Exhibit No.:
Issue: Fuel Hedging
Witness: Blake A. Mertens
Type of Exhibit: Surrebuttal Testimony
Sponsoring Party: Empire District Electric
Case No. ER-2016-0023
Date Testimony Prepared: May 2016

Before the Public Service Commission

of the State of Missouri

Surrebuttal Testimony

of

Blake A. Mertens

May 2016

EMPIRE
SERVICES YOU COUNT ON

SURREBUTTAL TESTIMONY
OF
BLAKE A. MERTENS
THE EMPIRE DISTRICT ELECTRIC COMPANY
BEFORE THE
MISSOURI PUBLIC SERVICE COMMISSION
CASE NO. ER-2016-0023

INTRODUCTION

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

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

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. The Empire District Electric Company ("Empire" or "Company"). I am Vice President Energy Supply and Delivery Operations.

Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND.

A. I graduated from Kansas State University in 2000 with a Bachelor of Science Degree in Chemical Engineering and a minor in Business. I received a Masters Degree in Business Administration from Missouri State University in December 2007. I am also a professionally licensed engineer in the state of Kansas.

Q. HAVE YOU PREVIOUSLY PRESENTED TESTIMONY BEFORE THE MISSOURI PUBLIC SERVICE COMMISSION ("COMMISSION")?

A. Yes. I have presented testimony in several Empire rate cases.

Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY IN THIS CASE?

A. I respond to the assessment and assertions made by Office of Public Council (OPC) witness John S. Riley regarding Empire's fuel hedging practices and demonstrate why

Mr. Riley's recommendation that Empire "cease its current natural gas hedging policy" is unfounded.

Q. DOES EMPIRE HAVE A COMPREHENSIVE HEDGING POLICY IN PLACE?

A. Yes. Empire first implemented its Energy Risk Management Policy ("RMP") in 2001. While slight modifications have been made throughout the years largely to update organizational or nomenclature changes, the most substantive of which was prior to the SPP IM going live to reflect changes in daily processes and reflect transmission congestion rights procurement practices, our natural gas hedging policy and practices have remained consistent.

Q. HAS THE COMMISSION BEEN INVOLVED WITH THE HEDGING PROGRAMS OF MISSOURI'S ELECTRIC UTILITIES?

A. Yes. By order issued September 5, 2012, the Commission opened an investigatory docket, File No. EW-2013-0101, to review the hedging policies and procedures of Missouri's electric utilities "to assist the utilities with developing effective hedging programs that serve the public interest by mitigating the rising costs of fuel." As part of that docket, Staff presented 12 questions to the utilities. Empire provided its responses on July 3, 2013.

Q. DID THE COMMISSION REACH ANY CONCLUSIONS IN FILE NO. EW-2013-0101?

A. In its Order Closing File issued on April 16, 2014, the Commission stated that there is no broad agreement about how to evaluate whether an electric utility's gas hedging program is cost effective and noted the challenges of judging a hedging program.

Q. DO YOU BELIEVE EMPIRE'S RMP IS A PROPER ISSUE FOR THIS RATE CASE?

A. No. Empire's RMP is a complex and lengthy document and would be better addressed in a docket devoted exclusively to hedging strategy. Also, the prudence of Empire's fuel costs (including hedging costs) has been the topic of five fuel prudency reviews.[1]

Q. WHAT ELSE HAS EMPIRE DONE TO KEEP INTERESTED PARTIES APPRISED OF THE COMPANY'S NATURAL GAS HEDGING ACTIVITIES?

A. Empire submits triennial Integrated Resource Planning filings and annual updates, which discuss natural gas forecast and hedged volumes, and Empire participated in Commission File No. EW-2013-0101, discussed above. Empire also included natural gas hedging strategy updates in its SPP Integrated Marketplace presentations, provided responses to data requests regarding fuel costs, and provided accounting schedules during the various general rate cases. Lastly, Empire provides Staff copies of the RMP as it is updated.

Q. HAS STAFF OR OPC SUGGESTED IMPRUDENCE IN EMPIRE'S HEDGING PRACTICES IN ANY OF THESE PROCEEDINGS?

A. No. That is what makes OPC's witness Mr. Riley's rebuttal testimony so confounding. Instead of bringing forth any potential concerns in these various dockets and working cooperatively with Empire to address any concerns, OPC seems to have waited to suggest "imprudence" in a rate case simply because Empire's

[1] File Nos. EO-2010-0084, EO-2011-0285, EO-2013-0114, EO-2014-0057, and EO-2015-0214.

hedged gas prices are higher than the lowest spot natural gas prices seen in the market in 15-plus years.

Q. PLEASE EXPLAIN HOW THE STRATEGIES SET FORTH IN EMPIRE'S RMP ARE MISREPRESENTED IN MR. RILEY'S REBUTTAL TESTIMONY.

A. On page 4 of his rebuttal testimony, Mr. Riley states that the "sole purpose of Empire's natural gas hedging policy is to mitigate price volatility." This is blatantly false. Also, on page 6 of Mr. Riley's testimony, he states "OPC has received Empire's hedging policies and seen no indication reducing fuel costs through its hedging plan is even contemplated." Although Empire's RMP indicates the primary focus of its hedging strategy is price mitigation, protecting against upward price trends is also emphasized in the document. Specifically, Empire's RMP references balancing market risk with "minimizing costs and volatility" and "providing tools to mitigate adverse impacts associated with changing natural gas [prices]". As mentioned in the RMP, Empire uses a "progressive dollar cost averaging approach" for its hedging practice. This strategy provides the annual procurement boundaries with a focus on price volatility mitigation. However, within this strategy, Empire has attempted to take advantage of the lowest costs possible when procuring these hedges, by engaging in seasonal purchases when natural gas costs are historically lower. For example, the swaps Empire purchased in 2015 for delivery in years 2016-2019 were primarily (~96%) purchased in October and November which, according to the Henry Hub Natural Gas Spot Price table supplied on page 9 of Mr. Riley's rebuttal testimony, were two of the three lowest natural gas price months of the year. Although Mr. Riley endorses a price mitigation strategy with an additional focus on minimizing costs, referencing testimony from Kansas City Power & Light Company-Greater Missouri

Operations ("GMO"), he fails to acknowledge that Empire's RMP also recommends that strategy and that this strategy is reflected in Empire's procurement practices.

Q. HOW DOES MR. RILEY INDEPENDENTLY DEFINE "PRUDENTLY INCURRED HEDGING POLICIES"?

A. On page 5 of his rebuttal testimony, Mr. Riley states that "OPC defines 'prudently incurred hedging policies' as 'policies that seek to both reduce significant price volatility and upward energy price risk'." As best as I can tell, Mr. Riley is providing a definition that was generated within the OPC and is attempting to use this as the yardstick with which hedging policies should be evaluated with regard to fuel adjustment prudence. However, "prudently incurred hedging policies" are never mentioned in the 4 CSR 240-20 as criteria for inclusion in a fuel adjustment clause. 4 CSR 240-20.090 specifically mentions "prudently incurred costs" and goes on to define those as costs those that "…do not include any increased costs resulting from negligent or wrongful acts or omissions by the utility." Empire's hedging policy has been consistent, and the Company's procurement efforts have never led to increased costs due to negligence, wrongful acts, or omissions.

Q. IS EMPIRE'S HEDGING POLICY PRUDENT ACCORDING TO MR. RILEY'S DEFINITION?

A. Yes. Empire's hedging policy seeks to "both reduce significant price volatility and and upward energy price risk."

Q. DO YOU AGREE WITH MR. RILEY'S DEFINITION OF PRUDENTLY INCURRED HEDGING POLICIES?

A. No, although I certainly agree that a prudent hedging policy should *include* the goals of reducing significant price volatility and guarding against upward energy price risk.

First of all, I believe that Mr. Riley has attempted to redefine the criteria for which hedging prudence must be scrutinized because he incorrectly believes he has discovered imprudence in Empire's hedging policy. Mr. Riley then attempts to use the alleged imprudence as a reason for recommending a disallowance of hedging losses in the fuel adjustment clause. Secondly, narrowly defining a hedging policy as prudent if it seeks only to reduce upward price risk and significant volatility would be ill conceived. This narrow definition of a "prudent hedging policy" would not view a policy as imprudent if it failed to take into account creditworthiness of a counterparty or failed to require accompanying fuel runs to determine volumetric risk. In short, Mr. Riley is taking a term that is not included in the Missouri CSR regarding fuel prudency, creating his own narrow definition of that term, and then applying it to a misinterpretation of Empire's hedging policy.

Q. HOW DOES MR. RILEY'S REBUTTAL TESTIMONY MISAPPLY OTHER COMMISSION LANGUAGE FROM THE MISSOURI CODE OF STATE REGULATIONS?

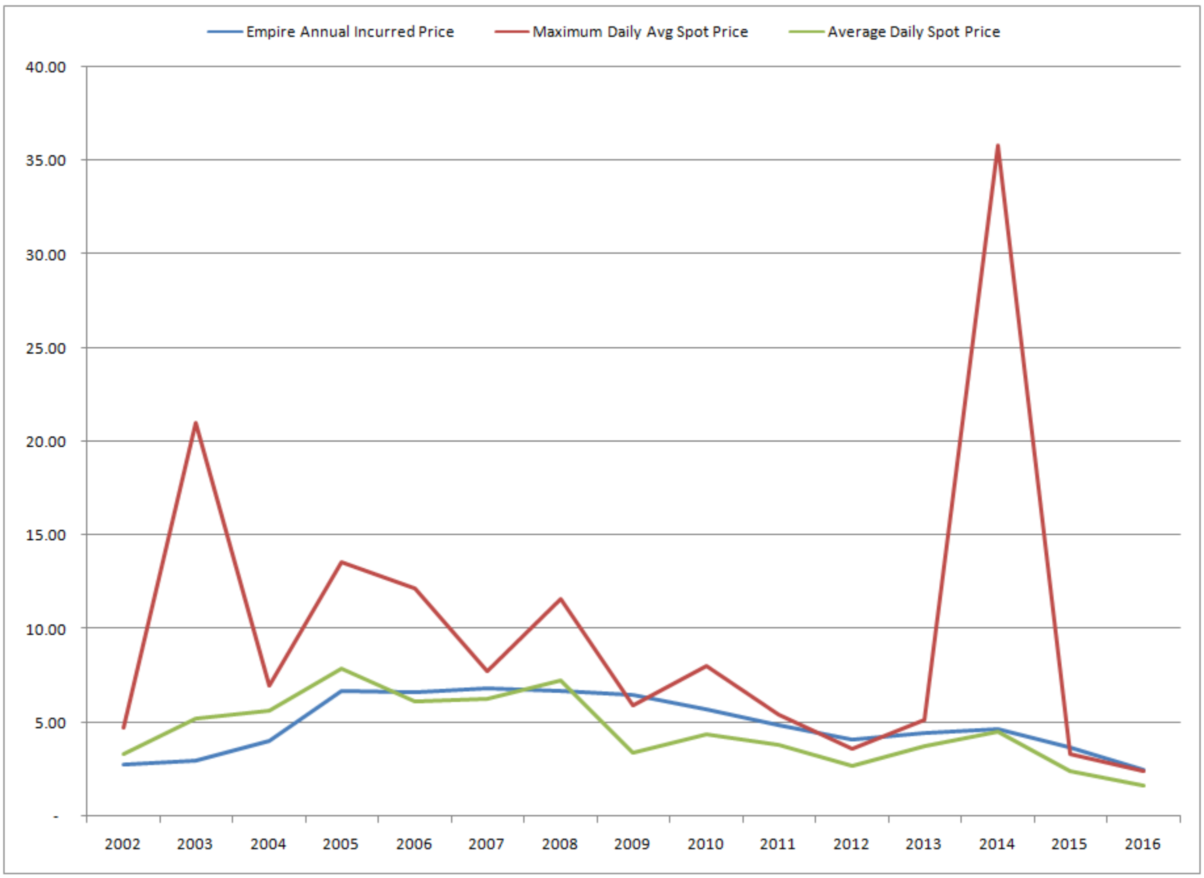
A. On page 5 of his rebuttal testimony, Mr. Riley quotes language from the Missouri CSR regarding a "…prudent effort to mitigate upward natural gas price volatility." The issue with including this language as it relates to an electric company's hedging prudency is it is pulled from chapter 40 - Gas Utilities and Gas Safety Standards. In Mr. Riley's efforts to lend some credence to his own definition of "prudence," he sought to use any language from the Missouri CSR, regardless of whether it was relevant to the existence of Empire's FAC. Further, on page 6, Mr. Riley references 4 CSR 240-3.161(3)(R) which states "Information that shows that the electric utility has in place a long-term resource planning process, important objectives which are to minimize overall delivered costs of energy." Although Mr. Riley is now in the correct chapter of the CSR, he is misrepresenting the intent of the language, as it is very clearly discussing minimizing overall delivered energy costs as it refers to long-term resource planning. Mr. Riley's quote is one of the 19 requirements for when an electric utility seeks to establish a RAM as described in 4 CSR 240-20.090(2). Although Empire clearly takes into account minimizing overall energy costs as a part of its hedging strategy, Mr. Riley's misapplication of passages from the CSR for the purpose of framing his criticism of Empire's hedging policy only seeks to add confusion to the objectives and requirements of procuring prudent fuel and purchased power costs.

Q. DOES EMPIRE AGREE WITH MR. RILEY'S CONCLUSION THAT EMPIRE'S HEDGING PROGRAM DOES NOT CONSIDER NATURAL GAS PRICE REDUCTION?

A. No. Mr. Riley's unsupported conclusion on page 10 of his rebuttal testimony that Empire has "…eliminated any focus of its hedging program on natural gas price reduction" is of particular concern. Mr. Riley has constructed a logical fallacy to suggest that the existence of Empire's FAC, which to some extent insulates the Company from hedging losses, has led Empire to adopt imprudent hedging practices. Mr. Riley's rebuttal testimony references a Henry Hub Natural Gas Spot Price table (on page 9) that illustrates a downward trend in the cost of natural gas. Mr. Riley then erroneously uses this table to imply that Empire's hedging policy is not prudent due to the losses it has incurred, without acknowledging the fact that in a declining market such losses are to be expected and are more than offset by the potential risk that has been eliminated. The table below shows that while Empire's hedging practices do not guarantee the lowest possible natural gas prices will be secured (no hedging policy does nor should purport to), it does mitigate risks associated with high natural gas prices that are seen in the spot market.

TABLE 1

Historical Natural Gas Prices



Q. PLEASE EXPOUND FURTHER ON WHAT THE ABOVE TABLE DEPICTS.

A. The line depicting Empire's Annual Incurred Price shows the dollar per decatherm ($/DTh) price Empire has incurred for natural gas historically on an average annual basis. The Maximum Annual Avg Spot Price line shows the maximum daily average spot price that occurred throughout the year. Finally, the line depicting the Average

Daily Spot Price is self explanatory but shows the annual average daily spot price. Clearly, the line graph shows Empire's average incurred natural gas price hovers near the average spot price, while offsetting risk associated with the highs seen in the market.

Q. DOES OPC POINT TO ANY SPECIFIC ALLEGED IMPRUDENCE ON THE PART OF EMPIRE?

A. No. OPC does not point to any specific activities on the part of Empire that OPC alleges are imprudent. Instead, OPC questions whether it is prudent to engage in hedging at all and asserts that Empire should cease its current natural gas hedging policy "unless Empire can show that it is prudent and reasonable to continue to hedge natural gas prices in a non-volatile natural gas market" and that all gas hedging costs should be excluded from Empire's FAC "until Empire demonstrates its natural gas hedging policy and its hedging costs are prudent and reasonable." (Riley rebuttal, p. 4)

Q. DOES EMPIRE AGREE THAT THERE IS A "NON-VOLATILE NATURAL GAS MARKET," AS ASSERTED BY OPC?

A. Empire agrees that the price of natural gas has declined over the last few years and is at lows that would not have been predicted five years ago; however, the past does not predict the future. There are many market factors that could cause a market disruption (pipeline infrastructure issues, fracking bans, regulatory or political changes, etc.) and greatly impact the price of natural gas and create volatily, thus the reason for a hedging policy to be in place.

Q. OPC RECOMMENDS THAT EMPIRE STOP USING ITS CURRENT NATURAL GAS HEDGING POLICY. DOES OPC PRESENT ANY ALTERNATIVE HEDGING POLICY?

A. No. As noted above, OPC simply questions whether it is prudent to engage in natural gas hedging at all.

Q. IS EMPIRE'S HEDGING STRATEGY PRUDENT, AND HAS EMPIRE BEEN PRUDENT IN EXECUTING ITS HEDGING STRATEGY?

A. Yes. It is Empire's belief that any prudent hedging program's primary function should be risk management, rather than market gains. However, within its framework of achieving risk management, Empire has also put a focus on avoiding the adverse impacts of rising prices when possible. An example of how Empire is achieving this balance is found when looking at the amounts hedged in the December 31, 2015 Gas Position Summary ("position report"). The volumes hedged in the position report for years 2017, 2018, 2019, & 2020 are nearly at the minimum requirements as required by the RMP. If Empire's strategy was solely to create "price predictability" as Mr. Riley alleges on page 6 of his rebuttal testimony, our end of the year 2015 hedge percentages would not be hugging the minimum guidelines as denoted in our RMP. Empire has recognized that the market was trending downward and made a conscious effort to react to the market while still remaining within the RMP guidelines, thereby ensuring a price mitigation strategy with an additional focus on minimizing cost.

Q. DO YOU AGREE WITH MR. RILEY'S SUMMATION THAT EMPIRE'S HEDGING POLICY IS NOT PRUDENT AND REASONABLE AND THUS ANY HEDGING GAINS AND LOSSES OUGHT TO BE EXCLUDED FROM FUEL ADJUSTMENT CLAUSE RECOVERY?

A. No. Empire has been found to be prudent in ALL five of its FAC audits[2]. The overall policies and practices governing Empire's fuel hedging program have remained consistent since these reviews.

Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?

A. Yes, it does.

[2] File Nos. EO-2010-0084, EO-2011-0285, EO-2013-0114, EO-2014-0057, and EO-2015-0214.

AFFIDAVIT OF BLAKE A. MERTENS

STATE OF MISSOURI)
) ss
COUNTY OF JASPER)

On the 13th day of May, 2016, 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 13th day of May, 2015.

NOTARY PUBLIC
NOTARY SEAL
STATE OF MISSOURI

JANET L. HUNLEY
My Commission Expires
September 20, 2019
Jasper County
Commission #15243846

Janet L. Hunley
Notary Public

My commission expires: Sept 20, 2019.