved by the Commission. The answer is found in Exhibit 4 where, on February 15, 2006, Mr. Williams corresponds with Mr. Gottsch that

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[10] Exhibit 108, p. 57.

[11] Tr. p 193.

> The sharing mechanism in the steam case provides for the flow through of hedge costs into the fuel sharing mechanism. Therefore, I believe that hedging of the anticipated gas volumes necessary to serve the steam load is prudent and that a policy similar to the one for electric volumes (1/3, 1/3, 1/3) if stated in advance in writing would be deemed prudent.
>
> Just one note of clarification. The steam settlement has not been filed with the Commission yet pending some last minute Staff review. However, I do not think that impacts the prudence of our decision to hedge the gas volumes. We should follow whatever procedure we would normally take whether or not there is sharing mechanism.[12/]

Now, unless one would take the position that Mr. Clemens was seeking to mislead Commissioner Clayton, the only reconciliation between these two inconsistent versions was that, on February 27, 2006, Mr. Clemens was speaking of the ***electric*** hedging program, not the gas program.

And, as to Aquila's electric hedging program, as noted in AGP's Initial Brief, Commissioner Kenney drew from Mr. Clemens the level of the Staff's dissatisfaction with that program

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QUESTIONS BY COMMISSIONER KENNEY:
        Q.    What was the feedback you got from Staff?
And I know you said it was just applicable to the
electric side, not the steam side.
        A.    The electric side of -- of the programs
beginning in -- probably in 2006 and '7, they had some
concerns with the program just I think in a -- Gary
Gottsch could talk about more the details of that
program.  But the philosophy of being one-third,
one-third wasn't an issue.  It was just some -- more
the detail inside it.
        Q.    You said the one-third, one-third,
one-third was not the problem --

00193
        A.    No.
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[12/] Exhibit 4.

Q. -- or was?

A. ***My understanding it was just how some of the steps were implemented.*** But I didn't do the hedge program so it would be better to ask Mr. Gottsch for that.

Q. And just so I'm clear, the particular date that we're talking about is prior to February 2006. Right? There was -- that was the date prior to which there was no hedging for the steam --

A. That's correct.[13]

and then with GMO Witness Gottsch:

QUESTIONS BY COMMISSIONER KENNEY:

Q. I'm sorry. You said that there was -- the concerns that Cary Featherstone expressed were with respect to inflexibility of the purchasing?

A. Right. His -- his opinion at the time was you were making purchases each month ***regardless of where the price of the market was.*** In particular, during the run-up in prices after the Hurricane Katrina, the program continues to make purchases each month regardless of price. And his concerns at the time were that you were making purchases in September, October, November, December during that time frame.

Q. And when did -- when were those concerns expressed?

A. Again, I -- I know I was in a meeting with him and I can't recollect the exact time.

Q. Just the month and the year.

A. I thought it was in the winter of '06,

00245

'07. Probably the spring of '07 I believe is when we had meetings with them.

Q. So the hedging program for the steam production had begun, but you weren't having discussions specifically with respect to the hedging program?

A. I was not personally.

Q. Did -- who was?

A. I believe it was Andy Korte, Gary Clemens.

Q. Mr. Clemens who just testified?

A. Correct.

Q. Well, he said he wasn't having conversations; that you would be the one that would be having conversations with Staff about hedging.

A. Past -- past implementation of the program.

Q. Okay. All right. And then the hedging program for steam production ceased in '07?

A. Correct. October of '07.

Q. Okay. Now, the programs are similar. Right? So would Mr. Featherstone's critiques or criticisms with respect to the electric side have been applicable to the steam side?

A. I believe that's correct.

00246

Q. Even though -- even though he wasn't speaking specifically to the steam production side, the critique would have been equally as applicable?

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[13] Tr. 192-93.

A. I believe so.[14]

GMO also cited to page 77 of Exhibit 108 as confirming AGP’s "knowledge" of the steam hedging program. That portion, apparently found at lines 5-10, seemingly pertains to Aquila’s hedging of natural gas for its ***electric*** operations, but does confirm that coal costs were included in the Stipulation and Agreement.

Bluntly, the Commission should recognize this attempt for what it is: GMO’s after-the-fact attempt to mislead yet again. Sadly, Aquila’s shifting references between its electric program and the separate steam hedging program that was implemented subsequent to the Commission’s post-February 27-approval of the Stipulation and Agreement continue into GMO’s brief.

Yet again, as detailed in AGP’s Initial Brief,[15] Aquila’s ***electric*** hedging program is not in issue here and it was an entirely ***different*** program from what Aquila implemented for the steam system.

AGP’s position should not be misconstrued nor should GMO be permitted to drag it as a red herring across the trail. Certainly Mr. Brubaker’s months-earlier testimony did not frown on hedging *sui generis*. But GMO has produced no evidence that AGP requested ***this*** hedging program and certainly no evidence of a ratification of an ***imprudent*** hedging program that after introduction continued without prudent oversight until its suspension at

[14] Tr. 244-46.

[15] AGP Initial Brief, pp. 31-35

AGP's request in 2007. GMO witness Fangman, upon whom GMO relies for its source of information flowing to the customers, denied knowledge of the hedging program until AGP management ***complained*** to him about it. Plainly, complaining about a program that wasn't working does not equate in any way to a request for hedging, let alone imprudence in conception or administration.

Third, it should be obvious (but given GMO's efforts, necessary to state) that the Stipulation and Agreement ***didn't prohibit*** any particular kind of hedging program but correspondingly ***didn't approve*** any in advance. It did not approve any imprudent program nor a program that wasn't based on the facts of the situation and an analysis of the need for hedging and the methodology need to mitigate any risk.

Fourth, GMO's entire approach seemed to be that because the customers raised no objection to Aquila's use of the 1/3 strategy, that strategy was acceptable. Of course, when AGP did raise an objection, we were met initially with a defense of untimeliness. There is simply no evidence that AGP, or any other customer, agreed to Aquila's implementation of the ***imprudent*** program. As noted on Exhibit 4, Aquila's consideration of the program consisted of a 31 minute e-mail exchange, There was no mention of customer input nor was there any opportunity whatsoever provided for that input.

Fifth, in its Initial Brief, GMO now triumphantly claims that the 80/20 cost sharing mechanism and the QCA were not hedging methods. Of course they were not.[16/] Their purpose was entirely different. It does not, however, follow that the QCA mechanism, or, indeed, the Stipulation and Agreement, should have been ignored in the design of a hedging program. Indeed, the QCA mechanism was inherently designed to mitigate volatility. In its hindsight effort to reconstruct history, GMO/Aquila has the temerity to suggest a hedge program to mitigate volatility has no relationship to a rate structure that by design addresses volatility without the risk of a hedge program.

Sixth, it has been well documented in this record that Aquila simply performed no analysis of the nature of the natural gas load for the steam operation. None of Aquila's witnesses "fessed-up" to having designed or structured the program or taken into account the "swing" nature of the natural gas load, even though GMO's much-touted Exhibit 108 seems to show that Aquila was aware of the relationship between the base load coal fuel for steam and the "peaking" or "swing" nature of the natural gas load.[17/]

[16/] Exhibit 2, Johnstone Rebuttal, p. 4.

[17/]

CHAIRMAN DAVIS: Okay. So is there any way -- way feasible that you can beat this $3 per million Btu amount?
MR. CLEMMONS: Well, the other third gas that we have not hedged, we are in the process of buying that at a lower rate just through efficiencies. And if we can burn more coal at the plant, that would lower the ratio. If we can burn higher than the 2.1 that's built into the rate, that would give an opportunity for us. It gives us incentive to try to be efficient on the --
CHAIRMAN DAVIS: On the coal side.
MR. CLEMMONS: -- on the coal side, yeah.

Exhibit 108, pp. 77-78.

D. The Stipulation and Agreement and the QCA Were Not Intended to Be Hedging Programs, But Aquila's Failure to Take That Structure Into Account Is Evidence of Imprudence.

Mr. Johnstone noted that the QCA was not intended to be a hedging program.[18/] If there was to be a hedging program, the Stipulation and Agreement taken as a whole should have given Aquila an incentive to get serious about the design of a steam hedging program that would have taken into account ***all*** of the fuel components ***and*** would have established a program that would have accommodated a proper forecast of natural gas requirements and the inherent uncertainty. Said another way, it would have taken into account that a simple cookie-cutter gas purchasing strategy based on what had been implemented on its ***electric*** system[19/] would not work properly when the base load fuel was coal and natural gas was intended to be the swing fuel for the steam system.

E. Aquila Must Take Responsibility for Its Incorrect Usage Forecasts Rather Than Attempting to Shift That Responsibility to Steam Customers.

Aquila had and continues to have responsibility for its forecasts for the system load and Btus required of each fuel -- coal, natural gas, and oil. Customer information came from Mr. Fangman who interpreted and translated the data collected into information for Aquila corporate. He then forwarded that infor-

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[18/] Exhibit 2, Johnstone Rebuttal, p. 4.

[19/] And was, of course, the subject of the Staff criticism to which GMO witnesses Gottsch and Clemens referred.

mation on to Mr. Nelson at the corporate level who actually did the forecast. Mr. Nelson was not tendered as a witness in this proceeding and there is ***no*** evidence of how he prepared forecasts of steam load overall and the system’s monthly natural gas fuel requirements in particular. In presenting no witness and no evidence, GMO concedes the point. There is simply no evidence to support Aquila’s forecast as being prudent in development or result.

Mr. Fangman, who claimed intimate knowledge of customer operations and needs, then testified that he reviewed the returning forecasts for "reasonableness." Aquila simply cannot escape responsibility for its forecasts.

Yet those forecasts wholly failed to take into account the established unavoidable uncertainty that is inherent in even the best intentioned customer information. As shown on Exhibit 109, Aquila claimed to have hedged 2/3 of its forecast natural gas fuel requirements (just over 2 million mmBtus) when the actual burn necessitated by customer requirements was less than 1.5 million mmBtus. Had Aquila done even what it purportedly undertook to do, it would have hedged a good deal less than that in recognition that customer requirements were largely fueled by coal (the base load fuel), which itself was subject to a coal performance standard and the 80/20 tracking mechanism that together encouraged more coal usage and less gas usage. Additional or "swing" load from increased customer requirements could have, would have and should have been handled on the spot market and purchased without the necessity to even have a hedging program and certainly not handled by a hedge program burdened by extreme and extraordinary purchases wherein monthly and even quarterly monitoring were eschewed so that the initial error was never mitigated. What Aquila missed (and now GMO misses) that the Stipulation and Agreement was addressing the ***entire*** fuel costs for raising steam.[20] Looking at natural gas in a vacuum, as Aquila apparently did, lead them astray. Moreover, as detailed in AGP's Initial Brief, mindlessly implementing a program what might have worked for Aquila's electric or its natural gas distribution systems simply did not work for the more limited application to the natural gas needs for a swing fuel for steam production.

F. Aquila Failed to Adjust or Manage Its Gas Hedge Positions When Confronted With Actual Results.

The record is also undisputed that Aquila simply ignored what GMO witnesses acknowledged were significant variations from forecasts of customer usage.

> Q. Do you have Exhibit 9 up there?
> A. I do not.
> MR. CONRAD: Permission to approach.
> JUDGE DIPPELL: Go ahead.
> BY MR. CONRAD:
> Q. Let me show you one. Have you seen that before?
> A. About 30 minutes ago.
> Q. Okay.
> A. I believe I've actually seen this maybe within the last year also as we've scrounged up documents, but --
> Q. And let's look at -- oh, just pick one here, Triumph. 683-- I'm looking at 2006, at least
>
> 00223

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[20] Exhibit 108, pp. 77-78.

that's one of the years in concern here. Budget was 683,191 MMBTus.

A. I see that.

Q. And actual 324,637. And then there's a variance calculation. I haven't done the math but I'll -- I'll trust whoever did the spreadsheet here, 358,554 variance. Looks about right. ***Would you agree with me that that's a significance variance?***

A. I would agree.

Q. Look in that same column for Albaugh. And I won't go through the budget numbers. You can read those. But a variance of 307 and change -- 307,000 MMBTus. MMBTus, by the way, would I be right in equating that to dekatherms?

A. Yes.

Q. ***Again, a fairly significant variance? That's a question --***

A. Yes.

Q. -- it was a significant variance?[21]

Exhibit 9 shows a net difference of roughly 212,000 mmBtus for 200***5***. This discrepancy should have put Aquila on notice that forecasts based on customer projections were problematic. Indeed, Mr. Rush acknowledged that

QUESTIONS BY JUDGE DIPPELL:

Q. And I'm not sure if you're the right person to ask about this or not, Mr. Rush. On page 11 of your testimonies, on line 3 you say: The company has a robust planning process that it has utilized for years.

Do you know have the forecasts for this particular process ever been off like they were in this or appear to have been in this particular process in past years?

A. ***Yes, they have been.*** I -- I was actually responsible for the forecasting side at my life at St. Joseph Light and Power Company. And I remember very well the time when we were changing from Farmarco, which was the predecessor to AGP. And Ag Processing was developing and installing an entirely new system which has grown immensely since that time.

And I remember when we were putting in their 850-pound line system and the forecasts were just incredibly erratic because AGP kept saying this was what was going to happen. It didn't happen on time. ***And, I mean this is not uncommon***, but we had to be there. And, you know, that's just part of the

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process of doing things. I mean that's why -- related to a steam business.

Q. Right.

A. Other steam business eradications [sic], we had pork processing plant in St. Joseph, a very large one called Monford Pork at the time that we had high expectations of their continued growth, et cetera and all of a sudden one day they simply announced that they were closing and there were a thousand people out

[21] Tr. pp. 222-23 (emphasis added).

> of work one day. That was again a very erratic time.
>
> So when you go through big transitions like that, you do have those things. But with the steam system, you've got to sit there and -- you know, for -- for example, for this we had to put a new boiler in in 2006. We put in boiler eight. We hadn't done anything prior to that for 30 years or -- I can't remember the dates, but they're in my schedule that talk about the date of those boilers. That was a big deal to have to go out and say we've got to spend enough money to support this new growth.
>
> And so, you know, you go and you talk to the customers and you make sure it's happening. Same thing happened when we went through the 850-pound line. We had never tapped a line on the 850-pound side of our system -- if you saw the diagrams that
>
> 00313
>
> were put on the first day -- to be able to meet that load. So that happens and you've got to be able to deal with it. But this is not uncommon.[22]

Had there been prudent management, the longer history set forth by Mr. Rush would have been considered. Had there been prudent management, the experiences of 200***5*** would have informed Aquila's forecast for 200***6***. But, that proved not to be the case. The discrepancy between budget and actual usage for 200***6*** was 752,653 mmBtu or almost three times the discrepancy for 200***5***. Had there been prudent management, with both the 2005 and 2006 forecast disasters under its belt, Aquila would have awakened for the 2007 forecast. It did not. Aquila still did not prudently adjust its forecast of natural gas requirements and did not prudently review and adjust its hedge program. The 2007 discrepancy is 682,991 mmBtu and was unfortunate, costly and avoidable. The costly impact on the hedge program was entirely avoidable and due only an imprudent disregard of both the long history of the business and the immediate past history of 2005 and 2006. GMO does not seek to defend these

[22] Tr. pp. 311-13 (emphasis added).

discrepancies. Rather it puts on Mr. Rush who acknowledges the difficulty.[23] Fortunately the program was "suspended" in late 2007 -- but only at AGP's request. GMO's Initial Brief sought neither to refute (it could not) or justify these discrepancies.

Of course, forecasts are bound to be wrong, but how wrong, and in any event there is an unavoidable responsibility for monitoring and correction. But the mechanism that Aquila applied at the inception of the program completely failed to account for the swing fuel nature of natural gas in this equation. Moreover, Aquila failed to reasonably monitor (they used annual as opposed to monthly in the electric), adjust, or react to these discrepancies, leaving customers to pick up the costs of the excessive hedges that Aquila bought. One need only look to Exhibit 109 to see the problem. And consider that the major portion of the "actual burn" bar on Exhibit 109 was supplied by base load coal enforced by the coal minimum and incented by the 80/20 tracking mechanism.

First, Aquila had or should have had more than adequate foreknowledge that customer-derived prognostications had a history of being incorrect. Mr. Rush acknowledged this in a colloquy with the law judge that is quoted *supra*.

Second, GMO admits that Aquila developed the forecasts that turned into the budget. GMO's claim in its Initial Brief (at p. 18) that it used the "most accurate volumes possible" is neither accurate nor true. Mr. Fangman provided customer infor-

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[23] *Id.*

mation to corporate, then corporate developed the forecasts, then Mr. Fangman reviewed them for "reasonableness."

> A. Right. I was the customer contact and -- and -- and got the information from customers with regard to their changes and Tim Nelson did the actual forecasting.
>
> Q. And Mr. Nelson was somebody back at home office. Right?
>
> A. Yes. He was back at home office.
>
> Q. Did you ever get involved in the operations that he did?
>
> A. I did not do the forecasting. I mean he did the forecasting. I would pass information on and then there would be somewhat of an iterative process in which he would do the forecast. And then I would then give it to me and take -- and I would take a look at it and look at it for reasonableness.[24]

No tendered GMO witness recommended the hedge program as prudent, indeed no GMO witness confessed responsibility for designing the program and no GMO witness acknowledged responsibility for or explained the forecasts. The list of salient omissions mounts and expands. Mr. Gottsch acknowledged that he simply did what somebody told him to do.[25] Mr. Blunk wasn't even there (and, incidentally, when he did design a program for KCPL, it was an entirely different method than what Aquila implemented).[26] Mr. Fangman disclaimed responsibility for the forecasts and even disclaimed knowledge of the hedging program altogether. When pressed by the bench, Mr. Clemens referred

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[24] Tr. p. 276.

[25]

> Q. So the only experience you have is just doing what somebody tells you to do?
>
> A. With Aquila, yes.
>
> Q. No -- no initiative at all?
>
> A. Correct.

Tr. p. 212.

[26] Exhibit 12HC.

design questions to Mr. Gottsch.[27/] Mr. Rush wasn't there either, having only worked for Aquila for roughly one month after the Aquila acquisition of St. Joseph Light & Power.[28/] It is similar to the cartoon where a line of kids heads into the carnival and starting at the front of line each says "my brother has the tickets." Of course, once they get to the end of the line, nobody has a ticket, so they all make a run for it. This exercise in finger-pointing and avoiding responsibility ought to be something the Commission quickly sees through. There is no legitimacy to this presentation. It certainly was not the management that was bargained for nor which customers have a reason to expect from their serving utility. The numerous salient omissions cannot be happenstance. GMO's silence simply cannot prove the prudence of its troubled forecasts.

Third, GMO now admits that the 1/3 not hedged was supposed to accommodate volume uncertainty, but at the same time

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[27/]

A. My understanding it was just how some of
the steps were implemented. But I didn't do the hedge
program ***so it would be better to ask Mr. Gottsch*** for
that.

Tr. p. 193 (emphasis added).

[28/]

Q. But just -- to just cover that at a high
level, you worked for a number of years for St. Joe
Light and Power. Right?
A. That's correct.
Q. And you left their employ and came to
work for at that time it was Kansas City Power & Light
only ***shortly before or right around the time that***
Aquila -- UtiliCorp at that point took over St. Joe
Light and Power; is that fair?
A. That's correct.

Tr. p. 300 (emphasis added).

loudly defends its program as being 2/3 hedged. Exhibit 109 shows the unfortunate result, and Exhibit 9 shows the discrepancies running back to 200***5***. Exhibit 109 shows that Aquila left itself no room to accommodate uncertainty, an uncertainly that GMO now acknowledges[29/] but never explains. Aquila's results show an insouciance to actual events and confirm the Staff's concern about Aquila's application of its mechanical 1/3 approach even when used in the different electric program. Aquila did not provide the prudent management that a hedging program requires, particularly one that must accommodate the uncertain impacts and interactions of the uncertain loads, the large base of coal usage and natural gas swings as the froth on the top of the mug. Neither GMO's evidence nor its Initial Brief acknowledge that the Stipulation and Agreement covered more than just natural gas. Indeed, the Stipulation and Agreement addressed the need for a coal performance standard and even Mr. Clemens, when queried in 2006, acknowledged that the base fuel level encompassed coal as well as natural gas.[30/] Aquila also failed to even attempt to analyze the nature of the natural gas load as a swing fuel, and the impact and implications of the coal performance standard as creating a base level of fuel cost. Instead Aquila simply applied a cookie-cutter approach to its hedging program with the result that the customers picked up the cost.

[29/] GMO Initial Brief, p. 24.

[30/] Exhibit 108, pp. 77-78.

Fourth, GMO/Aquila should not be allowed to have it both ways. It should not on one hand claim that the customers should not be allowed to manage the utility's actions, and at the same time shift responsibility for a hedging program to the customers. It is simply not AGP's responsibility to communicate to Aquila what sort of program, if any, it should adopt, nor ride herd on the implementation of that program. It is an Aquila responsibility and no amount of hand waving can change that. Indeed, one function of the coal performance standard and the 80/20 "skin in the game" approach of the QCA in the Stipulation and Agreement was to maintain a vested interest on the part of Aquila in the outcome. It was not enough. Indeed the QCA even allowed a 10% band to accommodate less than perfect judgment but Aquila blew through this generous allowance for imprudence choices that amounted to a "get out of jail free" pass on its imprudence.

Fifth, GMO's Initial Brief now claims (p.22) that Aquila's hedging program was "adjusted for significant changes." GMO witnesses acknowledged that the discrepancies between budget and actual usage were significant,[31/] yet took no action to adjust those positions, even while admitting that they could have made adjustment. There is no evidence of adjustments in this record and GMO's Initial Brief cites none, merely citing instances that "they could have." Moreover, despite claims about adjustments, Mr. Gottsch purchased all of the 2006 hedges at one

[31/] Tr. p. 223.

time, and did virtually the same thing for 2007, for while there were purchases throughout the year, all were based on the annual budget without the benefit of adjustment to accommodate the reality of lower natural gas burns that were continuously unfolding before an indifferent management. The litany of unanswered questions and puzzling results bespeaks a lack of management attention. Aquila's actions left no room for adjustment, and, as Exhibit 8 acknowledges:

> By the time it was apparent that actual steam load was significantly less than budgeted volumes ***it was too late to affect Aquila's natural gas hedge program for the steam system. The hedges would have already been purchased. [Emphasis added]***

It would not have been too late for 2006 had Aquila considered the 2005 data, nor would it have been too late for 2007. Aquila's response is simple spin because Exhibit 9 shows that information was available regarding 2005 and Witness Rush acknowledged that customer projections were known to be routinely uncertain inputs to the forecast process. It is disingenuous for Aquila (through GMO), while not producing the forecaster or a responsible manager, now to make the empty claim that the customer information was the problem while having to admit that it alone (indeed the missing Mr. Nelson) prepared the forecasts not just of system load, but also the fuel forecast that had to sort out and accommodate base and swing fuel requirements.

Sixth, GMO now attempts a comparison to Kase hedging programs. But GMO witnesses admitted that neither of the Kase hedging programs were used for steam.[32] It is no justification for a speeding citation to argue that another motorist was driving faster.

III. CONCLUSION.

Under the *Associated Natural Gas* standard, Aquila, currently doing business as GMO, now must meet the burden of proof that its programs were prudently designed and implemented and costs were prudently incurred. No evidence to prove prudent design has been offered, indeed no GMO witness accepted responsibility for designing the program. Analysis was non-existent and documentation of the program consists of one short e-mail thread. Mr. Gottsch simply did what he was told and made the purchases and disclaimed any role in analysis or evaluation of the nature of the fuel load that was needed. And, contrary to even its representations about its different ***electric*** program, Mr. Gottsch did not execute hedging positions proportionally, but rather bought all 2006 hedge positions in one block, leaving no room for adjustment.

Even when faced with actual usage that significantly differed from forecasts, Aquila did not act to adjust its hedge positions, but left them alone for the customers to absorb.

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[32]

Q. Now, clarify one thing for me then. Was the Kase, K-a-s-e, you know what -- how to spell it, I'm sure.
A. Yes.
Q. Was that used on steam?
A. It was not.

Tr. p. 221.

There is no proof of prudent administration of the program, but rather proof of corporate neglect. Mr. Gottsch, the designated expert, did his job. He placed the orders for the hedges, and he testified that he could have easily and quickly adjusted to remove them. But, no one with the authority to react to the huge variances from Aquila's fuel budget was watching. Far from a proof of prudence, the record demonstrated imprudent neglect.

There is no proof that the hedge program was prudent in its design and implementation. There is no proof that the program was prudently monitored. This leaves but one conclusion for the costs. There is no proof that the costs of the hedge program were prudently incurred. Indeed AGP has identified the many specific ways in which Aquila was imprudent, including Mr. Johnstone's Direct and Rebuttal testimony,[33/] the record as summarized in AGP's Initial Brief, as well as this reply brief. The imprudence is compounded by the salient omissions and corporate failures to act first recounted in Johnstone's rebuttal, but clarified and given more weight by record adduced at the hearing.

Under the legal standards, AGP needed only to raise a "serious question" to overcome the initial presumption of prudence. But AGP has gone well beyond this standard and has proved affirmatively that Aquila was imprudent. ***In contrast, Aquila/GMO has not provided the Commission with the testimony of even one person who designed this hedge program.*** Mr. Clemens punted to Mr. Gottsch. Mr. Gottsch only did what he was told and exercised

[33/] Exhibits 1 and 2 respectively.

no independent judgment. Mr. Fangman didn't even know there was a hedging program until AGP complained about it. Mr. Blunk never was an Aquila employee. Mr. Rush was an Aquila employee only briefly several years before the relevant facts occurred.
GMO has produced not a single witness who acknowledged any responsibility for the analysis of the steam fuel load, the design of the Aquila program, or the identification of objectives that program was to achieve. Only Mr. Clemens was able to even discuss the Stipulation and Agreement and he perpetually shifted between the electric program and the steam program. GMO wholly failed to meet its burden. AGP is entitled to a decision that GMO must make a refund to all the steam customers.

Respectfully submitted,

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ATTORNEYS FOR AG PROCESSING INC.

SERVICE CERTIFICATE

I certify that I have served a copy of the foregoing pleading upon identified representatives of the parties hereto per the EFIS listing maintained by the Secretary of the Commission by electronic means as an attachment to e-mail, all on the date shown below.

Stuart W. Conrad, an attorney for
Ag Processing Inc a Cooperative

February 9, 2011