BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

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.	))))	**Case No. EO-2011-0390**

POSITION STATEMENT OF KCP&L GREATER MISSOURI OPERATIONS COMPANY

COMES NOW the KCP&L Greater Missouri Operations Company ("GMO") and for its Position Statement states as follows:

1. On April 23, 2012, the Commission issued its *Order Modifying Procedural Schedule* ("Order") which, inter alia, ordered the parties to file their Position Statements by May 25, 2012 which concisely addresses their position on the List of Issues filed in this matter.

2. In response to the Commission's Order, GMO files the following Position Statement.

I. Procedural History

1. On June 9, 2011, the Staff filed its Notice To Start Third Prudence Review which initiated this case.

2. On November 29, 2011, the Staff filed its Staff Report entitled "Prudence Review Of Costs Related To The Fuel Adjustment Clause For The Electric Operations Of KCP&L Greater Missouri Operations Company" (Staff Report) which contained the results of its prudence review for the period June 1, 2009 through November 30, 2010. In its Staff Report, the Staff recommended that "the Commission find GMO imprudent for including costs and revenues associated with GMO's hedging future purchases of spot market power by buying options to purchase natural gas during that period in determining the associated FAC charges both because

such costs and revenues are not within the scope of GMO's FAC and because such "hedging" is in and of itself imprudent, and order GMO to refund to its customers, in the aggregate, $18,755,865 plus interest accrued at GMO's short-term interest rate until refunded by an adjustment to its FAC charge." (Staff Report, p. 4)

3. On December 5, 2011, GMO filed its Request For Hearing which disputed the Staff's claim of imprudence, and requested a hearing in the matter.

4. On February 22, 2012, GMO filed testimony of Dr. C.K. Woo, Wm. Edward Blunk, Tim M. Rush, and Scott H. Heidtbrink which explained the reasons that GMO disputed Staff's claim of imprudence.

5. On March 21, 2012, the Staff filed the Direct/Rebuttal Testimony of Dana E. Eaves, the Rebuttal Testimony of Lena Mantle, and the Rebuttal Testimony of Charles R. Hyneman.

6. On May 10, 2012, GMO filed its Surrebuttal Testimony of Dr. C.K. Woo, Wm. Edward Blunk, Tim M. Rush, Gary Clemens, and Ryan Bresette.

7. On May 11, 2012, a joint Issues List, Witness List, Order of Witnesses And Order Of Opening Statements was filed by GMO and Staff in this proceeding.

8. Evidentiary hearings are scheduled for June 5-6, 2012.

II. Statement of Position on Issues List

1. **Has Staff raised a serious doubt as to the prudence of GMO's use of natural gas hedges to mitigate the price risk associated with spot purchased power?**

GMO Position: No. GMO does not believe that the Staff has raised a serious doubt as to the prudence of GMO's use of natural gas hedges to mitigate the price risk associated with spot purchased power. Staff has recommended a proposed disallowance and refund of approximately $ 18.8 million in its Staff Report and the Direct/Rebuttal Testimony of Dana E. Eaves on the ground that it was imprudent for GMO to have used natural gas futures contracts to hedge the risk associated with purchased power costs. (Staff Report, p. 4; Eaves Direct/Rebuttal, pp. 2-5) However, the Staff has not provided competent and substantial evidence to raise a "serious doubt" regarding the reasonableness or prudence of the Company's hedging practice. All Staff has done is present conclusory statements in the Staff Report and testimony without supporting evidence to demonstrate that cross-hedging the risk of purchased power costs by using natural gas futures contracts is unreasonable or imprudent. As a result, Staff has not overcome the presumption of prudence that exists with regard to GMO's hedging costs, as discussed below.

A. Missouri Case Law

The Commission recently reviewed and reaffirmed the prudence standard used in Missouri in its *Report & Order* in Re Kansas City Power & Light Company, Case No. ER-2010-0355 (April 12, 2011) at 74-77. As explained by the Commission in the *Kansas City Power & Light Company* decision, the prudence standard is articulated in the *Associated Natural Gas Case* (which was an PGA/ACA case) as follows:

> [A] utility's costs are presumed to be prudently incurred.... However, the presumption does not survive "a showing of inefficiency or improvidence."

...[W]here some other participant in the proceeding creates a serious doubt as to the prudence of an expenditure, then the applicant has the burden of dispelling these doubts and proving the questioned expenditure to have been prudent. (Citations omitted).

In the [Union Electric] case, the PSC noted that this test of prudence should not be based upon hindsight, but upon a reasonableness standard:

[T]he company's conduct should be judged by asking whether the conduct was reasonable at the time, under all the circumstances, considering that the company had to solve its problem prospectively rather than in reliance on hindsight. In effect, our responsibility is to determine how reasonable people would have performed the tasks that confronted the company.

See State ex rel. Associated Natural Gas v. Public Serv. Comm'n, 954 S.W.2d 520, 528-529 (Mo. App. W.D. 1997).

Furthermore, in order for the Commission to disallow a utility's recovery of costs from its ratepayers, the Commission must apply the following two pronged test: (1) evaluate whether the utility acted imprudently (that is, did it act reasonably at the time under the applicable circumstances); and 2) evaluate whether such imprudence was the ***cause*** of the harm (increased costs) to the utility's ratepayers. *See Associated Natural Gas,* 945 S.W.2d at 529.

B. Burden of Proof

As stated above, under the prudence standard, the Commission presumes that the utility's costs were prudently incurred. See State ex rel. Associated Natural Gas v. Public Serv. Comm'n, 954 S.W.2d 520 (Mo. App. W.D. 1997); State ex rel. GS Technologies Operating Co. Inc. v. Public Serv. Comm'n, 116 S.W.3d 680 (Mo. App. W.D. 2003) (citations omitted).

Staff or any other party may challenge the prudence of an expenditure by presenting competent and substantial evidence that creates "a serious doubt" as to the

prudence of an expenditure. Once a serious doubt has been raised, then the burden shifts to the public utility to "dispel those doubts" and prove that the questioned expenditure was prudent.

Missouri case law has described the showing necessary to create a serious doubt sufficient to shift the burden back to the utility. In the *Associated Natural Gas* case, the Missouri Court of Appeals held that the Staff must provide evidence that the utility's actions caused higher costs than if prudent decisions had been made. *See Associated Natural Gas*, 945 S.W.2d at 529. Substantive and competent evidence regarding higher costs includes evidence about the particular controversial expenditures and evidence as to the "amount that the expenditures would have been if the [utility] had acted in a prudent manner." *See id.* In other words, Staff or the other parties must satisfy the following two-pronged evidentiary test to support a disallowance: 1) identify the imprudent action based upon industry standards and the circumstances at the time the decision or action was made; and 2) provide proof of the increased costs caused by GMO's imprudent decisions. To meet this standard, a party must provide substantive, competent evidence establishing a causal connection or "nexus" between the alleged imprudent action and the costs incurred. In this case, Staff has failed to meet their burden.

In this case, Staff has failed to meet its burden to raise a serious doubt regarding GMO's long-standing practice of using natural gas futures contracts to hedge the purchase power costs. As a result, the Company is entitled to rely upon the presumption of prudence with regard to these expenditures.

2. Was GMO imprudent in its use of natural gas cross-hedges to mitigate the price risk associated with spot purchased power during the FAC audit period?

GMO Position: No. The Staff's proposed disallowance and refund of GMO's hedging costs is based upon the contention that: "Staff has found GMO was imprudent in its use of natural gas hedges to mitigate risk associated with its future purchases in the spot power market." (Staff Report, p. 2)

More specifically, Staff is contending that the two markets—the Purchase Power and the NYMEX Natural Gas markets—are not directly linked sufficiently that a prudent person would use purchases in the natural gas futures market to prudently offset the risk of price volatility in the spot purchased power market. (Eaves Direct/Rebuttal, pp. 2-3) As GMO's experts will clearly demonstrate, this Staff position is erroneous and should be rejected by the Commission.

More specifically, the evidence will show that:

1. Cross-hedging spot purchased power with natural gas futures contracts is a widely accepted method of hedging the risk associated with volatile spot purchased power costs. (Blunk Direct, p.15-19; Blunk Surrebuttal, p. 35)

2. Cross-hedging has been used by GMO since 2004. (Heidtbrink Direct, p. 4; See also Clemens Surrebuttal, pp. 2-5) Ameren and other electric companies around the country also use this hedging technique. (Blunk Direct, p. 16-17; Blunk Surrebuttal, pp. 37-38; WEB-17)

3. Cross-hedging has been taught by the Electric Power Research Institute since the mid-1990s. (Blunk Surrebuttal, p. 35) Numerous Staff, including Dana Eaves and Chuck Hyneman, have attended webinars presented by PGS Energy Training where this cross-hedging technique was explained and taught. (Blunk Surrebuttal, pp. 33-36)

4. The natural gas and electric markets are highly correlated (Woo Direct, p. 5; 28; Woo Surrebuttal, p. 3-8; 10-20) and the hedges themselves are considered "highly effective" judged by existing industry and accounting standards. (Bresette Surrebuttal, pp. 9-10; Blunk Surrebuttal, pp. 44-51; Schedule WEB-9)

5. Based upon the correlation coefficients for natural gas and electricity prices, GMO's outside expert Dr. C.K. Woo has concluded: "It is prudent to use cross hedging to effectively manage daily on-peak price risk." (Woo Surrebuttal, pp. 3-8)

6. Dr. Woo testifies that while the spot electricity market is hourly, NYMEX natural gas futures can still be used to cross hedge the daily on-peak electricity price. (Woo Surrebuttal, pp. 3-8)

7. Staff has been aware of GMO's cross-hedging program since 2005 and has never previously suggested that it was imprudent to use natural gas futures contracts to hedge the price of electricity. Staff has never previously suggested that cross-hedging was imprudent in the four rate cases, and two FAC prudence reviews that have been conducted since the Company began this hedging practice. (Rush Direct, p. 10; Heidtbrink Direct, pp. 3-10; Clemens Surrebuttal, pp. 4-10)

8. Finally, the evidence will show that GMO will discontinue the use of cross-hedges if the Commission believes it should do so. However, it is fundamentally

unfair and unlawful for the Commission to order a refund in this case, based upon Staff's flawed analysis and hindsight review. (Rush Surrebuttal, pp. 26-27)

3. If so, must GMO refund to ratepayers some amount plus interest through GMO's FAC mechanism? What is the amount that should be refunded, if any?

GMO Position: GMO does not believe that a refund is appropriate in this case. See GMO response to Issue 2.

If, contrary to the position of GMO, the Commission found that a refund is appropriate, the Commission should not accept the recommended disallowance and refund of $18.8 million contained in the Staff Report and Direct/Rebuttal Testimony of Dana E. Eaves. The original number recommended by Staff contains hedging costs which the Commission has determined would not be subject to a disallowance. (Blunk Direct, pp. 33-34; Schedule WEB-5; Blunk Surrebuttal, p. 5; Schedule WEB-7) In addition, even under Staff's accounting issue theory, the Staff's number should be adjusted for the fact that it contains hedging costs that clearly were allowed in the FAC tariffs. (Blunk Surrebuttal, p. 5; Schedule WEB-7) With these corrections, the Staff's proposed disallowance would be $10,600,248 . (Blunk Surrebuttal, p. 5; Schedule WEB-7) As explained above, however, it is inappropriate, unreasonable, and unlawful for the Commission to order any refund or disallowance based upon the competent and substantial evidence in the record.

4. Did GMO properly account for its hedging costs under the Uniform System of Accounts, previous stipulations and orders of the Commission? If not, what is the appropriate remedy?

GMO Position: Yes. In this case, Staff has erroneously suggested that the Company accounted for the costs of its electric hedging program in the wrong FERC Account. Staff has argued that the Company did not place the hedge costs in the correct FERC account No. 555. This is an account for purchased power costs. Instead the Company has placed hedge costs in Account No. 547 which relates to natural gas costs.

In the Non-Unanimous Stipulation and Agreement in Aquila's 2005 rate case, Case No. ER-2005-0436, the parties agreed as follows: "The Signatory parties agreed, for accounting and ratemaking purposes, that hedge settlements, both positive and negative, related costs (e.g. option premiums, interest on margin accounts, and carrying costs on option premiums) directly related to natural gas generation and on-peak purchased power transactions under a formal Aquila Networks-MPS hedging plan will be considered part of the fuel cost and purchased power costs recorded in FERC Account 547 or Account 555 when the hedge arrangement is settled." The Stipulation also required that Aquila "maintain separate accounting in Accounts 547 and 555 to track the hedging transaction expenditures recorded under this agreement."

The Company has followed the terms of this stipulation and agreement. The stipulation required the Company to record the settlement costs in Accounts 547 or 555 when the hedges were settled and required the Company to maintain separate accounts for those costs. The Company followed this requirement. (Rush Direct, pp. 9-10) The Company also contends that this accounting is appropriate under the Uniform System of Accounts, the Non-Unanimous Stipulation And Agreement in Case No. ER-2005-0436, and Commission orders directing that hedging costs should be passed through the Company's FAC mechanism.

Staff is taking the position that the hedge costs associated with the natural gas futures contracts that were part of the cross-hedging program should have been accounted for in Account 555, the purchased power account, rather than the Account 547, the natural gas account. According to Staff, this is important because Staff does not believe costs in the 555 account should be passed through the FAC, even though they are hedging costs, and the Commission has stated that hedging costs should be passed through the FAC. Staff bases its argument on a strained interpretation of GMO's tariffs which identifies costs that are to be included in the FAC.

The Company accounted for the natural gas hedging costs associated with its cross-hedging program in Account 547 because, as Mr. Rush explains in his Surrebuttal Testimony at page 11, at the time the hedges actually settle, the determination of whether or not the Company will generate or purchase power has not yet been made since that determination is based upon a review of the least cost option. Therefore all hedge settlement costs are actually natural gas settlement costs and are therefore recorded in the 547 account, the natural gas account.

It should not matter which account, Account 547 or Account 555 the hedge costs associated with the cross-hedging program were booked in. Both accounts include hedging-related entries, and all prudently incurred hedging costs are supposed to be flowed through the FAC, as noted by the Commission's *Order Clarifying Report and Order* in the 2007 Aquila rate case, and agreed to by the parties to the Aquila 2007 stipulation.

The Company has been recording its hedging costs associated with its cross-hedging program in Account 547 since the conclusion of the 2005 rate case. Company witnesses Ryan Bresette and Ed Blunk explain the appropriateness of this accounting practice. Staff auditors have been aware that GMO was hedging its Purchased Power with natural gas hedges, and the Staff has never questioned the accounting of these hedging costs until this case. In fact, until this case, GMO has had no indication from Staff that it disagreed with the inclusion of hedge settlement in the FAC. It would be unreasonable and unlawful for the Commission to disallow these prudently incurred costs on the ground that they should have been placed into a different bucket.

5. Do GMO's FAC tariffs authorize purchased power hedging costs for spot purchased power to be passed on to ratepayers through the FAC mechanism?

GMO Position: Yes. In the Commission's *Order Clarifying Report and Order* issued on May 22, 2007 in Case No. ER-2007-0004, (Aquila's 2007 rate case), the Commission clearly stated on page 1: "Under the Stipulation and Agreement, prudently incurred hedging costs will flow through the fuel adjustment clause…" . The Company's approved tariffs that were in effect during this FAC review period also included the pass through of the costs in FERC Account Nos. 547 and 555 (See Rush Surrebuttal, Schedule TMR-4, Tariff Sheet No. 125) and "hedging costs" and "settlement costs" in FERC Account Nos. 547 and 555. (See Rush Surrebuttal, Schedule TMR-5, Tariff Sheet No. 127.3)

6. Does the Commission want GMO to stop hedging using natural gas futures contracts to mitigate the price risk associated with spot purchased power?

GMO Position: In the event that the Commission decides that it believes that GMO should abandon its existing practice of using natural gas futures contracts to mitigate the price risk associated with spot purchase power, then GMO will agree to do so. (Rush Surrebuttal, pp. 26-27)

7. Should the Commission establish a policy which addresses the appropriateness of the use of natural gas hedges by electric utilities?

GMO Position: Yes. GMO believes that additional guidance from the Commission regarding the appropriateness of the use of natural gas hedges by electric utilities such as GMO would be helpful. (Blunk Surrebuttal, pp. 50-51)

WHEREFORE, GMO respectfully submits its Position Statement regarding the issues in this case, and prays that the Commission will enter a Report & Order consistent with these positions.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that copies of the foregoing have been mailed, hand-delivered, transmitted by facsimile or electronically mailed to all counsel of record this 25th day of May, 2012.

/s/ James M. Fischer
James M. Fischer