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Witness: Blake A. Mertens
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Sponsoring Party: Empire District Electric
Case No. EO-2017-0065
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Before the Public Service Commission

of the State of Missouri

Surrebuttal Testimony

of

Blake A. Mertens

July 2017

Empire District
A Liberty Utilities Company

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BLAKE A. MERTENS
ON BEHALF OF
THE EMPIRE DISTRICT ELECTRIC COMPANY
BEFORE THE
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I. INTRODUCTION

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. Blake A. Mertens. My business address is 602 South Joplin Avenue, Joplin, Missouri.

Q. ARE YOU THE SAME BLAKE MERTENS THAT FILED REBUTTAL TESTIMONY IN THIS CASE ON BEHALF OF THE EMPIRE DISTRICT ELECTRIC COMPANY ("EMPIRE" or "COMPANY")?

A. Yes.

Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?

A. My testimony will address misrepresentations of Empire's hedging strategies presented in the rebuttal testimonies of the Office of the Public Counsel ("OPC") witnesses.

II. EXECUTIVE SUMMARY

Q. PLEASE SUMMARIZE EMPIRE'S POSITIONS IN THIS CASE BEFORE THE MISSOURI PUBLIC SERVICE COMMISSION ("COMMISSION").

A. Empire employs a balanced approach to managing the risks associated with supplying fuel to its natural gas generators, a task requiring consideration of many factors. In this regard, Empire has maintained a consistent and comprehensive Risk Management Policy ("RMP") for over 15 years, allowing the Company to address various areas of risk including, but not limited to, price volatility, credit exposure, and volume. Empire's RMP was designed to (1) provide structure and guidance, (2) allow flexibility and offer a variety of approved tools and strategies to accommodate various market conditions, and (3) effectively managing all risks, rather than singularly focus on price risks. This policy was used to protect Empire from price volatility and other natural gas risks prior to the implementation of its fuel adjustment clause ("FAC") and has been kept in place to protect Empire's customers from the potential of large unpredicted price swings, while overall long-term trends are passed to customers over the course of time as is evident when the entire 15-year life of the hedging program is evaluated.

No specific instances of imprudence on the part of Empire with regard to its Fuel Adjustment Clause ("FAC") costs have been identified or quantified by OPC in this proceeding. Rather, OPC has deemed Empire's entire RMP to be imprudent due to hedging "losses" incurred during the audit period. This is despite general support of the policy from Staff and the Commission, and the lack of objection from OPC, in previous proceedings.

In addition, OPC continues to evaluate Empire's hedging program based on perfect information and identifies hedge transactions as losses, and therefore imprudent, if the market settled below the transaction price. This oversimplification dismisses the value and purpose of the hedge, which is to protect against exposure to risk. While a dollar to dollar comparison may result in the recording of a loss or gain for financial hedges, Empire's customers continue to benefit from Empire's RMP, which effectively manages risks and provides price stability. It has never been, nor should it be, the goal of the RMP to ensure the lowest possible price for fuel, a price no one can predict. Instead, the RMP is designed to identify and mitigate risks including the impact of price volatility over time. In its analysis, OPC disregards risks associated with attempts to purchase large volumes on the spot market, such as volume availability, credit limits, adverse price movement, and credit exposure.

For the audit period, as well as the preceding years, Empire has maintained compliance with its RMP and has effectively managed its natural gas risks through various market conditions. Empire would have grave concerns regarding the cessation of its hedging program, as suggested by OPC, and the exposure its customers would then face.

III. OPC'S MISREPRESENTATIONS OF EMPIRE'S HEDGING STRATEGY

Q. ON PAGE 4 LINE 17 OF HIS REBUTTAL TESTIMONY, OPC WITNESS JOHN RILEY STATES EMPIRE'S HEDGING STRATEGY IS NOT "PROGRESSIVE DOLLAR COST AVERAGING." DO YOU AGREE?

A. No. Although I understand the point Mr. Riley is attempting to make, the term dollar cost averaging <u>as it relates to commodity hedging</u> may be understood as spreading hedge positions over time to <u>average the market</u> rather than purchasing in a lump sum or as needed to meet a predetermined volumetric level. This is simply a semantic difference likely caused from the difference between dollar cost averaging as it relates to something akin to retirement stock purchasing and dollar cost averaging as it relates to commodity hedging. I have also heard this approach referred to as ladder hedging, installment purchase hedging, and time averaging.

Q. **IS THE DIFFERENCE IN "DOLLAR COST AVERAGING" INTERPRETATIONS IMPORTANT AS IT RELATES TO EMPIRE'S FUEL HEDGING PRUDENCY?**

A. No. However, Mr. Riley uses this semantic difference as a red herring to misrepresent Empire's hedging practice of purchasing much of its hedging volume in traditionally low-cost months as a method to keep costs low. What Mr. Riley describes on page 4 lines 15-17 of his rebuttal testimony is exactly the practice that Empire engages in and was described on page 4 lines 16-22 in my surrebuttal testimony in Commission File No. ER-2016-0023. If Mr. Riley would prefer to describe Empire's hedging method using a different term for his understanding then that is his prerogative, but that does not mean that Empire is not taking advantage of seasonal pricing to purchase natural gas hedges.

Q. WHAT ISSUES DO YOU TAKE WITH MR. RILEY'S AND MR. HYNEMAN'S DESCRIPTION OF "LOSSES" AS IT RELATES TO EMPIRE'S HEDGING ACTIVITIES?

A. Simply put, it attempts to evaluate the efficacy of a fuel hedging program simply by whether the positions beat the market. As indicated in articles cited by Mr. Hyneman and Mr. Riley and identified in my rebuttal testimony, prospective and fair analysis of decisions made require a lack of perfect future information. Mr. Hyneman and Mr. Riley continually pointing to "losses" incurred by Empire during the audit period as proof of imprudence is evidence in itself that they only take issue with Empire's hedging activities because Empire did not beat the market. With the exception of Mr. Riley mistakenly identifying the time frame of a few hedge transactions, as discussed by Mr. Doll on page 3 of his rebuttal testimony in this case, Mr. Riley and Mr. Hyneman have not even alleged imprudence of any particular transaction Empire executed during this audit.

Q. PLEASE CONTINUE WITH YOUR EXPLANATION OF THE ERRORS IN MR. RILEY'S AND MR. HYNEMAN'S DESCRIPTION OF "LOSSES" AS IT RELATES TO EMPIRE'S HEDGING ACTIVITIES.

A. The analogy Mr. Hyneman uses on page 19, lines 22-24, of his rebuttal testimony vastly oversimplifies this issue. I would expect Mr. Hyneman would see no value in earthquake insurance so long as no earthquake occurred while he held the policy. The value of the hedge, not unlike the earthquake insurance, is to mitigate exposure in the event of a potentially adverse situation. Hedging is not least cost planning (as acknowledged by the Commission in Rule 4 CSR 240-40.018), rather it is risk reduction and provides benefits to customers. If the adverse situation does not occur, the value of the protection must not be devalued. I understand the concern individuals may have when the market price settles below the transaction price, but commodity hedging is not about trying to consistently beat the market. Instead, as acknowledged by the Commission, it is to protect customers and mitigate risk associated with adverse outcomes. Empire's hedging strategy achieves these objectives. Empire witness Rob Sager provides additional information on the subject of losses in his surrebuttal testimony.

Q. DO YOU TAKE ANY ISSUE WITH MR. RILEY'S ATTEMPTS TO CLARIFY A POINT MADE IN YOUR REBUTTAL TESTIMONY REGARDING EMPIRE'S HEDGING ACTIVITY IN THE SPRING AND FALL?

A. Yes. On page 6, line 11, Mr. Riley explains that my rebuttal testimony confuses transacting **<u>in</u>** October and November for natural gas with transacting **<u>for</u>** October and November. I did not confuse nor mislead this issue. Empire does endeavor to transact **<u>in</u>** the shoulder months when forward prices are often times lower <u>for all months,</u> as denoted on page 4 of my surrebuttal testimony in ER-2016-0023 lines 18-22. Furthermore, Empire rarely purchases natural gas **for** the shoulder months as it is difficult to estimate exactly how much natural gas generation will be needed due to low load requirements. From Mr. Riley's answer on page 6 lines 11-21 it is difficult to determine whether he would advocate for transacting **for** October and November; and although he does indicate that natural gas prices are often cheaper in October and November, he ought to be made aware that the forward prices also reflect the cheaper seasonal cost. In short, there are no strategic gains to be had by transacting **for** October and November as the forward prices generally reflect these lower prices. Furthermore, it is difficult to understand Mr. Riley's confusion as to Empire's seasonal strategy, as my surrebuttal testimony in ER-2016-0023, that he sources in his rebuttal testimony, continues beyond his quote attributed on page 6 lines 7-10 to explain that transactions were executed **in** October and November, not for October and November. This confusion is a straw man tactic to heap criticism on a strategy never espoused by Empire as a means to delegitimize Empire's credibility and hedging strategy.

IV. COMPARISON AGAINST OTHER MISSOURI IOUS

Q. WHAT CONCLUSIONS DOES MR. RILEY MAKE WHEN JUXTAPOSING EMPIRE'S FUEL HEDGING WITH THAT OF KANSAS CITY POWER & LIGHT (KCPL), KCPL GREATER MISSOURI OPERATIONS COMPANY (GMO), AND AMEREN?

A. Mr. Riley concludes that KCPL and GMO both responded to the natural gas market by ceasing hedging activity.

Q. IS THIS STATEMENT TRUE?

A. I cannot speak to the provenance of those decisions, but it does appear they were the result of negotiations in rate cases, rather than unprovoked actions from the companies, like Mr. Riley would lead you to believe from his phrasing on Page 12 lines 6-7 of his rebuttal testimony.

Q. WHEN KCPL AND GMO AGREED TO CEASE THEIR HEDGING PROGRAMS, WERE ANY HEDGING LOSSES PAID BACK TO THEIR CUSTOMERS?

A. I can only be certain as to what is publicly available with respect to their respective cases, and it does not appear that there were any disallowances resulting in refunds. Furthermore, the open future positions appear to have been liquidated and passed through thefuel adjustment clauses.

Q. WHAT ABOUT AMEREN'S HEDGING PROGRAM?

A. Although I don't have many details as to Ameren's hedging policy or technique, it is worthy to note that in 2016, less than 1% of Ameren's energy generated was provided by natural gas fired generation.

Q. WHY IS IT IMPORTANT TO NOTE THAT AMEREN DOES NOT HAVE MUCH NATURAL GAS-POWERED GENERATION FOR ITS MISSOURI ELECTRIC CUSTOMERS?

A. The risk exposure is completely different for generation fleets with small percentages of natural gas turbines. 0.7% of Ameren's Missouri 2016 electric generation is sourced from natural gas generation, meanwhile Empire's June 2017 twelve-month-ending generation supplied by natural gas generation was approximately 40% of its total generation. This difference is important, in that if Ameren were to not hedge expected natural gas burns, by nature of its generation mix, its customers would not likely be impacted to the degree of Empire's customers. It's important to note that an increase in natural gas prices will cause market price increases <u>which will impact all electric customers</u>, but the point being made is that a utility that supplies nearly half of its generation from natural gas is likely to be impacted more than a utility that sources less than 1% of its generation from natural gas.

Q. ARE THERE ANY OTHER IMPORTANT POINTS TO MAKE REGARDING EMPIRE'S HEDGING WHEN COMPARED WITH THE OTHER MISSOURI UTILITIES?

A. Yes. Throughout Mr. Riley's and Mr. Hyneman's testimonies they point to other utilities hedging programs that have been modified or ceased recently as evidence of this tidal wave of reaction to natural gas prices that they insist Empire has ignored. Most often, the utilities they reference are natural gas distribution companies. Since Mr. Hyneman and Mr. Riley are comfortable using natural gas distribution companies as proxies for the natural gas hedging activities of electric companies, it may be important to note that Ameren Missouri's natural gas distribution company indicated in their 2016 10K that they have price hedged 73% of their 2017 expected requirements by the end of 2016. This is just one more example of OPC refusing to provide a complete and unbiased analysis and rather choosing to selectively cull information in an attempt to confirm their claims of imprudence.

Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?

A. Yes.

AFFIDAVIT OF BLAKE A. MERTENS

STATE OF MISSOURI)
) ss
COUNTY OF JASPER)

On the 28th day of July, 2017, before me appeared Blake A. Mertens, to me personally known, who, being by me first duly sworn, states that he is Vice President – Energy Supply of The Empire District Electric Company and acknowledges that he has read the above and foregoing document and believes that the statements therein are true and correct to the best of his information, knowledge and belief.

Blake A. Mertens

Subscribed and sworn to before me this 28th day of July, 2017.

Sherri J Blalock
Notary Public

My commission expires: Nov. 16, 2018

SHERRI J. BLALOCK
Notary Public - Notary Seal
State of Missouri, Newton County
Commission # 14969626
My Commission Expires Nov 16, 2018