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
INITIAL BRIEF

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ATTORNEYS FOR AG PROCESSING INC.

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I. INTRODUCTION AND SUMMARY OF ARGUMENT

This case is a prudence review even though denominated as a "complaint." It is so identified because of an approved Stipulation and Agreement, an approved compliance tariff, and a Commission Order, that directed that the complaint vehicle was to be used to raise the prudence inquiry. It does concern imprudence on the part of Aquila (now GMO).[1/]

The settlement in steam Case No. HR-2005-0450 included a Quarterly Cost Adjustment (QCA) mechanism. This was a unique structure at the time. There was no analog on the electric side; SB 179 did not exist. There was no Rate Adjustment Mechanism. While there are similarities, there are also important differences.

The QCA accumulated fuel costs that varied up or down from an agreed base level, then at the end of the quarter, began

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[1/] We will endeavor to use the terms "Aquila" and "GMO" in a manner that is consistent with the relevant time frame.

to be collected from (or flowed back to) customers over the following 12-month period. The QCA results in a "smoothing" of what might otherwise be price volatility. There was a coal performance standard that, since coal was a base load fuel for the steam system, helped to assure that the cheaper coal fuel would continue to be so used and the coal boilers maintained, while natural gas, the "swing" fuel, would also be recovered through the QCA.

Unfortunately Aquila failed to appreciate that the QCA structure provided a mitigating effect on natural gas volatility. On the electric side, Aquila enjoyed an Interim Energy Charge (IEC) from a prior case and had instituted a hedging program for its natural gas purchases, an approach that it shorthanded as a "1/3, 1/3, 1/3" strategy. As though using a cookie-cutter, Aquila then sought to apply this same electric strategy to natural gas for steam purposes. However, it wholly failed to perform any analysis of the "base" and "swing" fuels on volumes needed for the steam system, or whether it was even realistically possible to hedge natural gas for the steam system. Aquila did not even consider the implications of the QCA on this strategy.

Aquila performed its own forecast of volumes to hedge, then directed the purchases. No GMO witness has accepted responsibility for the design of the program and no GMO witness has accepted responsiblity for the flawed forecast.

Aquila's forecast was grossly wrong in a direction resulting in Aquila substantially over-hedging its natural gas

purchases. When gas prices tumbled, Aquila was left with a large overhang of hedges that it had to settle at large losses that were passed to the customers under the QCA's 80/20 sharing mechanism.

AGP questions Aquila's prudence in these actions. Imprudent costs are not recoverable from customers. Under the Stipulation and Agreement that (upon its approval) established the QCA tariff, the customers are entitled to a refund of the settlement costs of these imprudent hedges.

II. STATEMENT OF FACTS

A summary of the facts of this case begins with Aquila's steam rate increase filing in Case No. HR-2005-0450. On May 27, 2005, Aquila, Inc., submitted proposed tariff sheets (YH-2005-1066) intended to implement a general rate increase for steam service provided to retail customers in its L&P operating division in Missouri. On June 1, the Commission suspended the Company's proposed tariff sheets until April 24, 2006. On February 17, 2006, Aquila, Inc., the Staff of the Missouri Public Service Commission, AG Processing, Inc., and the City of St. Joseph filed a nonunanimous stipulation and agreement. ("Stipulation and Agreement").[2/] This steam rate increase case was a companion to Case No. ER-2005-0436. Fuel and purchased power

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[2/] The Stipulation and Agreement, after approval by the Commission on February 28, 2006, was embodied in a compliance tariff promptly filed by Aquila. References to either are generally intended to be references to both.

electric issues were addressed in the ER electric case; issues relevant to the steam service were raised in the HR case.

Aquila's electric and steam cases proceeded in parallel but with different customer groups involved. Although several St. Joseph electric customers were represented through industrial groups and Public Counsel, only AGP was involved in the steam rate case.[3/]

At the time of these filings, there was no fuel adjustment authorizing legislation from the General Assembly. Aquila had from an earlier settlement[4/] an Interim Energy Charge (IEC). An IEC differs from the current fuel adjustment clause in several significant ways. The significance of the IEC will be addressed later in this brief.

The Stipulation and Agreement resolved all disputes between the parties regarding the proposed steam rate increase. Staff filed suggestions in support of the stipulation and agreement on February 24. On February 27, the Commission held an on-the-record presentation regarding the proposed stipulation and agreement. At that proceeding, the Commission questioned the signatory parties, as well has those parties that did not sign but did not object to the stipulation and agreement.

On February 28, 2006 the Commission issued an Order effective March 6, 2006, approving the Stipulation and Agreement, directing the parties to comply with its terms, and authorizing

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[3/] Ex. 108, pp. 96-97.

[4/] ER-2004-0034.

Aquila to file the tariffs that had been attached to the Stipulation and Agreement as a *pro-forma*. On March 2, 2006 the Commission approved the compliance tariffs that Aquila filed.

Aquila began to submit quarterly adjustment factors pursuant to the Commission's Order. In due course, the 2006 and 2007 adjustment years were completed in Case Nos. HR-2007-0028 and HR-2007-0399. A series of negotiation sessions ensued involving Aquila, AGP and Commission Staff, ultimately proving unsuccessful. Meanwhile, Aquila was acquired by Great Plains Energy and renamed KCP&L Greater Missouri Operations Company or "GMO." During this period, negotiations were put on hold at Aquila's request, and unsuccessfully resumed with GMO after the acquisition was completed. Pursuant to the tariff provisions, AGP submitted a complaint/request for prudence review in the two QCA matters, which the Commission then transferred to this case.

A hearing was held on November 18 and 19, 2010 at the Commission offices in Jefferson City, Missouri. This brief is submitted pursuant to the modified briefing schedule approved by the Commission.

III. ARGUMENT

A. Requested Briefing - Burden of Proof - This Case is a Prudence Review That Was Directed to Use Complaint Process.

While a utility may enjoy an initial presumption that its activities are prudent, the burden of proof remains on the

utility when another party in the case raises serious doubt regarding the prudence of an expenditure by the utility.[5/]

The HR-2005-0450 Stipulation and Agreement directed that the complaint procedure be used to conduct a prudence review. In approving the Stipulation, the Commission ordered the parties to comply with its terms. Thus, this case is a prudence review of charges included in a ***refundable*** rate being automatically passed on to steam customers by Aquila through a fuel rate rider mechanism approved by the Commission in a previous ratemaking case.

At the time of filing for a rate adjustment, Aquila was (and GMO now is) not required to file another ratemaking case before increasing the rate rider. But, each time Aquila adopts a new fuel rider, it is seeking to pass on its fuel costs to its customers and, consequently, it is Aquila's rate increases that are driving the prudence review of its expenditures that it has already passed on to its customers subject to refund if found to be imprudent.

The QCA Rider methodology was approved in a ratemaking case brought by Aquila. Both the Stipulation and the QCA Rider provide for prudence reviews by the PSC Staff and the steam customers and provide that fuel costs collected in rates "will be refundable based upon true-up results and findings in regard to

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

prudence" provided that the prudence adjustment exceeds 10% of the total fuel costs incurred each year.

Inasmuch as QCA charges to steam customers are automatically adjusted quarterly through the QCA Rider, each time Aquila files a new fuel rider rate, the utility is passing on its fuel costs to its customers as part of the original ratemaking process. Thus, the QCA process is explicitly a ratemaking process and the *Associated* rule as to burden of proof of prudence is fully applicable and GMO has the burden of proof.

This prudence review brought by a steam customer pursuant to the Stipulation establishing the QCA Rider, the rule as to who has the burden of proof as to the prudence of expenditures included in rates is the same as if Aquila had filed a separate ratemaking case each time it increased its QCA Rider. *Associated Natural Gas*, *supra*. Failure to prove prudence results in Aquila having to refund to customers the 80% collected from customers as agreed in the Stipulation and contained in Aquila's QCA Rider with respect to the imprudent costs.

B. Identified Issues.

1. Given that the Quarterly Cost Adjustment ("QCA") mechanism contained in the Stipulation approved in Case No. HR-2005-0450 included a price volatility mitigation mechanism, was Aquila/GMO imprudent in implementing a natural gas steam hedging program in order to mitigate price volatility?

The Quarterly Cost Adjustment or "QCA" is a critical part of this case. Indeed, Aquila has included it as an exhibit to Mr. Clemens' testimony and AGP attached it as an exhibit to its original complaint. It was and is a rate schedule with the approved tariff of GMO and references to the QCA should also be taken to the then effective sheets of the Aquila tariff.

The QCA as designed had several features including: (1) an 80%/20% cost sharing mechanism; (2) a quarterly accumulation period coupled with a 12-month extended recovery period; and (3) a coal performance standard; and (4) a 10% benchmark intended to limit prudence review to those cases where a large amount of imprudence was involved. While the cost sharing mechanism and the quarterly period go together, it is helpful to discuss them separately.

a. Cost Sharing Mechanism

As described by Mr. Johnstone, the difference between tracked fuel costs and the amount that was included in the fuel base is accumulated each quarter.[6/] This quarterly variance from the base amount is then collected over the following 12 months, thereby mitigating the variation, and collecting the differential subject to refund. Each new accumulation period captures this variation and then collects it over the following year, subject, again, to refund and possible prudence review. In

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[6/] Johnstone Direct, Exhibit 1, p. 7.

this manner, four "layers"[7] are netted and the net collected in each month.[8]

The cost sharing mechanism is designed to allow Aquila to recover 80% of this variation with 20% being Aquila's "skin in the game." All this results in more stable prices for the steam system customers while still permitting an 80% cost recovery for Aquila via the tracking mechanism.[9]

b. Coal Performance Standard

The coal performance standard was included to reflect the concerns of both customers and utility. The utility had concerns with an ability to recover fuel cost variations as prices increased, while AGP was concerned that the capability of the coal-fired boiler be maintained for economics and reliability. Absent a performance standard, customers would have become *de facto* insurers of the performance of the Lake Road coal plant; undergirding the mechanism with a minimum amount of coal burn would motivate Aquila to continue to maintain the coal-fired burners.

> A solution was found in a mechanism that provides more timely rate increases for increases in fuel cost caused by increased fuel prices, while at the same time ensuring that Aquila would continue to bear

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[7] After the startup period in which the QCA was implemented first with one charge and then a transition into the typical state with four in effect at any given time.

[8] Johnstone Direct, Exhibit 1, pp. 7-8.

[9] *Id.*

> the responsibility for maintaining adequate performance of the coal boiler with its lower fuel cost and reliability implications. In other words, in the context of a fuel adjustment mechanism, customers would not be subject to an increase in fuel cost that was caused by poor operation of the coal-fired steam boiler and the much higher cost of gas-fired steam used in its stead. Since one of the primary concerns was with increases in fuel prices, the parties developed and mutually agreed to the "Coal Performance Standard" as a mechanism to the satisfactorily address the concerns of both parties.[10/]

c. Limited Prudence Review

The QCA also limited a prudence review to those cases in which the imprudent fuel costs were greater than 10% of the total fuel costs in that period. This limitation makes sense given the 80/20 cost sharing alignment.[11/] Here that threshold has been exceeded.[12/]

d. QCA Resulted in Mitigation of Variations

There seems little question that the QCA mechanism not only was designed to, but did, mitigate or smooth fuel cost variations. GMO witness Clemens agreed that the QCA mechanism mitigates fuel cost variations and price spikes,[13/] and also

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[10/] Johnstone Direct, Exhibit 1, pp. 8-9.

[11/] Johnstone Rebuttal, Ex. 2, p. 10, ll. 7-10.

[12/] Ex. 10.

[13/] Tr., Page 176, ll. 7-12.

agreed that "it has the ability to take the costs that we have accumulated . . . and spread that over 12 months."[14/]

Mr. Clemens attempted to set up the false issue of whether the QCA was intended to be a hedging program.[15/] As Mr. Johnstone testified, the QCA was not designed or intended to be itself a hedging program, "[h]owever, it was designed to mitigate volatility, so there is a direct impact on what is needed in a hedging program if one is implemented."[16/]

> Aquila's program was designed only to lower the price of the highest cost natural gas and increase the lowest cost. Volatility mitigation was the goal, although the goal was not achieved. My point is that the QCA by its design does much the same thing and that is a large part of the basis for my statement that ***"the hedge program," the one designed and implemented by Aquila, was unneeded.***[17/]

GMO witnesses sought to distinguish between the retail "costs" that were collected from customers and the "price" that Aquila would pay for gas. Of course, because of the 80/20 sharing mechanism that gave Aquila "skin in the game," the distinction is meaningless. Cost swings result from price swings.[18/]

Mr. Johnstone responded:

[14/] Tr., p. 162, ll. 14-16.

[15/] Johnstone Rebuttal, Ex. 2, p. 5, l. 3.

[16/] Johnstone Rebuttal, Exhibit 2, p. 4, ll. 18-19.

[17/] Johnstone Rebuttal, Ex. 2, p. 5, ll. 5-10 (emphasis added).

[18/] Tr., p. 163, ll. 10-11.

> By my reading and understanding of the plain meaning of the [the QCA tariff language] it does two things. First, if there is a hedging program, the cost will be a part of the QCA. Second, the cost/benefit of a hedge position associated with any particular quarter will be accounted for in that particular quarter for QCA purposes. I am aware of no other ulterior motive, intent, or purpose beyond the plain meaning.[19/]

AGP's initial filings and direct testimony alleged imprudence. There was no effective rebuttal, nor was there an effort by GMO to explain how or why the hedge program was needed for the purpose of mitigated rate volatility given the effectiveness of the QCA design in mitigating rate volatility, that the particular program was prudent in its design, and was prudently implemented and administered.

2. Given that a price volatility mitigation mechanism was established in the Stipulation approved in Case No. HR-2005-0450, was Aquila/GMO imprudent in failing to take into appropriate consideration that mitigation mechanism before proceeding to implement a financial hedging program for natural gas fuel that was used to raise steam?

Beginning a hedging program, according to GMO witness Blunk, requires determination of the objectives, and an analysis of the risk to which the hedging party is exposed and wishes to mitigate.

> 22 Q. And then I had also asked you what the
> 23 first step would be in trying -- if you were trying to
> 24 design a hedging program, a gas hedging program, what
> 25 you were -- what -- where you'd start, in other words.

[19/] Johnstone Rebuttal, Ex. 2, p. 6, ll. 18-22.

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Where would you start with designing a hedging program generally?
A. Generally you'd start with what are the objectives? What are you trying to accomplish? What is the risk that you're exposed to? Why do you want a hedging program?
Q. And then after that, would you take a look at the risk?
A. Yes. Or it might have been the star-- it's -- they're both going to be at the beginning.[20]

AGP's witness Johnstone certainly agreed with this initial approach.

> The place to start is with a definition of the problem and the purposes to be achieved. At the most basic level the purpose of the Aquila program was to mitigate volatility in the price of natural gas.[21]

It was also necessary to identify the quantity of natural gas to be hedged, the hedging strategy and an accurate forecast are both of fundamental importance.[22] Mr. Blunk agreed:

Q. And Mr. Blunk, were you asked: Well, how would you go about selecting which instrument or combination of instruments to use?
And did you answer: We would look at the objective of our program, the risk we were facing and the character or the characteristics of the instruments and based on that, we would select a set?
A. Yes.[23]

The QCA should have also been a consideration in this identification of the objectives and the risk to be mitigated.

> [I]n Aquila's situation there was also the need to consider the QCA. It mitigated the impact of fuel price volatility and any price spikes by its design. In fact, the QCA pro-

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[20] Tr. 325-26.

[21] Johnstone Direct, Ex. 1, p. 11, l. 22 - p. 12, l. 1.

[22] Johnstone Direct, Ex. 1, p. 12, ll. 9-12.

[23] Tr. 327.

> vided for the accounting treatment of hedging costs and benefits, subject to refund and prudence determination, so the QCA had to be a consideration, but more important for program design purposes would have been the QCA's inherent mitigation of the effects of fuel price volatility.[24/]

The evidence, however, shows that Aquila failed to analyze any of these considerations or consider any of these factors. Mr. Blunk, GMO's subject matter witness, lays out what ***should*** have been done, but he was not an Aquila employee and could not testify as to what ***was*** done. The record is lacking in evidence of what was in fact done in terms of defining the problem to be addressed. Instead, the record shows that Aquila simply adopted a "model" for contract structure that it had used in its electric business. This was referred to as the "1/3, 1/3, 1/3 strategy."

> The Aquila contract structure was to cover one third of the cost of the physical gas volumes with futures and another third with options. This would leave one third of the cost of the physical gas uncovered by the hedge program, assuming the volumes were as forecast (volumes did not come close to forecast). All of the physical gas continued to be purchased in the same way as before the hedge program at market prices. There was no assurance of any particular market price for the physical supplies and there was no assurance that any particular volume of gas supply would be needed.[25/]

Sadly, Aquila cut this part of the analysis short.

[24/] Johnstone Direct, Ex. 1, p. 12, ll. 13-18.

[25/] Johnstone Direct, Ex. 1, p. 13, ll. 5-14.

As revealed by the evidence, the Stipulation and Agreement authorizing and approving the QCA mechanism was not approved by the Commission until February 28, 2006 effective March 6, 2006.[26/] On February 15, 2006, at 9:46 a.m., ***two full days ahead of the filing of the Stipulation and Agreement***, Mr. Gottsch queried his managers as follows:

> I have received from Tim Nelson a budget for steam usage volumes for St. Joe due to new and expanding existing customers. I have a breakdown by month for Nat Gas consumption for this purpose which amounts to around 1.5 BCF for '06, and around 2.4 BCF for '07 & '08 each. The discussion in the past is that we may want to incorporate these volumes into our Missouri Electric gas hedge plan. 1) Is that still the case? 2) If so, when can I begin to implement? 3) Do we want to keep these volumes seperated [sic] or just fold them into the existing Missouri Electric Hedge plan? 4) Is the 1/3, 1/3, 1/3 approach still acceptable?[27/]

In its presentation of how Aquila implemented its particular hedge program, GMO ignores the need for the basic analysis that was identified first by Mr. Johnstone and then corroborated by Mr. Blunk. There is simply silence. Aquila offered no evidence of the analysis that it agrees should have been done. There is no evidence of the procedure that parties agree should have been followed. There was no analysis of the risk, no identification of objectives to be achieved, and no quantification of the amount of the natural gas that should be

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[26/] *Order Approving Stipulation and Agreement*, Case No. HR-2005-0450.

[27/] Ex. 4.

considered as "base" fuel and "swing" fuel.[28] The intention stated at 9:45 am on Feb. 15, 2006 clearly was to "incorporate" or "fold in" the gas requirements for the steam system with the electric mechanisms. Significantly, there was no mention of the QCA or the terms and conditions of the HR-2005-0450 Stipulation and Agreement.

Then, almost appearing to answer himself, and only 21 minutes after his first e-mail, Mr. Gottsch issued a second e-mail:

> I will draft a procedure for the Risk Management committee review. ***At this point we would envision a procedure similar to the plan already in place for Missouri Electric designed for budgeted volumes, using the 1/3, 1/3, 1/3 strategy.*** We are assuming that the procedure would be deemed prudent with respect to the rate stipulation's risk sharing design.[29]

Mr. Gottsch may have received direction from an unnamed source. But, there was no analysis of the nature of the steam load and the fuel mix needed to meet it (either base or swing), and no reference to the mitigating effects of the QCA. Moreover, there was an "assumption" that the procedure would be deemed prudent, not as a result of a demonstrated analysis of the risk of the load, rather as a result of the "risk sharing design" embodied in the Stipulation and Agreement. "Skin in the game"

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[28] At the time the Stipulation was presented to the Commission, coal represented roughly 2.1 mmBtus, the rest gas. Ex. 108, p. 104, l. 22 - p. 105, l. 2.

[29] Ex. .

was intended to encourage a prudent result. But, by all appearances Aquila instead imprudently interpreted the provision as a license to act arbitrarily and unilaterally.

Finally, the word came from Mr. Williams, only 31 minutes after Mr. Gottsch's ***original*** query and ***just 10 minutes after his second e-mail***:

> 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 [a] sharing mechanism.

Aquila's decision to hedge was made two days ahead of even the filing of the Stipulation and Agreement and it was unambiguously based on the electric model. However, there is still no evidence of any analysis of the nature of the risk to be hedged, and certainly no analysis of the impact of QCA volatility mitigation attributes on the need, if any, for a hedge program. These e-mails are silent as regards these critical factors. Moreover, we are not familiar with any principle of Commission jurisprudence that results in a hedging policy being "deemed" prudent because it is "stated in writing."

In cross-examination, Mr. Clemens identified the real "decision-maker" as Mr. Empson.[30/] However Mr. Empson's name does not appear in this e-mail exchange.[31/] Thus, either he was not the decision maker or the Commission has not been provided with complete information from GMO. Given that this e-mail thread would appear to be complete (GMO Id. # 523), this exchange exposes the entirety of Aquila's decision to implement a hedging program for steam. As Mr. Clemens testified, these e-mails told Mr. Gottsch to "go do it."[32/] Thus, as to this question 2, Aquila is shown to be imprudent and utterly fails in its obligation to prove prudence.

3. Given that a price mitigation mechanism was approved by the Commission in the Stipulation in Case No. HR-2005-0450 and that there were only six steam customers, was Aquila/GMO imprudent in failing to discuss its proposed steam hedging program with its customers before implementing such a program?

Six steam customers, with facilities in near proximity to the Lake Road station, were not told that a hedging program with this structure was to begin. Aquila did not advise the

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[30/] Tr. 165, ll. 2-6.

[31/] Tr. 172, ll. 15-19.

[32/]

11 Q. So without regard to the 20/80 or the
12 80/20 depending on which way you want to look at it,
13 he's saying go do it?
14 A. Yes.

Tr. 172.

limited number of steam customers that would be affected that it was going to implement a hedging program using the same strategy as its electric program. There is no evidence of prudent consideration of customer input.

Although Aquila spends a great deal of time on this point (and, certainly, Aquila completely failed to provide any evidence that it solicited customer input on its hedging program), it does not in any manner address whether Aquila ***prudently*** implemented and engaged in whatever strategy it employed. Aquila was still obligated to take prudent steps if it engaged in hedging for steam-related natural gas needs.

In any event, Aquila's factual predicate is missing. Of the several witnesses that GMO offered in opposition to Mr. Johnstone, only Gary Clemens, Joe Fangman and Gary Gottsch were Aquila employees during the relevant time period. None offered evidence that customer input was solicited.

a. GMO Witness Fangman

Joe Fangman was the St. Joseph-located customer service representative. His testimony is filled with descriptions of numerous contacts with the several steam customers[33/] and he certainly had input into the forecast usage of the steam customers,[34/] an issue addressed elsewhere in this brief. However, on the critical issue of whether the customers had notice of a

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[33/] Tr. 267, ll. 18-24.

[34/] Tr. 268, l. 19 - Tr. 289, l. 16.

natural gas hedging program for steam, he disclaimed knowledge of the hedging program.

> Q. Now, this whole complaint has to do -- you probably picked up that it has to do with the hedging.
> A. Yes.
> Q. Do you see -- do you have anything to do with hedging?
> A. No, I did not.
>
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> Q. Did you ever have occasion to talk about the customers in the context of the hedging program for steam?
> A. I have not. Other than a discussion that -- with Gary Chestnut in which he mentioned his concern about the hedging program.[35/]

Not only did Mr. Fangman not inform the customers about the hedging program, he found out about the program from a discussion, not with his employer, but with AGP's management:

> Q. So we can just cover it all by just saying didn't have any discussion about the hedging program with any of the customers other than what you mentioned with Mr. Chestnut?
> A. Yes.
> ***Q. In fact, that's how you found out about the hedging program, wasn't it?***
> ***A. I believe so.***
> ***Q. With that contact with Mr. Chestnut?***
> ***A. Yes.***
> Q. Before that, you didn't even know that there was a hedging program going on; is that fair?
> A. I didn't know we were using hedging in the steam program.[36/]

b. GMO Witness Blunk

Mr. Blunk never worked for Aquila.[37/] He disclaimed

[35/] Tr. 282-283.

[36/] Tr. 284 (emphasis added).

[37/]
> Q. And, in fact, based on your indications in the deposition that we took some weeks ago, your entire career has been with Kansas City Power & Light; is that right?
> A. Mostly. I worked with John Deere Company for a short period before that.

(continued...)

connection with the steam hedging program and also disclaimed knowledge of the program.

> Q. Mr. Blunk, [I'll] try to shortcut this in view of the time. Would you agree with me that you had nothing to do with the development of the Aquila steam hedging program?
> A. If you're referring to this program, the one-third strategy, that is true.
> Q. At the time that that was either conceived or whatever term you want put on it, you were working for Kansas City Power & Light. Am I correct?
> A. Yes.[38/]

c. GMO Witness Gottsch

Mr. Gottsch implemented the hedge purchases, but did not testify that he had customer contact. An objection to purported testimony about information from customers was stricken as hearsay.[39/]

Mr. Gottsch purchased the hedges. He took orders and did what he was told. He exercised no initiative whatever during his work on this matter with Aquila. He did not design the program.

> Q. Mr. Gottsch, we had an opportunity to have a deposition together, didn't we?
> A. Yes, sir.
> Q. And one of the things we talked about in that was how you started the hedge program. What's the very first step you have to do when you start up a hedge program?
> A. Get authorization to begin a program.
> Q. And how would you go about doing that?
> A. In my particular position, I waited for my manager to instruct me to do so.

[37/](...continued)

Tr. 317.

[38/] Tr. 317.

[39/] Tr. 208, l. 8 - 209, l. 3.

Q. Okay. You just waited for him. This would have been Mr. Korte (ph.)?
A. At the time, correct.
Q. Have you ever had any instances in which you kind of said, well, I think there's a need for a hedge program here and I want to go talk to my manager?

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A. No.
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.[40/]

And further (although it took awhile):

Q. So is it -- is it fair -- and I don't mean this as a put-down because I'm not -- not in that

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mode, but is it -- ***is it fair to say that you took instructions from somebody else, in this case, Andrew Korte, and then executed those instructions?***
A. Correct.
Q. So if I was -- if I were to ask you if you had done any kind of an analysis of what might be consistent -- considered a consistent flow of natural gas or steam, you would say you didn't do that, somebody else had done that above you and you just did what they told you to do?
A. Regarding the flow of natural gas?
Q. Well, I'm sorry. That was a complicated question. I'll -- I'll back up.
Did you do any analysis of what might be considered a consistent flow for natural gas or steam?
A. No, I did not.
Q. And your role in the company, at least with respect to this hedge operation, somebody above you, let's call it Andrew Korte, gave you the budgeted volumes. Right?
A. I did not receive them from Andy, no.
Q. Who did you get them from?
A. I received them from the Resource Planning Group.
Q. But somebody above you in that group or

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somebody at a different level or different group gave you --
A. Somebody from --
Q. -- those numbers?
A. -- a different group, correct.
Q. That's a yes then?
A. Yes.[41/]

[40/] Tr. 211-12.

[41/] Tr. 216-18 (emphasis added).

d. GMO Witness Rush

Mr. Rush was a St. Joseph Light & Power employee for numerous years, was familiar with that company's steam distribution system, but only worked for Aquila for roughly a month after the St. Joseph utility was acquired by Aquila.[42] He had no evidence regarding customer notice or information to customers.

> 25 Q. Yeah. Okay. 2001 through 2008 you
>
> 00302
> 1 really didn't have any involvement with -- with the --
> 2 with the Aquila entity that was operating the steam
> 3 system up there; is that right?
> 4 A. I did not have any direct involvement,
> 5 that's correct.[43]

e. GMO Witness Clemens

Mr. Clemens was the only GMO witness who appeared to argue that customers were given information about the hedging program ahead of time.

First, Mr. Clemens argued that Mr. Brubaker had testified about the hedging program on behalf of AGP. While Mr. Brubaker certainly did so testify, Brubaker's testimony was in both the electric case (ER-2005-0436) and in the HR-2006-0450 docket. However, Mr. Brubaker's direct testimony was filed on October 14, 2005 and his Rebuttal testimony was filed on December 13, 2005, both well before the February 17, 2006 filing date of the HR-2005-0450 Stipulation and Agreement, and certainly before the Stipulation and Agreement was taken up by the Commission on

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[42] Tr. 301, ll. 1-21.

[43] Tr. 301-02.

February 28, 2006 (effective March 6, 2006). As stated by Mr. Johnstone,

> Mr. Blunk and Mr. Clemens both cite the testimony. Both fail to acknowledge that the testimony predates the QCA. Aquila did not propose a fuel rider in the case. Absent clairvoyance, there is no reason for Mr. Brubaker's testimony to have anticipated any fuel rider for the steam business, and no way to anticipate a fuel rider in the form of the QCA, with its volatility mitigating effects.[44/]

Exhibit 108 clarified that Mr. Brubaker's role in the case did not include the QCA.

> 20 Also, Mr. Brubaker is here, and his area
> 21 was in a few aspects of fuel pricing and to the costing,
> 22 which as this developed, it took a different
> 23 direction. So there may not be questions for him,
> 24 but he is here.[45/]

Second, Mr. Clemens appeared to suggest that the steam customers implicitly should have known about the steam hedging program because Aquila was using the same "strategy" on the electric side of its operations. Even GMO counsel agreed that "[t]here was only one hedging program. It was the one-third strategy."[46/]

Upon cross-examination, however, Mr. Clemens seemed to want to shift his description between a strategy, a program, a concept, or a "philosophy," or something else as his descriptions seemed to vary.

[44/] Johnstone Rebuttal, Ex. 2, p. 5, l. 22-p. 6, l. 2.

[45/] Exhibit 108, p. 36, ll. 20-24.

[46/] Tr. 52, l. 10-11.

Q. Which hedging program are we talking about there?
A. The one-third program that we've discussed this morning.
Q. Well, now, the electric, Mr. Clemens, or steam? Because we've discussed both this morning.
A. We've discussed the one-third program. That's the one that I'm referring to.
Q. All right. What is the one-third program?
A. It's the one-third program that we had utilized in the electric steam -- the electric business and also utilized that method in the steam business.
Q. So you're talking about the same programs on the electric side as now you're saying on the steam side; is that right?
A. It's the same ***philosophy***, yes.
Q. Well, now you slipped a gear on me there. Suddenly we're becoming philosophical. It's the same program, the same concept or the same philosophy? Which is it?

00137

A. The same ***concept***.
Q. And let's try and put, if we can, a little finer point on it. When you say "concept," what is the concept that is referred to there on line 14?
A. The one-third ***strategy***.
Q. Now, your question says: Did not discuss the hedging program with the steam customers prior to implementing the program.
Do you see that reference?
A. Yes.
Q. What is the program?
A. The steam program.
Q. Okay. On line 14 I thought we were talking about the electric program.
A. We were talking about the one-third ***strategy***.
Q. Okay. Now that's yet another term. We've talked about concept, we've talked about program, we've talked about philosophy. And I thought you had settled on concept.
A. ***They could be the same***.
Q. Well, they can be the same or they are the same?
A. They are the same in this reference.

00138

Q. In this reference they're the same?
A. Yes.[47/]

Setting all this aside, the important point is that the electric program that was heavily touted was ***not*** the steam program. No one, not any customer, nor any staff person, ever agreed that Aquila could hedge ***imprudently*** regardless of "philos-

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[47/] Tr. 136-38 (emphasis added).

ophy," "program," or "strategy." Therefore, it really makes no difference what customers were told about a program that did not exist unless Aquila substantiated that it told its customers that they were going to hedge in an imprudent manner. Aquila did not.

Apparently, from Aquila's point of view, being allowed to hedge equates to being allowed to imprudently hedge. We respectfully differ. And, this imprudence was not revealed until *post-hoc* reports were filed.

f. Electric Program Not Equal to the Steam Program

A comparison of the electric program to the steam program shows that they are clearly not the same. One of the most basic reasons is that the electric program was designed around an Interim Energy Charge or IEC.

Aquila's electric gas hedging program, was developed in the context of an IEC that had been approved in Case No. ER-2004-0034. A brief description of the IEC is necessary to distinguish it from a mechanism like the QCA.

An IEC initially establishes a base level of fuel to include in the rates that are approved. Along with this base level, a "threshold" or "floor" level is approved. At the end of the IEC period, the utility engages in a "true-up" or reconciliation process, validating its actual fuel expenses for the period against the base level that was included in the tariff

rates.[48/] If the actual level is less then the base, but greater than the floor, the utility refunds the difference between actual and base. If the actual expense is less then or equal to the floor level, the utility makes a refund, but only down to the floor level of the mechanism. If the actual costs rise above the base level, there is no additional recovery. Given this structure, it should be clear why the utility employing a hedging strategy in an IEC environment because it is concerned only about limiting its cost exposure. At the same time, if it is possible to bring the fuel cost below the agreed floor, the utility can simply retain the revenue below the floor level and need refund only to that level. Nonetheless, an analysis of the base level of fuel as distinguished from the swing fuel remains of critical importance for the QCA.

Exhibit 13 was claimed to describe the steam hedging program. Among other things, it states: "[F]orecasts are prepared based on sales history, which includes results through April." There was no evidence that this was done and there was no evidence that Aquila used 200***5*** actual usage information for its hedge purchases in 2006 or information from 2006 for hedge purchases in 2007.

Exhibit 13 also states that "An integral component of the sales forecasts is feedback on the projections for large industrial loads, which may not reflect history." Exhibit 13 was a response provided in April of 2008 and supposedly pertained to

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[48/] Ex. 108, p. 113, ll. 18-22.

the steam operations and budgeted sales figures. However, given that there are only six steam customers, and they are all "large industrial loads," it is apparent that Exhibit 13 referenced the electric program and ***not*** the steam hedging program. The exhibit also states: "Review is made of the prior calendar year's monthly actual billings (sales) and fuel inputs." The response then attached "[m]onthly annual data for 2006-2007 . . . ." This attachment demonstrated that 200***5*** actual data showed that actual usage was below the fuel purchase budget by 211,903 mmBtus or just over 10%.

Nevertheless, these inputs were used to purchase hedges for 2006. And, were these hedges purchased in accordance with the supposed "strategy" on the "sales history" as stated on Exhibit 13 or on a monthly basis as described in Exhibit 14? Well, no. In fact, as disclosed in Exhibit 14: "2006 purchases were all made in February 2006 and 2007 purchases were spread out from February 2006-October 2006." This, even though Exhibit 11 states:

> Revisions provided to Gary Gottsch, either as part of a forecast revision or the next annual budget, may adjust the planned hedge volumes. Increases are reflected as ratable increases in purchases for the balance of the buying cycle. ***Decreases are implemented by unwinding existing positions or by ratable decreases in purchases for the balance of the buying cycle.***[49/]

[49/] Ex. 11, GMO # 408.

Exhibit 9 shows that forecasted budget usage by the customers (the six steam customers -- all within walking distance of the Lake Road Plant) exceeded the 2007 actual usage by 752,653 mmBtus (roughly a 26% difference).[50/] But by then:

> 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***.[51/]

AGP alleged imprudence because Aquila did not consider the fact that the QCA tariff inherently mitigated retail price volatility. The volatility mitigation point was conceded by Aquila, reinforcing the conclusion of imprudence.

GMO provides no evidence that the volatility mitigation effect of the QCA was considered at all. There is silence and there is no proof of prudence.

g. The Basic Error in Aquila's Strategy

What was wrong with this "strategy," "philosophy," or "program"? Commissioner Kenney put his finger on the problem, first with GMO Witness Clemens:

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

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[50/] Ex. 9, GMO # 402.

[51/] Ex. 8, GMO # 407 (emphasis added).

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.
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.[52/]

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

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[52/] Tr. 192-93.

23 criticisms with respect to the electric side have been
24 applicable to the steam side?
25 A. I believe that's correct.

00246
1 Q. Even though -- even though he wasn't
2 speaking specifically to the steam production side,
3 the critique would have been equally as applicable?
4 A. I believe so.[53/]

Then look at GMO's own Exhibit No. 109. According to this Exhibit, confronted with actual "burn" of slightly under 1,500,000 mmBtus, under its "philosophy," Aquila hedged slightly over 2,000,000 mmBtus. This action was not even consistent with the stated 1/3, 1/3. 1/3 philosophy or strategy. According to Aquila, under this strategy, only 2/3 would be hedged; the remaining 1/3 would be purchased on the spot market at market prices. Had Aquila been consistent, total hedges would have been nearer 1,000,000 mmBtus with the remainder bought at market as needed.

h. Mr. Clemens' Schedules Demonstrate That Aquila Failed to Follow It's Own Program.

For additional evidence that the electric program that Aquila implemented was not what the steam customers got, we need only look to Mr. Clemens' own Schedules.

Although Mr. Clemens took great pains to try to confuse the two programs to attempt to blur the distinction with what was in place, the two programs are different.

[53/] Tr. 244-46.

First, the electric program was designed around an IEC.[54/] An IEC creates a "band" which is detrimental to the utility only if fuel costs rise above the cap or amount stated in the approved tariffs. If fuel costs come in lower than that, either the utility simply refunds down to the actual level of cost, or (if the cost goes below the threshold level) refunds only down to that level.[55/]

This creates a substantial incentive for the utility to hedge to limit rising costs, but little incentive (or indeed a perverse incentive) for reducing costs. The former can result in substantial losses for the utility. The latter results either in no losses or potential gains for the utility. Accordingly the bias of an IEC-designed hedging program is to mitigate upside risk while being less concerned about downside risk. Should an unanticipated downside occur, the utility stands to lose nothing. An unanticipated upside risk presents substantial potential for loss.

Mr. Clemens' Schedule 2 makes clear that Aquila's electric program was designed for an IEC.[56/] During cross-exam-

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[54/] Clemens Direct, Ex. 101, Schedule GLC-2, p. 2.

[55/] *Id.*

[56/] Clemens Direct, Ex. 101, Schedule GLC-2, p. 2, provides in part:

> The Missouri Public Service Commission ("MPSC") issued an April 2004 order accepting the Stipulated Settlement (the "Stipulation Agreement") between interveners and Aquila, Inc. d/b/a Aquila Networks - Missouri ("Aquila") regarding Aquila's rate disposition for the

(continued...)

ination, Mr. Clemens seemed to blank out on those details. The QCA is not an IEC-type mechanism.[57]

Second, the electric hedging program identifies as a "key element" the amount of price volatility the utility needs to mitigate.[58] The steam program made no such statement and, indeed, no evidence that an analysis of the steam need was performed was submitted by GMO.

Third, the electric hedging program states that it is to be executed by a series of monthly purchases over a 28 month period.[59] Aquila purchased all the monthly hedges for 2006 in

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[56](...continued)
period April 22, 2004 through April 21, 2006. Appendix A of the Stipulation Agreement details the Interim Energy Charge ("IEC") by which Aquila is allowed to recover, subject to the specified predetermined energy charge limitation, the production fuel and purchase power costs incurred to meet combined Missouri Public Service and St. Joseph Light & Power Company customer requirements during that period. In the event the cumulative two years of energy charges under the IEC are determined to be less than the! predetermined charge Aquila will be obligated to refund any over collection thereof to its constituent ratepayers.

[57] Ex. 108, p. 52, ll. 21-24.

[58] Clemens Direct, Exhibit 101, Schedule GLC-2, p. 2.

[59] Again, Schedule GLC-2, p. 3, attached to Mr. Clemens' Direct (Exhibit 101) states:

> The hedging plan is executed by purchasing one-third of the monthly forecast quantity, for each month over a 28 month period, proportionally procured in fixed price financial contracts. An additional one-third of the monthly forecast quantity is proportionately procured using options (primarily participatory collar) form . . . .

one batch and did not analyze or spread its purchases as specified in the electric program.

Fourth, the electric hedging program detailed in Schedule GLC-2 in Mr. Clemens' direct testimony (Exhibit 101) quite openly deals with purchased power and the conversion of on-peak purchase power to meet Aquila's net system requirements.

Fifth, the electric program specified a mechanism to adjust the hedges when the forecast changed that was supposed to be no less frequently than three months.[60/] The steam hedging program ignored this provision and was stated to be reviewed only annually, and even this purported review resulted in no apparent adjustment.

Sixth, according to the electric program, Aquila's Energy Resources and Commodity Risk Management group was to meet monthly in a documented process to discuss issues relevant to the

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[60/] Clemens Direct, Ex. 101, Schedule GLC-2, p. 3 states:

> If there are significant changes in key inputs to the volumetric forecast for natural gas and on-peak purchased power such as the cost of natural gas, the cost of on-peak purchase power, scheduled unit availability or whenever directed by Commodity Risk Management, Energy Resources will rerun the fuel budget model. These re-runs of the model will be done no less frequently than three months of the prior (re)run. The resulting new forecasted natural gas and on-peak purchase power natural gas equivalent quantities will then become the new-targeted procurement quantities. Energy Resources will then adjust its purchasing to meet the new target quantities.

hedging process.[61/] Neither Mr. Clemens nor GMO produced documentation of any such meetings regarding the steam hedging program.

Seventh, monthly option positions are to be closed mechanically and proportionally according to the electric program.[62/] There is no evidence of any mechanical (or otherwise) closing of unneeded hedge positions in the steam program.

There is enough dissimilarity between the two programs so simply conclude that they are not the same. Given that the electric program was the program that Aquila purportedly "told" all the steam customers about, Aquila simply did not communicate to the steam customers the parameters of the actual program that was used to hedge natural gas supplies for the steam system.

It should be apparent that the program, strategy or whatever Mr. Clemens chooses to call it was not implemented for the steam system in accord with what even Aquila can contend it told the six steam customers. Moreover, it is not the fact that Aquila hedged that caused the problem here, rather it is the imprudent manner in which Aquila hedged that caused the problem.

[61/] Clemens Direct, Ex. 101, Schedule GLC-2, p. 3 states:

> Energy Resources and Commodity Risk Management will meet no less than once a month to discuss all issues relevant to this hedging process. Energy Resources will record and otherwise document and all transactions including a summary of and current valuation of the hedge accounts.

[62/] Clemens Direct, Ex. 101, Schedule GLC-2.

i. Aquila Hedging Practices Exacerbated Volatility.

If the volume on a futures contract exceeds the underlying volume of the physical gas being consumed as shown by Exhibit 109, the results could be quite volatile and either very beneficial or very costly.[63/] In this case the result proved very costly to customers. Varying volumes certainly introduce uncertainly, but here Aquila failed to take into account that "[v]olumes were uncertain due to the uncertain demands of new loads and due to the role of natural gas as a swing fuel. Absent an accommodation of that reality, the program was very risky and intended results were unlikely to be obtained."[64/]

4. Given that natural gas is used as a "swing" fuel for raising steam and that analysis is required to establish the amount of natural gas to be hedged, was Aquila/GMO imprudent in adopting a steam hedging program design without analyzing the nature of its natural gas usage and quantifying the amount of natural gas fuel that should have been subject to any steam hedging program?

The function of natural gas as a swing fuel in the Lake Road steam generation system has been well documented and implicitly acknowledged by GMO.[65/] Indeed, it could not have been otherwise because of the coal performance standard that was part

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[63/] Johnstone Direct, Exhibit 1, p. 18, ll. 15-18.

[64/] Johnstone Direct, Exhibit 1, p. 19, ll. 9-12.

[65/] Johnstone Direct, Exhibit 1, p. 19, ll. 9-10; Johnstone Rebuttal, Exhibit 2, p. 12, ll. 6-7; Tr. 115, l. 7-p. 116, l. 10; Tr. 110, l. 7 - p. 111, l. 10; Blunk Direct, p. 17, ll. 17-18.

of the QCA. Indeed, even Mr. Blunk had to concede: "Aquila was obviously aware that natural gas was the marginal fuel at Lake Road . . . ."[66/]

Mr. Johnstone responded:

> The response comes primarily from Mr. Blunk. He thinks it is presumptuous of me to believe the fact was ignored. Since he had nothing to do with Aquila at the time, perhaps in effect he is suggesting that it is hard for him to fathom that Aquila would not have considered the fact. If that is his underlying point in response I would simply point to the complete lack of any documentation that shows that the swing fuel nature of the natural gas fuel and volumes was a consideration. Certainly the results do not support that.
>
> For the sake of discussion, assuming the swing fuel factor was considered, (although there is no indication whatsoever that it was) then it obviously was not given consideration sufficient to produce a hedge program that could accommodate large swings in usage without producing unintended effects.[67/]

And that is the salient point. Mr. Blunk, given his familiarity with hedging, simply had to concede that one begins a hedging program with the identification of the objectives of such a program.

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22        Q.    And then I had also asked you what the
23  first step would be in trying -- if you were trying to
24  design a hedging program, a gas hedging program, what
25  you were -- what -- where you'd start, in other words.

00326
 1  Where would you start with designing a hedging program
 2  generally?
 3        A.    Generally you'd start with what are the
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[66/] Blunk Direct, Ex. 105, p. 17, ll. 17-18.

[67/] Johnstone Rebuttal, Exhibit 2, p. 13, ll. 7-17.

objectives? What are you trying to accomplish? What is the risk that you're exposed to? Why do you want a hedging program?[68/]

The hedging instruments used would vary depending on the risk to be hedged against.

Q. And Mr. Blunk, were you asked: Well, how would you go about selecting which instrument or combination of instruments to use?
And did you answer: We would look at the objective of our program, the risk we were facing and the character or the characteristics of the instruments and based on that, we would select a set?
A. Yes.
Q. So I take it from that that there could be flexibility in designing a hedging program and what particular instruments you chose to use?
A. Generally, yes.
Q. It's not -- not just a cookie cutter type approach. Right?
A. Well, there may be limits on what your universe of instruments are available, but inside of that, depending what you're trying to achieve, your portfolio might look different.
Q. And that's driven by what you're trying

00328
to achieve and the objectives of the program. Are we -- are we communicating?
A. Yes.[69/]

The imprudence suggested in the statement of this issue remains and is, if anything, strengthened by the testimony from GMO. It is beyond question that use of natural gas as a swing fuel for the raising of steam is relevant. The best Mr. Blunk, who was not there, can offer, is that it is so obvious that it must have been considered. But his opinion is not backed by the facts. There was no evidence of consideration by Aquila. During the hearing and testimony process, Aquila had a full opportunity to present its proof. The result is a record empty of any

[68/] Tr. 325-26.

[69/] Tr. 327-28.

evidence to demonstrate consideration one of the very important points that should have been considered.

AGP proved imprudence to the maximum extent possible given that the proposition is a negative. Aquila offered not a shred of evidence in the affirmative. The only possible conclusion is imprudence.

5. Given that analysis is required to establish the amount of natural gas to be hedged for use as a "swing" fuel, did Aquila/GMO act imprudently in failing to analyze the nature of natural gas usage and the quantity to be hedged and in failing to properly use information purportedly obtained from consultations with its customers regarding their projected steam usage resulting in forecasts that were over twice the actual usage in many months?

Proper design of a hedge program is critical to its success. Otherwise it is a bit like setting out on a journey without first selecting a destination.

> The place to start is with a definition of the problem and the purposes to be achieved. At the most basic level the purpose of the Aquila program was to mitigate volatility in the price of natural gas. Aquila intended to create a program in which it would pay less than the market price if the market moved up, and more than the market price if the market moved down. The primary intent appears to have been protection from the possibility future increases in market prices.
>
> Another typical goal is to avoid the high cost that would accompany an extraordinary short-term movement that could be characterized as a spike in market prices. On the other hand, it is always desirable to participate in lower prices if the market falls.

> In order to implement the hedge program it is necessary to define the quantity of gas needed and it is necessary to devise a hedging strategy. The hedging strategy and an accurate forecast of the gas quantities to be hedged are both of fundamental importance.
>
> As previously discussed, in Aquila's situation there was also the need to consider the QCA. It mitigated the impact of fuel price volatility and any price spikes by its design. In fact, the QCA provided for the accounting treatment of hedging costs and benefits, subject to refund and prudence determination, so the QCA had to be a consideration, but more important for program design purposes would have been the QCA's inherent mitigation of the effects of fuel price volatility.[70/]

GMO Witness Blunk agreed with the initial need to define an objective for a hedging program.

> Q. And then I had also asked you what the first step would be in trying -- if you were trying to design a hedging program, a gas hedging program, what you were -- what -- where you'd start, in other words.
>
> Where would you start with designing a hedging program generally?
>
> A. Generally you'd start with what are the objectives? What are you trying to accomplish? What is the risk that you're exposed to? Why do you want a hedging program?[71/]

Mr. Johnstone summarized:

> Before embarking on a hedge program it is important to define the problem to be addressed and the objective of the hedge program. In depositions taken for this case KCP&L employees Blunk and Gottsch made statements to this effect. Likewise the impor-

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[70/] Johnstone Direct, Ex. 1, p. 11, l. 22 - p. 12, l. 18.

[71/] Tr. 325-26.

> tance of defining the problem and the objective was recognized by Mr. Somerer of the Commission Staff as well. Similarly, the importance of volumes is universally acknowledged.
>
> Once done, the next task would be to develop and analyze alternative hedging approaches and their effects under alternative market conditions.[72/]

> While AGP has worked diligently to discover what was done, I have found no indication of any work to define of the problem to be solved, no stated purpose before the design of the program, and no analysis of potential alternative solutions. Instead, by all appearances, Aquila arbitrarily and unilaterally adopted a variation of a hedging program it had used in its LDC and electric businesses.[73/]

Aquila provided no evidence that the nature of the steam generation natural gas load had been subject to any analysis to determine what objectives there were or should have been. Mr. Blunk noted that Aquila was "obviously aware that natural gas was the marginal fuel at Lake Road . . . ,"[74/] If so, there was no evidence of that this analysis had been done. In fact, based on the earlier testimony of Mr. Gottsch, he simply followed orders from Mr. Korte (who was not on the witness list) and those numbers came to him from Mr. Nelson.

Moreover, Exhibit 109 demonstrates that Aquila did not even follow its own "strategy" and established hedge positions,

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[72/] Johnstone Direct, Ex. 1, p. 30, ll. 12-19.

[73/] Johnstone Direct, Ex. 1, pp. 30, l. 21 - p. 31, l. 2.

[74/] Blunk Direct, Ex. 105, p. 18, ll. 17-18.

not on 2/3 of what was the actual burn volumes, rather Aquila over hedged its positions well in excess of the actual natural gas usage.

Hedging is not intended to be an exact science. That is why the QCA mechanism recognized that a cost would need to rise over 10% of the total before a prudence claim would be pursued. But Aquila's actions were simply egregious. Aquila bet that the market would continue to rise "for the foreseeable future."[75/] Instead the market price declined, requiring them to incur losses to settle their imprudent hedge positions.

The major problem was the error in forecasting which resulted in a massive over-projection demonstrated on Exhibit 109 and the identified errors shown on Exhibit 9. And, it should be recalled: There had been an error that was "significant" in the forecast for 200**5** and this should have alerted Aquila to the problem. Instead, however, Aquila purchased all the 2006 hedges in one batch.[76/] As their own documentation demonstrated, "[b]y 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 [had]

[75/]

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.

[76/] Ex. 108, p. 57.

already been placed."[77] This clearly was not what Aquila represented as equivalent programs, at least as Mr. Clemens understood the ***electric*** program.

> A. Other than they're going to purchase hedges one month at a time for the next -- over the 28-month period, just as it says.[78]

6. Given that Aquila/GMO claimed to be seeking to mitigate price volatility through its hedging program, did Aquila/GMO act imprudently in making a forecast of natural gas usage requirements that was two or more times actual usage thereby creating volatility in fuel costs and price spikes that moved prices up in a market when they should have been going down?

7. Given that Aquila/GMO claimed to be seeking to mitigate price volatility through its hedging program, did Aquila/GMO act imprudently by implementing a hedge program that sold puts for profit thereby contributing to costs of a steam hedging program that caused a spike in the October 2006 cost of natural gas and that was counterproductive to the stated volatility mitigation purpose of the hedge program?

a. Aquila Forecasts Were Excessive.

Review of Exhibit 109 shows that Aquila purchased hedges well in excess of 2/3 of the historic volumes used to generate steam by steam customers. There is no evidence that Aquila performed any analysis to distinguish a base level of

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[77] Ex. 8.

[78] Tr. 155; Clemens Direct, Ex. 101, Schedule GLC-2, p. 2.

steam-related gas usage from any portion that was a swing fuel. The structure of the QCA included a coal performance standard and coal, being the low cost fuel, was or should have been associated with the base level of steam usage to be anticipated. Why then did Aquila unilaterally choose to engage in such substantial over-hedging? The answer appears to be to profit at customer expense.

Mr. Johnstone was reluctant to identify this approach as speculative. Obviously a utility should not engage in speculation and GMO witnesses took great umbrage at the suggestion. However, the result that obtained was similar to that objective. Mr. Blunk sought to characterize the options as providing insurance to counterparties underwritten by Aquila. Without doubt, selling puts would produce some revenue but in a falling market could -- and did -- substantially raise costs.[79/] This is basically a bet that prices would continue to rise, for if the market price falls below the put strike price, there is a net cost compared to the market.[80/] There is no free lunch. Mr. Blunk's assertion of a "costless collar" mechanism is nothing more than a *post-hoc* justification. Aquila's sales of puts at a particular price creates cost exposure in a falling market.[81/]

Taken in conjunction with the substantially excessive amounts of natural gas that was hedged compared to actual custom-

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[79/] Johnstone Rebuttal, Exhibit 2, p. 24, ll. 3-10.

[80/] Johnstone Rebuttal, Exhibit 2, p. 24, ll. 20-21.

[81/] Johnstone Rebuttal, Exhibit 2, p. 25, ll. 1-4.

er usage, the simple facts are that hedged positions existed in volumes that substantially exceeded usage.[82] Aquila may not have initially intended to speculate. But taking such positions coupled with a "see no evil" approach to forecasting and adjustment of hedging positions creates a similar result.[83] This did not mitigate volatility in the Aquila hedge program. Instead it contributed to the very ***price volatility*** that Aquila asserted it was intended to mitigate.[84]

b. Aquila's Sales of Puts To Get Premiums Exacerbated the Problem.

When questioned about Aquila's sale of puts, Mr. Gottsch responded quickly that the reason to purchase a put as a hedging instrument was "to gather the premium." This was inconsistent with Aquila's position.

> Q. Oh, by the way, why would -- you're I think accepted as a hedging guru. Why would one ever sell puts? Why would you sell a put?
> A. To gather the premium.[85]

At several places in the record, including the transcript of the Stipulation presentation in 2006,[86] Aquila alleged that customers would participate in a down market two ways. ***First***, since the intent was to have hedges for only 2/3 of the

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[82] Ex. 109; Ex. 9.

[83] Johnstone Rebuttal, Exhibit 2, p. 25, ll. 6-11.

[84] Johnstone Rebuttal, Exhibit 2, p. 26, ll. 1-2.

[85] Tr. 236.

[86] Ex. 108.

volumes, the 1/3 uncovered would participate in the down market. in reality, because of the other substantial problems that led to hedge volumes in excess of natural gas volumes consumed, there was no 1/3 at market. ***Second***, the 1/3 allocated to coverage with a call option was not a pure call position. Instead, Aquila sold puts and gave up a substantial measure of down side protection -- at great cost.

Mr. Johnstone characterized this as "akin to speculation." Protection was not purchased for customers, but instead sold others at great risk to Aquila customers. GMO now recoils at the mere mention of speculation and we raise the term only to clarify the point that the strategy entailed a risk that came home to roost at significant cost to customers. Moreover, the approach defies the representation that customers participate in down markets with 2/3 of the volume. They did not. Costs went up, not down in the months of lowest market prices.

The imprudence is manifest. The misrepresentations, intended or not, were extraordinary and in themselves reinforce an imprudent management. Not only was the program imprudent in this regard, but the misrepresentations at best revealed imprudence and at worst revealed deceit. The issue can only be decided as imprudence.

c. Aquila Employed a "Cookie-Cutter" Mentality Regarding Its Strategy.

The only affirmative showing is that Aquila used the same 1/3 strategy for its natural gas LDC business in other jurisdictions, for its electric business, and finally for the steam business. Offered as an affirmative defense, these facts instead reveal a program based on supposition instead of analysis.

d. The Commission's Rule Does Not Provide Aquila a Safe Harbor.

Finally, there was an attempt by Aquila to use this Commission's rule applicable to hedging for LDCs as a defense of Aquila's hedge program. But that resort is unavailing, for instead we find a rule that again requires analysis of options and impacts. The rule cited with great fervor by Aquila, is yet another demonstration of Aquila's failure to proceed in a prudent manner.

e. Aquila's Approach Was to Shift Costs to Steam Customers.

The record on this issue demonstrates imprudence. Instead of mitigating volatility Aquila acquired risk in the form of puts, in direct conflict with the stated purpose of the program. In short, the only reason to sell a put is "to gather the premium." Whether or not it amounts to "speculation" is at this juncture a moot point. The purpose is acknowledged by Mr.

Gottsch. The sale of puts had no role in mitigating volatility. It is beyond the pale to suggest that it was prudent for Aquila to sell price insurance to others under the guise of mitigating natural gas price volatility for steam customers. Imprudence is shown by AGP. The best defense GMO can now muster is that other people engage in a somewhat related approach called the "costless collar". This collar was far from costless. It is a primary driver of natural gas cost increases in a down market.

8. Given that a forecast of natural gas usage was shown by actual consumption to have been excessive, did Aquila/GMO act imprudently in not adjusting its natural gas usage forecast and its hedging program in response to actual consumption data?

9. Given that divergence between actual steam sales and the Aquila/GMO budget first became manifest in 2006 and continued to be manifest in 2007, was Aquila/GMO imprudent in not adjusting its natural gas steam fuel hedging program to be more aligned with actual experience?

Aquila clearly failed to adjust or react to changes in customer usage patterns. The 2006 forecast was made in June, 2005,[87/] and information about the variance in the 2005 forecast, while not quantified on an annual basis, of course, should have been known to Aquila. It certainly would not have been known to customers.

[87/] Tr. 270, ll. 12-18.

Based on the 200***5*** 10+% variance between forecast and actual use, would it have not been prudent to make an adjustment in the amount hedged? But such was not to be because Aquila purchased all the 2006 hedges in one batch. Even though criticized with respect to its price-blind philosophy of its electric hedging program, Aquila simply used the cookie-cutter approach and implemented the same approach for steam. This should not have been and was not even in accord with Aquila's stated hedging philosophy. And, given the roughly 25% variation between forecast and actual steam usage for 2006, should not some adjustment have been made for 2007? Had Aquila chosen to adjust its hedges downward, it could have unwound them.

Mr. Rush was queried by the bench regarding his experience in forecasting accuracy. He testified:

> 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.[88/]

Mr. Rush went on to describe instances of inaccuracies in forecasting that simply validate that such forecasts are understandably inaccurate and make more critical the need for careful analysis of the nature of whether the fuel being hedged (natural gas) is being used as a base load fuel or as a "swing" fuel. Aquila did none of this. Rather, as noted by Mr.

[88/] Tr. 311.

Featherstone's criticism earlier noted, Aquila continued in a mechanical way, without regard to price, to lay in its hedges. Its methodology was confounded by declining prices in the gas market and by an over-hedged positions that could have been stopped, adjusted, or unwound but did none of these. As described by Mr. Johnstone:

> If the hedge volume could be made equal to the physical quantity needed, with certainty and at the same price location, the net price of gas could be locked in, regardless of the market price level. If the hedge volume is less than the physical volumes, the change in market price will be mitigated - to a greater or lesser extent, depending on the amount hedged in comparison to physical gas consumed. However, if the hedge volume is greater than the physical volume, the effect of the hedge will be extreme. It will not mitigate volatility in the market price, but instead produce a price change opposite in direction to the change in of the market.[89/]

a. Aquila Made No Adjustment Even Though Variances Were Significant.

Even according to Mr. Clemens' understanding of the ***electric*** hedging program, Aquila was supposed to rerun the fuel budget model and represented that this was to be done "no less frequently that three months of the prior (re)run."[90/]

The actual statement in Mr. Clemens' Schedule is: "If there are significant changes in key inputs to the volumetric

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[89/] Johnstone Direct, Exhibit 1, p. 18, ll. 4-11.

[90/] Clemens Direct, Ex. 101, Schedule GLC-2, p. 3; Tr. 155-56.

forecast for natural gas and on peak power . . . Energy Resources will rerun the fuel budget model. These re-runs of the model will be done no less frequently than three months of the prior (re)run." Despite having included this description of the electric program in his testimony and having stressed that the same "philosophy" or "strategy" was used in the steam program and that steam customers should have been aware of this, Mr. Clemens stumbled over the procedures identified in this own Schedule:

Q. Now, moving on down in that paragraph, when that happens, when there's a significant change, what is energy resources supposed to do?
A. They would make an adjustment.
Q. Well, let's read it and see what it says: Energy Resources will re-run the fuel budget model.
Do you see that?
A. Yes.
Q. What does "re-run" mean?
A. Run the model with new data.[91/]

If the electric program simply became the steam hedging "program," as appeared to be Mr. Clemens' testimony, then there is simply no excuse for Aquila to have so mismanaged the program by failing to respond to significant volumetric shortfalls.

Mr. Fangman testified that it was his job to obtain significant changes in usage from customers:

Q. Remind me, if you would, because it's been a few days, your role in this process is to -- to get volume information from customers. I want to focus on the steam customers now. Volume information from the steam customers. And how do you go about doing that?
A. Well, there's various ways. A lot --

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when a customer has a significant change as they're going to grow or -- or put on new equipment, they come to me. And like I said, I've been in this role for a long time. They know me very well. And they know they need to come to me with -- if they're going to

[91/] Tr. 156.

have some kind of a change.[92]

And Mr. Gottsch had to agree that the variances shown from Aquila's own records (Exhibit 9) were significant:

> Q. And let's look at -- oh, just pick one here, Triumph. 683-- I'm looking at 2006, at least
>
> 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***.[93]

These variances ought to have attracted Aquila's attention. Yet they did not. Instead, Aquila kept on "mechanically and proportionally" purchasing fixed price NYMEX positions.[94]

b. Aquila Developed the Forecasts, Not Customers.

It is also clear on this record that Mr. Fangman developed "numbers" from the customers about usage information and passed them up the line. This was his primary responsibili-

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[92] Tr. 268-69.

[93] Tr. 222-23 (emphasis added),

[94] Clemens Direct, Ex. 101, Schedule GLC-2, p. 4.

ty.[95] With all this, it is overwhelmingly clear that Aquila did the forecasting.

> A. I believe the forecast is a forecasting of the loads for these customers. A budget entails much more than just the forecast.
> Q. So let me just quickly replay. Sometime I think you said in June of 2005 you would have done a forecast, I think basically -- basically using your terminology. That would have covered '06, '07 and '08. Right?
> A. Correct.[96]

> A. The actual budgets for those years, those forecasts would have been done in the -- like I said, in the June time frame. So for the 2006 budget, it would have been done in the June of 2005 time frame. And -- and so on. ***And in those -- in those budgets, I would typically work with Tim Nelson who would prepare and -- and do the forecast.***[97]

And, not only that, but Mr. Rush confirmed, based on his experience, that the process was often unreliable.

> 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.[98]

The evidence is clear. Aquila -- more specifically -- Mr. Tim Nelson for the periods involved -- prepared the forecast. And based on Mr. Rush's testimony, Aquila should have known that there was a good chance that the forecasts were off. Accordingly, locking in a position in a group of hedges with an expectation that the market would climb was simply imprudent.

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[95] Tr. 267, ll. 22-24; Tr. 268-69.

[96] Tr. 271.

[97] Tr. 270.

[98] Tr. 311.

In summary, Aquila did not explain to its six steam customers its intent to implement a particular hedge program for natural gas in the steam business and most certainly did not solicit their input. Mr. Fangman, the man with job of customer communication was not even aware of the program until he was made aware of its existence well after implementation when the problems had surfaced.

With great fanfare GMO trumpets the Brubaker testimony that mentions hedging with favor and GMO even went so far as to reveal settlement discussions that pertained to the electric case -- with the assumption that the programs were one and the same. They were not, nor should they have been. The circumstances were different. Electric was operating under an IEC mechanism; there was no fuel rider. Moreover, the steam QCA did not exist when the testimony was submitted and the discussions in the electric case, which were needlessly revealed, pertained only to a discussion of hedging for the electric business.

c. Imprudence Has Been Established.

AGP's issue, alleged imprudence for failure to consult customers, stands. The best GMO can muster is customer knowledge of a hedge program conceived for the electric business under different circumstances. Even so, the program was hardly one of unquestioned prudence. Questions about the electric program were raised by Staff while the program was underway, but to no avail. The only adjustment to the steam program came with its suspension

at the behest of AGP in 2007 -- when the problems were manifest. Even then, it was at the ***customers'*** initiative while Aquila plowed forward relentlessly, regardless of result. Sadly, Mr. Gottsch states that he could have easily adjusted the program had he been given such direction from management, but none came. It was the customers that put a stop to the financial hemorrhage that was the Aquila steam hedge program for natural gas. Here again, there is no affirmative display of prudence from GMO; there is only inconsequential bombast on matters that miss the point.

This is a case of saying one thing and doing something quite different. Aquila asserted monitoring and adjustment as needed. The reality was only one adjustment as a part of the forecast of natural gas needs prepared in summer of 2006. The huge errors in volumes went forward unchecked and unadjusted.

Customers provided forecast of increasing steam usage. Indeed, their usage increased markedly, although not to the full extent anticipated by Aquila. It is a sad commentary that no one at Aquila kept their eye on the ball for the hedge program. There is a record of customer cooperation that was documented by Mr. Fangman. Information was provided whenever requested of customers. Yet Aquila could not figure out how to effectively use the information and seems oblivious to its limitation.

Judge Dippell asked Mr. Rush if there had been uncertainties is past forecasts. Mr. Rush gushed about the experience from earlier years when he was affiliated with the St. Joseph

steam business. It was a brief respite to see the candor in his answer. But the message was simple. Forecasts of customer steam usage were uncertain and the uncertainly was long documented, even if underappreciated, misunderstood, or simply ignored by the Aquila management when it designed and managed the steam hedging program.

The affirmative defense was that customers provided input used by Aquila in preparation of its forecast. True, but hardly dispositive. The input had to be interpreted first and then used in a forecast of system sales. From this there could proceed an Aquila analysis of base load coal fuel usage and natural gas usage, matters on which customers had no input whatsoever. In the end even this misdirected and meager defense in the name of prudence fails when Mr. Rush, in a moment of candor, admits that such problems were always a part of the business dating back to his work there many years earlier.

There is no credible defense of the lack of adjustment. Mr. Gottsch said he could have easily and quickly adjusted. In the description of the program review and adjustments were part of it. In reality, the program as approved and implemented had only a single review during the summer of 2006. The allegation was based on a demonstration that review had quite obviously not been adequate. As the record has made clear, review and adjustment, were virtually nonexistent. Mr. Gottsch's ability to adjust was there, but no one was watching the program and it was left to continue on its ill-fated course.

AGP has alleged and shown imprudence. GMO, with its affirmative burden to show prudence utterly fails.

10. What is the amount that is subject to refund to steam customers for the 2006 collection period?

This issue ends up being not contested. Mr. Johnstone testified that the 2006 net cost of the hedging program was $1,164,960.[99/] This figure was also confirmed on Exhibit 10. 80% of this amount was collected from customers so the refund amount for the 2006 collection period is $931,968.

Mr. Rush agrees with this number based on his testimony corrections.[100/]

11. What is the amount that is subject to refund to steam customers for the 2007 collection period?

This issue also ends up uncontested. Mr. Johnstone testified that the 2007 net cost of the hedging program was $2,441,861.[101/] This figure was also confirmed on Exhibit 10. 80% of this amount was collected from customers so the refund amount for the 2007 collection period is $1,953,488.[102/]

Mr. Rush agrees with this number based on his testimony corrections.[103/]

[99/] Johnstone Rebuttal, Ex. 2, p. 30, l. 9.

[100/] Tr. 297, l. 17.

[101/] Johnstone Direct, Ex. 1, p. 30, l. 9.

[102/] Johnstone Rebuttal, Ex. 2, l. 11.

[103/] Tr. 297, l. 19.

IV. CONCLUSION

AGP has raised the issue of Aquila's prudence in several particulars. The initial decision to employ a steam hedging strategy that mimicked Aquila's IEC-driven hedging strategy, without analysis of what was needed, whether portions of the natural gas used for steam was a base load or a swing load, and completely ignored the implications of the QCA that had been ordered was imprudent. Aquila was grossly imprudent in forecasting its needs. Aquila was imprudent in failing to adjust its hedges downward when the overhedging situation was discovered. And Aquila was imprudent in betting against the customers by selling puts in order to collect a premium at the expense of customers. When this structure collapsed, Aquila acknowledged that it was "too late" to fix, and charged the customers the cost of the collapse.

Aquila bears the burden of proving that it was prudent in its activities. It did not, nor could it. The charges were collected from customers subject to refund, and Aquila, and now GMO as the newly-renamed company, should now make that refund by calculating the amounts that were overcharged the six customers, then establishing a credit for each of them to offset current

charges. Should any customers have left, the amount of their overcharges should be refunded by payment to those customers.

Respectfully submitted,

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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

January 11, 2011