Missouri Public Service Commission

Judge or Division:	Appellate Number:
Appellant: KCP&L Greater Missouri Operations Company vs.	Missouri Public Service Commission File Number: HC-2010-0235
Respondent: Missouri Public Service Commission	

(Date File Stamp)

Notice of Appeal

Notice is given that KCP&L Greater Missouri Operations Company appeals to the Missouri Court of Appeals

☒ Western ☐ Eastern ☐ Southern District.

Date Notice of Appeal Filed
(to be filled in by Secretary of Commission)

Signature of Attorney or Appellant

The notice of appeal shall include the appellant's application for rehearing, a copy of the reconciliation required by subsection 4 of section 386.420, a concise statement of the issues being appealed, a full and complete list of the parties to the commission proceeding, and any other information specified by the rules of the court. The appellant(s) must file the original and (2) two copies and pay the docket fee required by court rule to the Secretary of the Commission within the time specified by law. **Please make checks or money orders payable to the Missouri Court of Appeals.** At the same time, Appellant must serve a copy of the Notice of Appeal on attorneys of record of all parties other than appellant(s), and on all parties not represented by an attorney.

CASE INFORMATION

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Date of Commission Decision:	Date of Application for Rehearing Filed:	Date Application for Rehearing Ruled On:
September 28, 2011	October 7, 2011	November 2, 2011

DIRECTIONS TO COMMISSION

A copy of the notice of appeal and the docket fee shall be mailed to the clerk of the appellate court. Unless otherwise ordered by the court of appeals, the commission shall, within thirty days of the filing of the notice of appeal, certify its record in the case to the court of appeals.

FILED

DEC 2 2011

Missouri Public
Service Commission
1:19pm MA

Certificate of Service

I certify that on December 2, 2011 (date), I served a copy of the notice of appeal on the following parties, at the following address(es), by the method of service indicated.

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APPLICATION FOR REHEARING

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

Ag Processing, Inc., a Cooperative, Complainant, v. KCP&L Greater Missouri Operations Company, Respondent.	)))))))))	Case No. HC-2010-0235

**APPLICATION FOR REHEARING OF
KCP&L GREATER MISSOURI OPERATIONS COMPANY**

KCP&L Greater Missouri Operations Company, formerly known as Aquila, Inc. ("GMO" or "Company"),[1] applies for rehearing of the Report and Order issued by the Commission on September 28, 2011 ("Report and Order"), pursuant to Section 386.500.1[2] and 4 CSR 240-2.106. In support of its application, the Company states as follows:

I. Legal Principles that Govern Applications for Rehearing.

1. All decisions of the Commission must be lawful, with statutory authority to support its actions, as well as reasonable. State ex rel. Ag Processing, Inc. v. PSC, 120 S.W.3d 732, 734-35 (Mo. banc 2003). An order's reasonableness depends on whether it is supported by substantial and competent evidence on the record as a whole. State ex rel. Alma Tel. Co. v. PSC, 40 S.W.3d 381, 387 (Mo. App. W.D. 2001). An order must not be arbitrary, capricious, or unreasonable, and the Commission must not abuse its discretion. Id.

2. In a contested case, the Commission is required to make findings of fact and conclusions of law pursuant to Section 536.090. Deaconess Manor v. PSC, 994 S.W.2d 602, 612 (Mo. App. W.D. 1999). For judicial review to have any meaning, it is a minimum

[1] The Company will frequently be referred to as "Aquila" in this pleading since the subject matter of this proceeding relates to the steam hedging program implemented by Aquila in 2006 and 2007.
[2] All citations are to the Missouri Revised Statutes (2000), as amended.

requirement that the evidence, along with the explanation thereof by the Commission, make sense to the reviewing court. State ex rel. Capital Cities Water Co. v. PSC, 850 S.W.2d 903, 914 (Mo. App. W.D. 1993). In order for a Commission decision to be lawful, the Commission must include appropriate findings of fact and conclusions of law that are sufficient to permit a reviewing court to determine if it is based upon competent and substantial evidence. State ex rel. Monsanto Co. v. PSC, 716 S.W.2d 791, 795 (Mo. banc 1986); State ex rel. Noranda Aluminum, Inc. v. PSC,24 S .W.3d 243, 246 (Mo. App. W.D. 2000); State ex rel. A.P. Green Refractories v. PSC, 752 S.W.2d 835, 838 (Mo. App. W.D. 1988); State ex rel. Fischer v. PSC, 645 S.W.2d 39, 42-43 (Mo. App. W.D. 1982), cert. denied, 464 U.S. 819 (1983).

3. In State ex rel. GS Technologies Operating Co. v. PSC, 116 S.W.3d 680, 691-92 (Mo. App. W.D. 2003), the Court of Appeals described the requirements for adequate findings of fact when it stated:

> While the Commission does not need to address all of the evidence presented, the reviewing court must not be "left 'to speculate as to what part of the evidence the court found true or was rejected.'" ... In particular, the findings of fact must be sufficiently specific to perform the following functions:
>
> > [F]indings of fact must constitute a factual resolution of the matters in contest before the commission; must advise the parties and the circuit court of the factual basis upon which the commission reached its conclusion and order; must provide a basis for the circuit court to perform its limited function in reviewing administrative agency decisions; [and] must show how the controlling issues have been decided[.]
>
> [St. Louis County v. State Tax Comm'n, 515 S.W.2d 446, 448 (Mo. 1974) (citing Iron County v. State Tax Comm'n, 480 S.W.2d 65 (Mo. 1972))].

4. The Commission cannot simply recite facts on which it bases a "conclusory finding," and must "fulfill its duty of crafting findings of fact which set out the basic facts from which it reached its ultimate conclusion" in a contested case. Noranda, 24 S.W.3d at

246. "Findings of fact that are completely conclusory, providing no insights into how controlling issues were resolved are inadequate." Monsanto, 716 S.W.2d at 795.

5. A review of the evidentiary record in this case demonstrates that the Report and Order failed to comply with these principles in certain respects and that rehearing should be granted as to the issues discussed below.

II. Issues on Which Rehearing is Sought.

6. The Commission found that Aquila was prudent in adopting a natural gas hedging program (Report and Order ¶ 25 at 9-10), and that Aquila's hedging program was prudently designed (Report and Order ¶ 31 at 11). Nevertheless, the Commission found that Aquila's hedging program was imprudently implemented because Aquila listened to, and believed, its five industrial customers regarding their estimated volume requirements of steam. (Report and Order ¶¶ 44-48 at 14-16).

7. In so finding, the Commission set an unreasonable and dangerous standard. Not only are a utility's industrial customers in the best position to estimate their volume requirements, as they possess all of the knowledge and expertise to make such an estimation (particularly in the instance of new load requirements), but a utility simply is not in the business of second guessing sophisticated industrial customers' volume estimations. A utility's business is quite the opposite, as a utility is obligated to provide adequate service. See Mo. Rev. Stat. § 393.130.1.

8. The Commission's finding of imprudence not only is unreasonable, but it is contrary to the Commission's "just and reasonable" prudence standard, whereby the prudence of a utility's costs is not based upon hindsight. Judging a utility's costs with the benefit of 20/20 hindsight, as the Commission did in this instance, allows for no range of reasonable deviation from perfect knowledge. Because the Commission erroneously found that Aquila was imprudent

for hedging based upon forecasted volumes of steam that its business customers told it they would require, its shift of the burden of proof from the complainant to Aquila was in error.

9. Even assuming that the Commission's shifting of the burden of proof was not in error, the Commission erroneously found that Aquila failed to meet its burden of dispelling purported doubts raised by the complainant and proving that the hedging program was operated prudently. So too did the Commission erroneously sustain the objection to proper rebuttal testimony, denying the Company the opportunity to dispel doubts and denying it due process of law.

10. Upon its finding of imprudence, the Commission improperly calculated the measure of damages, improperly and unlawfully expanded the scope of the Complaint to other steam customers in violation of the Quarterly Cost Adjustment Rider, and improperly failed to grant the Company's Motion to Dismiss.

11. As each of these errors renders the Report and Order unreasonable and unlawful, rehearing should be granted as to the errors discussed more fully in the sections that follow.

A. The Commission Erroneously Shifted the Burden of Proof to Aquila by Finding that Aquila Improperly Relied on its Five Industrial Customers' Volumes Estimates.

12. The Commission erroneously found that Aquila was negligent in relying on its customers' estimates and that, consequently, the operation of its hedging program was imprudent. (Report and Order ¶ 48 at 16). Without any citation to the record or law, the Commission concluded that "Aquila knew that those customer estimates were not reliable and had an obligation to structure its hedging program to account for the uncertainty of volumes of gas." Id. Such a conclusory finding is inadequate. Monsanto, 716 S.W.2d at 795.

13. A review of the evidentiary record demonstrates that the Commission failed to consider substantial and competent evidence that Aquila's forecasts of its customers' load were based upon its regular communications with customers who assured the Company of their load requirements, that Aquila had a duty to rely on its customers' estimates, and that the One-Third Strategy accounted for uncertainty of volumes of gas. Not only is a finding that Aquila was negligent in relying on its customers' estimates unreasonable and not supported by adequate findings of fact, but Aquila's reliance on customer information, even if erroneous, is not negligence. Thus, the Commission erroneously shifted the burden of proof to Aquila when it found that Aquila failed its purported duty to determine the reasonableness of its customers' estimates. (Report and Order ¶ G at 18).

(1) <u>Aquila Had No Basis to Doubt Its Industrial Customers' Estimates</u>.

14. The evidence shows that the five steam customers assured Aquila that that they would increase volumes to forecasted levels. (Ex. 102 at 11; Ex. 103 at 6-10). Contrary to the representation in the Report and Order that Company witness Joseph Fangman "periodically spoke with customers about their anticipated need for steam" (Report and Order ¶ 45 at 15), Mr. Fangman testified that he talked with steam customers about their operations and load requirements "on a regular basis." (Tr. [Fangman] at 269; Ex. 103 at 4). As noted in Mr. Fangman's Direct Testimony, assurances by Aquila's steam customers with regard to their load estimates continued throughout 2005 into 2007. (Ex. 103, Schedule JGF-3 at 17). Indeed, the information upon which Aquila launched its steam hedging program in mid-February 2006 was based upon an update that occurred days earlier. (Tr. [Gottsch] at 229-30, 252; Tr. [Fangman] at 274, 285-86; Ex. 102 at 13; Ex. 102 at Schedule GLG-2). Such efforts by both Mr. Fangman and Company witness Gary Gottsch continued into 2007. (Ex. 103 at Schedule JGF-13; Tr. [Gottsch] at 252-53).

15. What's more, the customers' estimated load requirements were largely based on new load. (Tr. [Johnstone] at 84-85; Ex. 104 at 10). Thus, Aquila did not have historical load data upon which to judge its customers' needs, and therefore had no basis to know that its customers' estimates were unreliable. (Tr. [Johnstone] at 85).

16. The Commission also inaccurately stated that "[t]he record does not indicate how Tim Nelson prepared his forecasts because he did not testify." (Report and Order ¶ 45 at 15). On the contrary, the record is replete with evidence as to Aquila's preparation of forecasts. Mr. Fangman testified that he worked on the forecasts of loads. (Tr. [Fangman] at 271). Mr. Fangman further explained in detail the forecasting of natural gas requirements in his Direct Testimony, the stated purpose of which "is to describe the process for preparing forecasts and annual sales budgets for steam operations at the St. Joseph Lake Road Generating Station." (Ex. 103 at 2). As Mr. Fangman explained in his Direct Testimony, "forecasts were prepared based on sales history and on customer projections for large industrial loads." (Ex. 103 at 3). Furthermore, Mr. Fangman reviewed Mr. Nelson's forecasts for reasonableness, based on the information steam customers had given Mr. Fangman regarding their anticipated steam load requirements. (Tr. [Fangman] at 276-77, 288). Mr. Fangman would make sure that steam customers' anticipated load requirements were reflected in the forecasts, and would make adjustments to Mr. Nelson's forecasts if needed. (Tr. [Fangman] at 276-77, 288 at 3-23; Ex. 103, Schedules JGF-2 at 9-14, JGF-3, and JGF-13).

17. There is no proper basis in the record for the Commission's findings that Aquila knew that its customers' estimates were unreliable, and the Commission failed to consider competent and substantial evidence in the record regarding Mr. Fangman's contacts with customers, the fact that there was little historical data upon which to judge customers'

needs, and the process of forecasting. As a result, the Report and Order is unreasonable, arbitrary, capricious, and not supported by adequate findings of fact.

(2) Aquila Had a Duty To Rely on Its Customers' Estimates.

18. Based on evidence that one industrial customer failed to increase production to anticipated levels, the Commission concluded "Aquila was aware that its customer's [*sic*] estimates of steam usage were unreliable" without setting out adequate facts from which it reaches this ultimate conclusion. (Report and Order ¶ 47 at 15-16). Such evidence is not only an inadequate basis from which to draw the conclusion that Aquila should not trust any of its customers, but also runs contrary to Aquila's duty to ensure reliable steam service, which the Commission recognized. (Report and Order ¶ 48 at 16).

19. While Mr. Fangman acknowledged that customers' estimates were not always accurate, the estimates were nevertheless based on the five customers' best estimates at the time they were provided. Significantly, Aquila's duty to provide safe and adequate service prevented it from second guessing its customers' needs. The evidence shows that it is critical to the operations of its steam customers that Aquila meet its customers' capacity and operational needs. (Tr. [Fangman] at 294; Ex. 104 at 7-8). For this reason, Aquila had an obligation to pay attention to the anticipated load growth of its steam customers. (Tr. [Johnstone] at 85). See also MO. REV. STAT. § 393.130.1 (obligation to provide "safe and adequate" service and facilities). Consequently, Mr. Fangman testified that Aquila spent a great deal of time with the customers in order to gain an understanding of their needs. (Ex. 103 at 4-7).

20. Because the Commission failed to consider competent and substantial evidence in the record concerning Aquila's duty to ensure reliable steam service, the Report and Order is unreasonable, arbitrary, capricious, and not supported by adequate findings of fact.

(3) Aquila Did Structure its Hedging Program to Account for Volume Uncertainty.

21. Not only did Aquila adjust its forecasts and hedge purchases in light of customer requirements, but uncertainty in volumes was accommodated by the One-Third Strategy, which had the capacity to manage downward volume variances of as much as 66%. (Ex. 105 at 11, 18). Nevertheless, the Commission relied on its unsupported statement that Aquila "had an obligation to structure its hedging program to account for the uncertainty of volumes of gas" in reaching its conclusion that Aquila was negligent in relying on its customers' estimates and that, consequently, the operation of its hedging program was imprudent. (Report and Order ¶ 48 at 16).

22. The Commission plainly failed to recognize the evidence in the record that Aquila's One-Third Strategy did account for such uncertainty. As explained by Company witness William Edward Blunk, only the one-third consisting of fixed-price futures contracts locked Aquila into gas purchases. (Ex. 105 at 11, 18). Because one-third of the forecast volume requirements was not hedged and one-third of the forecast volume was hedged using options, 66% of the forecast had the ability to float with fuel requirements. (Ex. 105 at 18). If volumes fell, the Company was not required to exercise its options contracts and the remaining third that was left open for as-needed purchases on the spot market. Thus, by design and in operation, Aquila's One-Third Strategy provided for the chance of reduced load and properly managed any variance between steam customers' projected load requirements and actual usage. Id. Importantly, the Commission appears to have forgotten its conclusion earlier in the Report and Order that Aquila's hedging program was prudently designed. (Report and Order ¶ 31 at 11).

23. In short, Aquila's steam hedging program clearly managed the risk of actual burn below forecasted volumes. That the Report and Order finds otherwise is unreasonable, arbitrary, and capricious.

(4) The Commission Erroneously Shifted the Burden of Proof to Aquila.

24. Without citing to the record or any law, the Commission stated in its Report and Order that "it was Aquila's responsibility to determine the reasonableness of its customer's estimates [of steam usage]." (Report and Order ¶ 48 at 16). The Commission's statements are completely conclusory, and the Report and Order provides no adequate findings of fact or conclusions of law for the Commission's assigning to Aquila the responsibility to determine whether its customers' volume estimates are reasonable.

25. Furthermore, the law on prudence requires that judgments be evaluated on the information that was available at the time. Aquila operated its hedging program to account for the estimated load requirements given to it by its five industrial customers, as it had no indication at that time that its customers' estimates of their business needs should not have been trusted. Yet the Commission effectively found that there is no reasonable level of forecast error, and judged Aquila's decisions from a position of perfect hindsight. In so doing, the Commission disregarded its "just and reasonable" standard to determine whether a utility's costs meet the prudence requirement. See In re Union Electric Co., 27 Mo. PSC (N.S.) 183, 193 (1985). According to the Commission, such a determination should not be based upon hindsight, but rather upon a reasonableness standard:

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

Id. at 194 (quoting Consolidated Edison Co. of New York, Inc., 45 P.U.R. 4th 325, 331 (N.Y. P.S.C. 1982)).

26. Reviewing courts recognize this standard, holding that the Commission "looks at whether the utility's conduct was reasonable at the time, under all of the circumstances." State ex rel. GS Technologies Operating Co. v. PSC, 116 S.W.3d 680, 693–94 (Mo. App. W.D. 2003). See also State ex rel. Associated Natural Gas Co. v. PSC, 954 S.W.2d 520, 529 (Mo. App. W.D. 1997).

27. The Commission confirmed that it is inappropriate to use "the benefit of 20/20 hindsight" when it determined that the adoption of Aquila's hedging program was not imprudent. (Report and Order ¶ 25 at 10). The Commission went on to state in its Report and Order that "[t]he prudence standard does not require that Aquila correctly foresee the direction the natural gas market will take." (Report and Order ¶ 36 at 12). Nevertheless, in reaching its determination that the operation of Aquila's hedging program was imprudent, the Commission engaged in exactly that 20/20 hindsight review by requiring that Aquila correctly foresee the direction that its customers' usage will take.

28. Resting on 20/20 hindsight, the Commission stated that "[t]he problem is that Aquila chose to purchase financial instruments to hedge much more gas than it actually burned" without analyzing why Aquila made that "choice." (Report and Order ¶ 37 at 13). Indeed, as discussed above and as demonstrated repeatedly in the evidence, Aquila chose to hedge the volumes that it did based on assurances from the five industrial customers that they would require their estimated volumes. (Ex. 102 at 11; Ex. 103 at 4, 6-10, Schedule JGF-3 at 17). Yet the Commission concluded that Aquila should have foreseen that the growth plans of its steam customers would not be fully realized. (Report and Order ¶ 48 at 16). Aquila, a regulated utility, is not in the business of determining whether a pork processing plant will ramp

up production as quickly as it anticipates or whether a crop protection chemical plant will increase production to the levels it claims. It is improper for the Commission to hold Aquila to decisions it could have made only with the benefit of hindsight. It is inappropriate for the Commission to allow no range of deviation from perfect knowledge. It is unreasonable for the Commission to conclude that there is no reasonable level of forecast error.

29. Nevertheless, the Commission relied exclusively on hindsight to determine that Aquila should have known that its customers' estimates would turn out to be unreasonable, and therefore shifted the prudence burden to Aquila. (Report and Order ¶ G at 18). Because the Commission's finding that Aquila was negligent in relying on its customers' estimates is unreasonable, not supported by adequate findings of fact and conclusions of law, and contrary to the Commission's own "just and reasonable" prudence standard, the Commission erroneously shifted the burden of proof to Aquila.

B. Assuming that the Commission did not Improperly Shift the Burden of Proof to Aquila, the Company Met Its Burden of Proof.

30. The Commission erroneously found that Aquila failed to meets its burden of dispelling purported doubts raised by AGP and proving that the hedging program was operated prudently. (Report and Order ¶ 44 at 14-15). As discussed above, the record is replete with evidence demonstrating that Aquila acted properly.

31. First, Aquila prudently administered its One-Third Strategy by hedging to the most accurate volumes possible, based on information received directly from steam customers who continued to assure Aquila that their operations would require such levels of service. (Tr. [Gottsch] at 229-30, 252; Tr. [Fangman] at 268-79, 285-86, 288; Ex. 102 at 11, 13, Schedule GLG-2; Ex. 103 at 4, 6-10, Schedule JGF-2 at 9-14, Schedule JGF-3 at 17, JGF-13).

32. Second, sophisticated industrial customers are in the best position to determine their steam load requirements, and Aquila has a duty to them to ensure reliable steam service. (Tr. [Johnstone] at 85; Tr. [Fangman] at 294; Tr. [Rush] at 311-313; Ex. 103 at 4-7; MO. REV. STAT. § 393.130.1). Aquila's steam customers are large businesses with expertise in their products and knowledge of what is required to produce those products. Because their loads did not materialize to the level that they had planned does not mean that imprudence on the part of Aquila occurred. Additionally, Aquila entered into the steam hedge program during a time in which analysts expected the United States to be in a supply-limited natural gas environment with a number uncertainties concerning that supply. (Ex. 105 at 21-22). Aquila fulfilled its duty to ensure reliable steam service by using the volume estimates provided to it by those customers in the operation of its steam hedge program. Id.

33. Third, Aquila adjusted its forecasts and hedge purchases in light of changing customer requirements. (Tr. [Gottsch] at 229-30, 239-40, 252-53; Tr. [Fangman] at 271, 275, 285-86; Ex. 102 at 11-13, Schedule GLG-2, Schedule GLG-3; Ex. 103 at 3-5, 8, Schedule JGF-4, Schedule JGF-5, Schedule JGF-6, Schedule JGF-7, Schedule JGF-11, Schedule JGF-13).

34. Finally, uncertainty in volumes is accommodated by the One-Third Strategy, which has the capacity to manage downward volume risk of as much as 66%, as discussed above. (Ex. 105 at 18).

35. There is no proper basis in the record for the Commission's finding that Aquila failed to meet its burden of proof, and the Commission failed to consider competent and substantial evidence in the record regarding Aquila's prudent administration of its steam hedging program. As a result, the Report and Order is unreasonable, arbitrary, and capricious.

C. Assuming that the Commission did not Improperly Shift the Burden of Proof to Aquila, the Commission Improperly Sustained the Objection to Proper Rebuttal Testimony Offered by the Company, Denying it the Opportunity to Dispel Doubts and Denying it Due Process of Law.

36. As noted by the Commission, "[i]n form, this is a complaint brought by AGP against Aquila/KCPL-GMO. Normally in a complaint brought before the Commission, the burden of proof would be on AGP, the complainant, as the party asserting the affirmative on the issue of the utility's imprudence." (Report and Order ¶ A at 16). Because this case was tried as a complaint, complainant Ag Processing ("AGP") was afforded the opportunity to submit both direct and rebuttal testimony. It did just that, on September 22, 2010 and November 5, 2010, respectively. Because of the presumption of prudence and the structure of the proceeding, Aquila was afforded the opportunity to file only direct testimony, which it did on October 22, 2010. Aquila did not have the opportunity to rebut claims raised or clarified by AGP subsequent to the filing of Aquila's direct testimony.

37. Relying on AGP's rebuttal testimony, the Commission found that "[t]hroughout the years in question, Aquila's forecasted/budgeted natural gas usage far exceeded the actual amounts burned for steam production." (Report and Order ¶ 44 at 14, citing Johnstone Rebuttal, Ex. 2, Page 22, Chart Reb-2). This finding served as the linchpin for its Conclusion of Law in paragraph G, where the Commission determined that such variation "is sufficient to demonstrate a serious doubt as to the prudence of Aquila's operation of that hedging program. Thus, the initial presumption of prudence is overcome, and the burden shifts to Aquila to dispel those doubts and prove that the hedging program was operated prudently. Aquila has failed to meet the burden." (Report and Order ¶ 44 at 15) (emphasis added).

38. The Commission "concluded that AGP demonstrated serious doubt about the prudence of Aquila's decisions regarding its gas-cost hedging program. Therefore,

Aquila/KCPL-GMO must shoulder the burden proving that those decisions were prudent." (Report and Order ¶ G at 18).

39. Nowhere does the Commission account for the fact that Aquila was not afforded the opportunity to dispel the doubt created by AGP witness Donald Johnstone's Rebuttal testimony. In fact, the Commission prevented Aquila from dispelling the doubts created by Mr. Johnstone's Rebuttal testimony by structuring the proceeding as a complaint case and by excluding Aquila's offer of rebutting testimony and evidence at the hearing. This was prejudicial error.

40. As discussed above, the Commission structured the proceeding as a complaint case, wherein the burden of proof lies on the complainant, AGP. Consequently, AGP was given the opportunity to have the final word and rebut all pre-filed testimony submitted by the Company. On the other hand, Aquila was denied the opportunity to rebut in pre-filed testimony all of AGP's pre-filed testimony, including the rebuttal testimony of Mr. Johnstone that proved crucial to the Commission's findings.

41. Significantly, the exclusion of testimony and exhibits offered at the hearing by the Company to rebut live testimony by Mr. Johnstone was error. At the hearing, Aquila attempted to present evidence which would have dispelled the doubts created by Mr. Johnstone's Rebuttal testimony and would have established the prudence of Aquila's operation of the hedging program. (Tr. at 335-338).

42. AGP recognized the significance of the evidence and fiercely argued against the admission of the evidence and supporting testimony by Company witness Blunk. (Tr. at 335-337). As counsel for AGP stated at the hearing, "[t]here's a sequence and there's a process here. The sequence and process, your Honor, is they do direct and they have the opportunity in their direct to put that -- these materials in." (Tr. at 337). In other words, AGP

argued that pursuant to the procedure in this complaint case, Aquila should have no opportunity to rebut the testimony of its witnesses or dispel any doubts about the prudence of Aquila's hedging program.

43. The hearing judge agreed with AGP that it is improper for Aquila to put on evidence outside of its direct testimony, sustained AGP's objection, and thereby prevented Aquila from dispelling the doubts created by Mr. Johnstone's Rebuttal testimony. (Tr. at 337-338). This occurred just minutes before the end of the hearing, and was Aquila's final opportunity to submit any rebutting evidence.

44. Consequently, Aquila's evidence, offered to dispel the Commission's doubts and prove that the hedging program was operated prudently, did not come into evidence, and Mr. Blunk was not given a chance to explain it or undergo cross-examination or Commissioner questions regarding it. As Aquila was deprived of the opportunity to be heard on this rebutting evidence, it was denied due process. What's more, the hearing judge appears to have held a different opinion as to the burden of proof at the conclusion of the hearing than did the Commission when it stated in its Report and Order that "AGP is not saddled with the burden of proof throughout the proceeding." (Report and Order ¶ E at 17). Had the hearing judge believed that the burden of proof had shifted to Aquila, it would only make sense for her to allow such dispelling evidence to be admitted.

45. If this action truly "took on the character of a prudence review rather than a complaint" (Report and Order ¶ I at 18), the law requires that Aquila be afforded the procedural protections of such a review. It wasn't so afforded, and the structure of the procedural schedule and the hearing maintained the character of a complaint case, as evidenced by the "sequence and process" arguments of AGP counsel and the determination by the hearing judge regarding the Company's offer of evidence. (Tr. at 337-338).

46. In light of the Commission's finding that AGP demonstrated serious doubt about the prudence of Aquila's operation of its steam hedging program, and that, therefore, Aquila "must shoulder the burden of proving that those decisions were prudent," the exclusion of testimony and exhibits of Mr. Blunk offered at the hearing to rebut live testimony by Mr. Johnstone was error and denied Aquila due process. (Report and Order ¶ G at 18). As a result, the Report and Order is unjust, unreasonable, arbitrary, capricious, unlawful, not supported by substantial and competent evidence of record, and not supported by adequate findings of fact and conclusions of law.

D. The Commission Improperly Calculated the Measure of Damages.

47. The Commission erroneously ordered GMO to refund that portion of the cost of the hedging program borne by all of its steam customers at the Lake Road Plant in St. Joseph during the two relevant years, despite the fact that no other customer joined this complaint, that there is no evidence as to AGP's discrete damages, and that there is no evidence about what the costs of the program would have been had forecasts matched actual volumes or if the amount hedged had been within a "reasonable" variance to actual volumes. As a result, the Report and Order is unreasonable, arbitrary, capricious, not supported by substantial and competent evidence of record, and not supported by adequate findings of fact.

(1) The Commission Erroneously Ordered a Refund Without Any Evidence as to AGP's Discrete Damages.

48. In finding that "the relief ordered by the Commission should apply to all of Aquila's steam customers," the Commission accordingly did not make any findings as to AGP's discrete damages. As discussed below in Sections II.D.(3) and II.E., ordering a refund to all of Aquila's steam customers is unlawful and unreasonable. Nevertheless, in the event that AGP is deserving of relief, there is no evidence in the record regarding its discreet damages.

49. A complainant such as AGP "had the burden of proving the existence and amount of damages with reasonable certainty." American Laminates, Inc. v. J.S. Latta Co., 980 S.W.2d 12, 23 (Mo. App. W.D. 1998). Any calculation of damages must be "reasonably certain and not speculative." Total Economic Athletic Mgmt. of America, Inc. v. Pickens, 898 S.W.2d 98, 107 (Mo. App. W.D. 1995). Given AGP's failure to provide evidence to the Commission of its own losses, there are no facts in the record to support any calculation of costs that were incurred solely by AGP as a result of Aquila's steam hedging program during 2006 and 2007.

50. As the Commission can neither order a refund to AGP without substantial and competent evidence of record, nor do so without adequate findings of fact, an evidentiary hearing or other post-determination proceeding must be convened to calculate any relief due to the complainant.

(2) The Commission Erroneously Ordered a Refund Without Any Evidence as to the Actual Costs of the Program In Light of Its Finding of Imprudence.

51. The Commission erroneously ordered a refund of the entire net cost of Aquila's natural gas hedging program for steam production without any findings of fact or citations to the record that imprudence in operation of the program necessarily results in a refund of the entire cost of the program. (Report and Order Decision at 20).

52. The Commission admitted on pages 19-20 of its Decision:

> The record is not clear about how much net hedging costs Aquila would have incurred if it had properly forecast the amount of natural gas it needed to purchase to supply steam to its customers. Perhaps it would have incurred some costs even if it had been completely accurate in is forecasting. Neither party presented any evidence that would allow the Commission to make that determination.

While the Commission thus acknowledged that there may have been costs resulting from the operation of Aquila's hedging program even if the volume forecast had been perfect, it nevertheless ordered a refund of the entire cost of the program without taking any evidence as to the cost of the program had hedged volumes matched actual volumes.

53. The Commission noted that "it appears that net hedging costs would have been small if the required amount of natural gas had been accurately forecast," but makes no findings of fact as to the amount of those costs. (Report and Order Decision at 20). In awarding the entire net cost of the hedging program, the Commission assumed that the costs of the program had it been operated to perfect volumes would have been zero, without any supporting evidence of record. The Commission therefore overcompensated the claimant by refunding the entire net cost of the program without any regard to the losses that the claimant would have had to pay even if the volumes had been more accurately forecasted.

54. Because there is no competent and substantial evidence in the record as to what the actual costs of the hedging program were, the Commission's ordering the refund of the entire net cost is unreasonable, arbitrary, and capricious. Furthermore, the assumption that actual losses if the volumes had been more accurately forecasted would be so small as to have no effect on the Commission's relief granted is not supported by adequate facts on the record. Such an assumption furthermore is conclusory, speculative, and improper.

55. As the Commission cannot order a refund without substantial and competent evidence of record, an evidentiary hearing or other post-determination proceeding must be convened to establish what the costs of the program would have been if the volumes hedged had been more accurate.

56. Additionally, in refunding the entire cost of the program, the Commission has allowed for no range of reasonable deviation from perfect knowledge of actual volumes burned. The result of the Commission's determination and refund is precedent that there is no

prudent margin of error -- in other words, that prudent hedging programs must be operated to perfect volumes, otherwise they are imprudent and must result in a total loss. This is plainly unreasonable.

57. As the Commission cannot order a refund without substantial and competent evidence of record, an evidentiary hearing or other post-determination proceeding must be convened to establish what a prudent level of volumes would have been and to calculate the costs that the steam hedging program would have suffered at that prudently forecasted level.

58. Additionally, the statement that the Commission relied upon for deciding that Aquila's entire net cost of operating its natural gas price hedging program in 2006 and 2007 must be refunded was Mr. Johnstone's opinion about the hypothetical adjustment of a graph comparing cost to price for just one month, October 2006, during that period. (Report and Order ¶ 43 at 14). Yet Company witnesses Gottsch and Blunk explained that Mr. Johnstone's analysis ignores the market environment during that month, that Aquila's hedge positions were still "in the money" as late as July 31, 2006, and that it was not uncommon to see poor performance in October 2006 among utilities that use hedging tools to protect against volatility. (Tr. [Gottsch] at 252; Ex. 102 at 9, 14-15; Ex. 105 at 33). Significantly, Mr. Johnstone even described this month as "extremely bad" and "one of the worst." (Ex. 1 at 20-21). The Commission's refund is, therefore, not supported by substantial and competent evidence of record.

59. Any calculation of damages must be "reasonably certain and not speculative." Total Economic Athletic Mgmt. of America, 898 S.W.2d at 107. Because the Commission determined that the entire net cost of the hedging program must be refunded without any evidence as to the actual costs of the program due to any imprudence in hedging of volumes, and without any evidence as to the reasonable margin of error in hedging of volumes,

the Report and Order is unreasonable, arbitrary, capricious, not supported by substantial and competent evidence of record, and not supported by adequate findings of fact.

(3) The Commission Erroneously Included All Steam Customers In Its Decision.

60. Without citing any law or precedent, the Commission granted relief in this complaint case, filed as "HC" ("steam complaint"), to "all of Aquila's steam customers," included non-complainants. (Report and Order ¶ J at 19). As GMO did not know at the outset of this steam complaint that there were four additional phantom complainants, and thus did not have the ability to defend against their claims, it was denied due process.

61. One of the basic tenets of the U.S. judicial system is the concept of fundamental fairness afforded by procedural due process. Due process is violated if a proceeding "offends some principle of justice so rooted in the traditions and conscience of our people as to be ranked as fundamental." Snyder v. Massachusetts, 291 U.S. 97, 105 (1934). Among those principles of justice are the requirement that one "must receive notice and an opportunity for a hearing appropriate to the nature of the case." Moore v. Board of Educ. of Fulton Pub. School No. 58, 836 S.W.2d 943, 947 (Mo. banc 1992).

62. The record is clear that no other customer has joined this complaint. (Tr. [Johnstone] at 104; Tr. [Rush] at 297). Furthermore, while the Commission transformed this steam complaint case into a full prudence review, purportedly applicable to all of Aquila's steam customers (Report and Order ¶ J at 19), it admitted that Aquila's steam customers other than AGP "significantly overestimated the amount of steam they would use." (Report and Order ¶ 46 at 15). Conversely, the Commission stated that "AGP offered Aquila reasonably accurate estimates of its steam usage." Id. Hence, while AGP may have a valid claim against Aquila because its information was largely accurate, the remaining phantom plaintiffs may have a much

weaker case. Needless to say, had Aquila's other steam customers been parties to this complaint case, it likely would have presented different or additional evidence regarding, among other things, the estimated versus actual volume usage of those other customers.

63. GMO was denied adequate notice that a refund would be awarded to any customer other than AGP, and denied the opportunity at the hearing to rebut any potential claims by these phantom plaintiffs. Because the Commission ordered a refund to customers who were not party to the complaint, the Report and Order is unlawful, unreasonable, arbitrary, capricious, not supported by substantial and competent evidence of record, and not supported by adequate findings of fact.

E. <u>The Commission Improperly and Unlawfully Expanded the Scope of This Complaint to Other Steam Customers, in Violation of the Quarterly Cost Adjustment Rider.</u>

64. Without any legal or factual basis, the Commission determined that this complaint case filed by <u>only one</u> customer permits the Commission to grant relief to other customers who did not file a complaint under the Quarter Cost Adjustment (QCA) Rider that governs steam service in this case. The pertinent part of the QCA Rider is set forth in Schedule TMR-1, attached to the Direct Testimony of Company witness Tim M. Rush. The QCA Rider provides a two-step approach to review prudence issues. In Step One, Commission Staff is to ascertain "that the concept of aligning of Company and customer interests is working as intended," and "that no significant level of imprudent costs is apparent." (Ex. 104, Schedule TMR-1 ("QCA Rider") at § 6.1). There is no evidence in the record that in its review of the Company's hedging program in 2006 and 2007 Staff found any imprudent costs. (<u>See</u> QCA filings in Cases No. HR-2007-0028 and HR-2007-0399 (administrative notice taken, Tr. at 74); Ex. 104 at 17).

65. Staff "may proceed with Step Two, a full prudence review, if deemed necessary." This "full prudence review, if pursued, shall be complete[d] no later than 225 days after the end of each year." (QCA Rider § 7). It is also undisputed in this case that Staff never proceeded with a Step Two full prudence review. (See QCA filings in Cases No. HR-2007-0028 and HR-2007-0399 (administrative notice taken, Tr. at 74); Ex. 104 at 18).

66. However, the QCA rider provided: "Any customer or group of customers may make application to initiate a complaint for the purpose of pursuing a prudence review by use of the existing complaint process." (QCA Rider § 8). This provision's only other sentence stated: "The application for the complaint and the complaint proceeding will not be prejudiced by the absence of a full (Step Two) prudence review by Staff." Id.

67. There is nothing in the QCA Rider or any other tariff applicable to this case that permits AGP to go beyond the standard Commission complaint procedures. Similarly, there is nothing in the QCA Rider, any tariff, any regulation, or in Missouri law that gives the Commission the authority to grant a special preference to AGP to represent the interests of non-complaining customers and to enlarge the standard complaint procedures set forth in Section 386.390 and 4 CSR 240-2.070. Therefore, the Commission's finding that "this case is more complicated than a straight-forward complaint" (Report and Order ¶ A at 16), and that this is not "an ordinary complaint" (Report and Order ¶ E at 17) or "not a typical complaint" (Report and Order ¶ H at 18) is wholly without legal or factual support.

68. Furthermore, without any factual or legal basis, the Commission found that this complaint case brought under the QCA rider by AGP is "actually a full prudence review of Aquila's fuel purchasing decisions." (Report and Order ¶ E at 17). The QCA Rider in Section 8 allows any customer "to initiate a complaint for the purpose of pursuing a prudence review by use of the existing complaint process." The next sentence similarly states that the application

"for the complaint and the complaint proceeding will not be prejudiced by the absence of a full (Step Two) prudence review by Staff." (QCA Rider § 8).

69. There is nothing in Section 8 of the QCA Rider that creates a new breed of complaint or declares that a customer complaint is a "full prudence review" such as contemplated by in Section 7 when initiated by Staff. As the Commission observed, Staff did not present any evidence and did not take any position regarding AGP's complaint. (Report and Order at 3). Staff itself advised the Commission that it performed no audit related to the 2006 and 2007 QCA periods. (Tr. at 54).

70. Significantly, interpreting Sections 7 and 8 of the QCA Rider, the Commission stated in this docket that a full prudence review and a complaint plainly are not the same thing.

> The tariff contemplates that a "full prudence review" is one that is conducted by Staff. The tariff goes on to state that any customer may initiate a complaint to pursue "a prudence review" and that the customer will not be prejudiced by the lack of a "full prudence review." <u>The Commission interprets these provisions as clearly setting out two different types of prudence reviews.</u> One that may be initiated by Staff within 225 days of the end of the year; and one that may be initiated by a customer through the complaint process without a specific time limitation and without prejudice by Staff having not conducted a "full prudence review." [<u>Order Denying Motion to Dismiss</u> at 4, Case No. HC-2010-0235 (July 21, 2010) (emphasis added)].

71. Thus, the Commission's conclusion that the 2006 Nonunanimous Stipulation and Agreement ("2006 S&A") in Case No. HR-2005-0450 "allowed AGP to initiate a <u>full prudence review</u> of Aquila's fuel purchasing decisions by filing this complaint" is erroneous and contrary it its prior holdings in this complaint case. (Report and Order ¶ I at 18) (emphasis added). To the contrary, Section 8.7 of the QCA Rider permitted Staff to proceed "with a full prudence review, if deemed necessary," but Section 8.8 simply stated: "Any Aquila steam customer or group of steam customers in the L&P service area may make application to initiate a

complaint for the purpose of pursuing a prudence review by use of the existing complaint process." (QCA Rider § 8).

72. There is nothing in the 2006 S&A or in the Commission's "Order Regarding Stipulation and Agreement" of February 28, 2006 approving it that granted Staff's exclusive right to conduct a Step Two, full prudence review to AGP or any other customer. While a complaint filed by a customer is not prejudiced by the lack of a Step Two review, the complaint process of Section 8 and the Step Two process of Section 7 are plainly not the same thing.

73. Therefore, the Commission erroneously concluded: "Since this action is a full prudence review, it applies to all of Aquila's steam customers." (Report and Order ¶ J at 19) (emphasis added).

74. This erroneous conclusion is even more glaring because the Commission itself found that customers other than AGP provided Aquila with inaccurate information and estimates regarding their anticipated use of natural gas. As discussed above, the Commission observed that "AGP offered Aquila reasonably accurate estimates of its steam usage," but the estimates from "some of its other steam customers" were described by the company's witness Joe Fangman as "soft" and "fuzzy." (Report and Order ¶ 46 at 15). This led the Commission to conclude those other customers' estimates were "less reliable." Id. The Commission concluded: "In fact, those other customers significantly overestimated the amount of steam they would use." Id.

75. It is, therefore, startling that the Commission would reward customers (a) who never filed a complaint and (b) who never resorted to the complaint procedures offered by the QCA Rider, and propose to award them a refund related to a hedging program where they themselves were the cause of hedging costs that the Commission concluded were not prudent.

76. The decision of the Commission to award a refund to customers who never filed a complaint and who the Commission found directly caused or contributed to what it concluded were imprudent hedging costs is neither lawful nor reasonable, is a denial of due process, and is unjust and unreasonable.

F. The Commission Improperly Failed to Grant the Company's Motion to Dismiss.

77. The Company filed a Motion to Dismiss, Answer and Affirmative Defenses on March 15, 2010. The Commission issued its Order Denying the Motion to Dismiss on July 21, 2010. This order was unlawful and unreasonable for the following reasons.

78. AGP failed to set forth in its Complaint any provision of law, rule, order or decision within the Commission's jurisdiction which the Company allegedly violated. As a result, the complaint should have been dismissed for failure to state a claim on which relief may be granted under Section 386.390 and 4 CSR 240-2.070(6).

79. AGP's claims were barred by the terms of the QCA Rider tariff since any prudence review must have been conducted no later than 225 days after the end of each QCA year. In this case, AGP waited for 1,123 days after the end of the 2006 QCA period, and 758 days after the end of the 2007 QCA period to file its complaint.

80. AGP's claims were barred by the doctrine of laches since any prudence review must have been completed no later than 225 days after the end of QCA year, pursuant to Paragraph 7 of the QCA Rider. If this is indeed a full prudence review, as the Commission stated in the Report and Order (Report and Order ¶ J at 19), AGP's claims clearly are untimely.

81. AGP's claims are barred by state law since the Commission has no authority to award a refund to AGP.

82. AGP's claims are barred by state law since the Commission has no authority to recalculate the charges to AGP for steam service already rendered, as though the

Company had not incurred hedging costs as part of its cost service. Such relief would constitute a form of equitable relief, which the Commission is not authorized to grant.

G. Conclusion.

83. The Commission's actions noted above were unreasonable, arbitrary and capricious, and contrary to the letter and spirit of Section 386.266.

84. As a result, the Report and Order is unjust, unreasonable, unlawful, not supported by substantial and competent evidence of record, and not supported by adequate findings of fact and conclusions of law.

WHEREFORE, KCP&L Greater Missouri Operations Company respectfully requests that the Commission grant rehearing of its Report and Order, consistent with the arguments set forth above.

Respectfully submitted,

/s/ Karl Zobrist

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Certificate of Service

I hereby certify that on this 7th day of October, 2011 copies of the foregoing have been mailed, transmitted by facsimile, or emailed to all counsel of record.

/s/ Karl Zobrist
Attorney for KCP&L Greater Missouri Operations Company

SEPTEMBER 28, 2011 REPORT AND ORDER

BEFORE THE PUBLIC SERVICE COMMISSION OF THE STATE OF MISSOURI

Ag Processing, Inc., a Cooperative,	)	
	)	
Complainant,	)	
	)	
v.	)	**File No. HC-2010-0235**
	)	
KCP&L Greater Missouri Operations Company,	)	
	)	
Respondent.	)	

REPORT AND ORDER

Issue Date: September 28, 2011

Effective Date: October 8, 2011

BEFORE THE PUBLIC SERVICE COMMISSION OF THE STATE OF MISSOURI

Ag Processing, Inc., a Cooperative, Complainant, v. KCP&L Greater Missouri Operations Company, Respondent.	))))))))))	**File No. HC-2010-0235**

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Appearances

Stuart W. Conrad, Esq., Finnegan, Conrad & Peterson, 1209 Penntower Office Center, 1109 Broadway, Kansas City, Missouri 64111,

and

David L. Woodsmall, Esq., Finnegan, Conrad & Peterson, 428 East Capitol Avenue, Suite 300, Jefferson City, Missouri, 65101, for Complainant, Ag Processing, Inc., a Cooperative.

Karl Zobrist, Esq., and **Lisa A. Gilbreath, Esq.**, SNR Denton US LLP, 4520 Main Street, Suite 1100, Kansas City, Missouri 64111, for Respondent, KCP&L Greater Missouri Operations Company.

Samuel D. Ritchie, Associate Counsel, Missouri Public Service Commission, Post Office Box 360, 200 Madison Street, Jefferson City, Missouri 65102, for the Staff of the Missouri Public Service Commission.

Judge: **Morris L. Woodruff, Chief Regulatory Law Judge.**

REPORT AND ORDER

Findings of Fact

The Missouri Public Service Commission, having considered all of the competent and substantial evidence upon the whole record, makes the following findings of fact:

Procedural History

On January 28, 2010, Ag Processing Inc., a Cooperative, (AGP) filed a complaint against Aquila, Inc., d/b/a Aquila Networks – L&P, now known as KCP&L Greater Missouri Operations Company (KCPL-GMO). The complaint is related to Aquila's provision of industrial steam service to AGP's soybean processing plant in St. Joseph, Missouri.

AGP initially filed its complaint in Case Numbers HR-2007-0028 and HR-2007-0399, which are cases in which the Commission is considering possible Quarterly Cost

Adjustments under KCPL-GMO's steam tariffs. The Commission separated AGP's complaint from those two cases and assigned it its current case number in an order issued on February 11, 2010.

KCPL-GMO filed a timely answer to AGP's complaint on March 15, 2010. Thereafter, AGP and KCPL-GMO prefiled direct and rebuttal testimony. Although the Commission's Staff and the Office of the Public Counsel are parties to this complaint action, neither presented any evidence and neither took any position regarding AGP's complaint.

The Commission conducted an evidentiary hearing on November 18 and 19, 2010. AGP and KCPL-GMO filed initial briefs on January 11, 2011, followed by reply briefs on February 9, 2011.

The Steam Services Provided by KCPL-GMO

1. KCPL-GMO's predecessor companies began making and supplying industrial steam from the Lake Road Plant in St. Joseph, Missouri in the 1930s, originally serving the animal packing plants located in that area. The Lake Road Plant's boilers are also used to produce steam to drive turbines to generate electricity. KCPL-GMO currently has five customers for the steam it produces. They are AGP; Triumph Foods, LLC; Albaugh Chemical; Nestlé/Purina PetCare; and Land O' Lakes, Omnium Division, a chemical company.[1]

[1] Rush Direct, Ex. 104, Pages 6-7, Lines 18-23, 1-2.

2. AGP is KCPL-GMO's largest steam customer. During 2006 and 2007, the period at issue in this case, AGP took about two-thirds of the industrial steam supplied to the steam customers from the Lake Road Plant.[2]

3. The industrial steam is produced primarily from a coal-fired boiler. But, since the steam load exceeds the capacity of the coal-fired boiler, natural gas is also used as a fuel source. Natural gas costs more than coal, so coal is used as the base-load fuel, while natural gas is used as a swing fuel when extra steam production is needed.[3]

The Hedging Program

4. In February 2006, KCPL-GMO's predecessor, Aquila, instituted a program of financial hedging for its natural gas supply. The company continued to purchase physical natural gas supplies in the same manner, but began buying and selling financial instruments to adjust its effective gas cost.[4] Previously, the company had simply purchased the natural gas it needed at market rates.[5]

5. Aquila decided to make all purchases for its 2006 hedging program on February 16, 2006, believing that it had an opportunity to lock in its natural gas needs for the year at a satisfactory price level.[6] Aquila's average hedge purchase price for all of 2006 for steam customers was $8.15 per MMBtu for future contracts, and an average strike price of $8.71 per MMBtu for call option purchases. The company sold puts at a

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[2] Johnstone Direct, Ex. 1, Page 2, Lines 6-7.

[3] Johnstone Direct, Ex. 1, Page 2, Lines 8-12.

[4] Johnstone Direct, Ex. 1, Page 2, Lines 13-19.

[5] Transcript, Page 190, Lines 6-13.

[6] Gottsch Direct, Ex. 102, Page 14, Lines 13-16.

$6.00 per MMBtu average. Aquila made these purchases anticipating that natural gas prices would rise throughout the balance of the year.[7]

6. However, natural gas prices did not rise throughout the balance of the year, instead dropping to $4.12 per MMBtu in September 2006.[8]

7. Aquila's natural gas hedge program for its steam production was in place once again for 2007. Aquila also purchased the 2007 hedge positions in 2006, but spread those purchases out over 9 months.[9] Again, natural gas market prices trended lower than the hedge positions.[10]

8. At AGP's request, Aquila suspended its natural gas hedging program for its steam production in October 2007.[11]

9. The net cost of Aquila's natural gas hedge program for its steam production was $1,164,960 in 2006 and $2,441,861 in 2007. Under Aquila's Quarterly Cost Adjustment tariff, 80 percent of those costs were collected from Aquila's steam customers. The net hedging program costs Aquila collected from its steam customers amounted to $931,968 for 2006 and $1,953,488 for 2007.[12] Those are the costs that AGP contends should be refunded to Aquila's steam customers.

Should Aquila have Adopted a Hedging Program?

10. The mere fact that Aquila's hedging program's cost exceeded the savings realized from that program does not mean that Aquila was imprudent or that the hedge

[7] Gottsch Direct, Ex. 102, Pages 14-15, Lines 23, 1-5.

[8] Blunk Direct, Ex. 105, Page 24, Line 8.

[9] Johnstone Direct, Ex. 1, Page 13, Lines 17-21.

[10] Johnstone Direct, Ex. 1, Page 20, Lines 6-7.

[11] Johnstone Direct, Ex. 1, Page 31, Lines 18-19.

[12] Johnstone Rebuttal, Ex. 2, Page 30, Lines 8-11.

program's net costs should be refunded to Aquila's steam customers. The purpose of a hedging program is not to make money, nor is it to ensure that customers pay the lowest possible cost. Rather the purpose of a hedging program is to mitigate the risk of price volatility. A properly designed and implemented hedging program will reduce peak prices, but may also may limit participation in a falling market.[13] In other words, in some circumstances customers may pay more for natural gas than they would have if the hedging program was not in place.

11. Aquila's hedging program was designed to be market neutral, meaning the company was not supposed to attempt to predict whether the price of natural gas would rise or fall, but rather would purchase financial contracts that would result in an average market cost over a period of time in the future.[14]

12. In general, the Commission has encouraged utilities to implement and utilize hedging programs to mitigate price volatility. In fact, the Commission has a rule, 4 CSR 240-40.018, which requires natural gas utilities to engage in hedging activities to mitigate price volatility. That regulation does not apply to Aquila's steam operations, but it does indicate the Commission's support for hedging activities by Missouri's utilities.

13. Aquila's concerns about price volatility in the natural gas marketplace were certainly justified in 2006 and 2007. Since the winter of 2000-2001, the natural gas marketplace had experienced significant price fluctuations. In that winter alone, gas prices ranged from $4.485/MMBtu to $9.978/MMBtu. In December 2004 gas was at

[13] Gottsch Direct, Ex. 102, Page 5, Lines 3-19.

[14] Gottsch Direct, Ex. 102, Page 8, Lines 1-4.

$6.83/MMBtu. By December 2005, it peaked at $15.378/MMBtu.[15]

14. Volatility did not end in 2006. By September 2006, prices had dropped to $4.120/MMBtu. Prices climbed back to $13.58/MMBtu in July 2008, but then dropped below $4.00/MMBtu in January 2009.[16]

15. In addition, in the summer of 2005, the natural gas producing regions of the United States Gulf Coast had been struck by two severe hurricanes, Katrina and Rita, causing major disruptions in the nation's supply of natural gas.[17] In early 2006, weather forecasters were again predicting an active hurricane season for 2006[18], with a resulting chance for new natural gas price spikes.

16. Because of the history of price volatility and predictions of future volatility due to concerns about the weather and natural gas supplies, Aquila acted prudently when it considered entering into a natural gas hedging program in February 2006.

17. In February 2006, Aquila entered into a stipulation and agreement to resolve Case No. HR-2005-0450, its pending rate case before the Commission. The implementation of a natural gas price hedging program for Aquila's steam operations had been discussed in the testimony filed in that case, including in the testimony filed on behalf of AGP by Maurice Brubaker.[19]

18. The stipulation and agreement that resolved Case No. HR-2005-0450 contemplated the establishment of a natural gas price hedging program by Aquila for its

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[15] Blunk Direct, Ex. 105, Page 24, Lines 1-12.

[16] Blunk Direct, Ex. 105, Schedule WEB-12.

[17] Blunk Direct, Ex. 105, Page 27, Lines 5-21.

[18] Gottsch Direct, Ex. 102, Schedule GLG-4.

[19] Blunk Direct, Ex. 105, Schedule WEB-6, Pages 6 and 7 of 16.

steam operations. Specifically, Section 8.1 of that stipulation and agreement provided that "[t]he cost of gas in Account 501 will include the cost of physical gas deliveries and financial instruments, when settled, associated with gas deliveries in the quarterly period."[20]

19. The parties to the stipulation and agreement discussed and understood the term "financial instruments" as used in Section 8.1 to mean the futures contracts and option contracts that would be used in Aquila's natural gas hedging program for its steam operations.[21]

20. The stipulation and agreement that resolved Case No. HR-2005-0450 created a Quarterly Cost Adjustment (QCA) mechanism. The QCA required Aquila to file quarterly rate adjustments to reflect 80 percent of changes in actual fuel costs above or below an established base amount. Aquila was not allowed to pass 20 percent of its fuel costs to its customers under the QCA to better align its interests with those of its customers.[22]

21. The QCA also contained a coal performance standard that limited the amount of fuel costs that could be passed through to the steam customers. Aquila primarily produced steam using a coal-fired boiler. It used its natural gas-fired boiler only when demand for steam could not be met using the coal-fired boiler. Since coal was a less expensive fuel than natural gas, the QCA established a minimum standard for coal-fired steam production that protected customers from higher fuel costs if Aquila

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[20] Clemens Direct, Ex. 101, Schedule GLC-1, Page 5 of 16.

[21] Clemens Direct, Ex. 101, Page 3, Lines 10-14. See also, Transcript, Page 64, Lines 5-25.

[22] Clemens Direct, Ex. 101, Schedule GLC-1, Section 8, Page 4-16.

failed to meet those production standards.[23]

22. Under the QCA, quarterly fuel cost variations are collected from customers over the following twelve-month period. The effect is to protect steam customers from price volatility by increasing retail prices gradually in a period of increasing prices and reducing prices gradually in a period of decreasing prices, thereby averaging the ups and downs as fuel prices move up and down from quarter to quarter.[24]

23. Since the QCA, apart from a separate hedging program, had the effect of reducing fuel cost volatility for customers, AGP contends Aquila was imprudent in not taking that effect of the QCA into account when deciding to implement its natural gas fuel cost hedging program.

24. While the QCA had the effect of reducing fuel cost volatility for Aquila's steam customers, it was not a fuel cost hedging program. The QCA did not affect the effective price that Aquila would have to pay to obtain its natural gas supplies.[25] In other words, the QCA would delay Aquila's ability to pass higher natural gas costs to its customers, but it would only be a delay. Inevitably, those higher costs would be passed to the steam customers. In contrast, a properly functioning hedging program could effectively reduce the costs paid for fuel, to the benefit of both Aquila and its customers.

25. When they created the QCA, the parties to the stipulation and agreement contemplated the creation of a price hedging program as part of the QCA as evidenced by the language in section 8.1 of that stipulation and agreement that allowed the cost of

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[23] Johnstone Direct, Ex. 1, Pages 8-9, Lines 7-24, 1-4.

[24] Johnstone Direct, Ex. 1, Pages 6-7, Lines 3-8, 1-9.

[25] Transcript, Page 176, Lines 7-12.

financial instruments to be included as a cost of gas.[26] It is only with the benefit of 20/20 hindsight, knowing that natural gas prices did not rise precipitously during the period in question, that it can be argued that the price protections afforded by the hedging program were not necessary. Therefore, the Commission finds that Aquila was not imprudent in implementing a natural gas price hedging program of some type. The next question is whether the hedging program it actually adopted was prudently designed.

Was Aquila's Hedging Program Prudently Designed?

26. The hedging program that Aquila implemented for its steam operations was taken directly from the hedging program it had been using for its electric operations.[27]

27. Aquila's natural gas hedging program for steam production was to procure one-third of the monthly forecast quantity of natural gas through fixed price New York Mercantile Exchange (NYMEX) futures contracts, one-third in options contracts, and the remaining one-third at the then prevailing spot market.[28]

28. Aquila's one-third program was designed to dampen both upward and downward swings in the market price of natural gas. When natural gas prices went up Aquila's exposure to the increased costs was limited because one-third of those costs would be fixed by the options contracts, one-third would be capped by the options contracts, and only one-third would be subject to market rates. If market prices dropped, Aquila would not have to exercise the options on one-third of the gas

[26] Clemens Direct, Ex. 101, Schedule GLC-1, Page 5-16.

[27] Transcript, Page 164, Lines 17-24.

[28] Gottsch Direct, Ex. 102, Page 3, Lines 15-22.

requirements, while another one-third of those gas requirements would be purchased at market rates. Thus, two-thirds of the gas requirement could be purchased at the lower market cost, to the benefit of both Aquila and its steam customers.[29]

29. Aquila's one-third hedging program for steam production was taken directly from its hedging program for electric production. Aquila did not closely evaluate that program to customize it for application to its steam production, but no evidence was presented to establish that the one-third hedging program was imprudently designed or that it would not have produced reasonable results given appropriate inputs.

30. Indeed, Aquila ran a comparison study of what the results would have been if an alternative gas hedging program administered by Kase & Company known as EZ Hedge had been used in 2006 and 2007. Using the same inputs as Aquila's one-third program, EZ Hedge would have lost $1,457,660 for 2006 and $3,686,720 for 2007. Both amounts are significantly higher than the losses that resulted from Aquila's one-third hedging program.[30]

31. The Commission finds that AGP has failed to present sufficient evidence to create a serious doubt about the prudence of the design of Aquila's natural gas hedging program for its steam operations. Rather, the problem with Aquila's hedging program was with its implementation, not its design. The Commission will address that issue in the next section of this report and order.

Was the Hedging Program Prudently Implemented?

32. AGP alleges that Aquila's hedging program was imprudently implemented in two respects. The first involves Aquila's transactions in financial instruments.

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[29] Gottsch Direct, Ex. 102, Pages 6-7, Lines 17-23, 1-10.

[30] Gottsch Direct, Ex. 102, Page 17, Lines 9-13.

33. As part of its hedging program, Aquila purchased financial instruments to balance the cost of purchasing the physical supplies of natural gas it would need to produce steam. As previously indicated, part of Aquila's hedging program was to purchase options to hedge one-third of anticipated volumes.

34. Options come in two flavors. A call option provides the purchaser with the option to purchase gas in a future month at a price referred to as a strike price. A call option helps protect the purchaser against a rising price.[31] The other flavor of option is a put option. A put option provides the purchaser with the option to sell gas in a future month at a set strike price. Such an option would give the holder of the option an opportunity to participate more fully in a falling price market.[32]

35. AGP criticized Aquila as imprudent for selling put options in the apparent belief that market prices would rise, thereby depriving its customers of protection against the falling market that actually developed.[33]

36. Aquila bought and sold both call and put options to hedge its costs through the use of a price collar. That program applies the premium gathered from selling a put to the cost of the premium of the call.[34] Thus, Aquila's decision to sell puts does not by itself indicate that the company acted imprudently. The prudence standard does not require that Aquila correctly foresee the direction the natural gas market will take. The company's sale of put options in a market in which prices fell does not establish that the company acted imprudently.

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[31] Johnstone Direct, Ex. 1, Page 14, Lines 6-12.

[32] Johnstone Direct, Ex. 1, Page 14, Lines 16-22.

[33] Johnstone Direct, Ex. 1, Page 15, Lines 2-17.

[34] Gottsch Direct, Ex. 102, Page 7, Lines 16-19.

37. AGP's other accusation of imprudence in the implementation of Aquila's hedging program concerns the volumes of gas that Aquila decided to hedge. The problem is that Aquila chose to purchase financial instruments to hedge much more gas than it actually burned.

38. For the period of April 2006 through December 2007, Aquila purchased hedge positions for approximately 2,000,000 mmBtus of gas for steam production. During the same period the company actually burned only 1,500,000 mmBtus of gas for steam production.[35]

39. Remember, Aquila intended to operate a one-third hedging program. That means that one-third of its natural gas purchases for steam production should have been unhedged, to be purchased at market rates. Since its forecasts of usage were so far off, Aquila in effect bought none of its gas supplies at market rates, rendering its one-third hedging program ineffective from the start.

40. Aquila's hedging of more gas than it actually burned is problematic because that position tends to amplify variations in the natural gas market. If the hedged volume is reasonably close to the physical quantity needed, the net price of the amount of gas hedged can be locked in regardless of market price levels.[36] If Aquila's one-third hedging program had been based on a better forecast of gas usage, that program could have worked as designed and Aquila's customers would have benefited from reduced volatility.

41. However, when physical volumes of gas are substantially less that the volumes hedged, the hedging program will create a price change opposite in direction to

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[35] Transcript, Pages 88-89, Lines 3-2 5, 1-11. *See also*, Ex. 109.

[36] Johnstone Direct, Ex. 1, Page 18, Lines 4-6.

the change in the market. In other words, the net cost of gas under the hedging program will actually go up in a down market and down in an up market. The results will be very volatile and potentially very beneficial or very costly.[37]

42. Since market prices in 2006 and 2007 trended down as compared to the hedge positions, the effect was to substantially increase net gas costs. If costs had gone up instead, windfall benefits would have resulted from substantially decreased net gas costs. But the point of a hedging program is to decrease volatility, not to speculate on windfall profits or losses.[38]

43. The impact of the hedging program on net gas prices in October 2006 provides a good illustration of the problem with the operation of Aquila's hedging program. In that month, the market price of gas had fallen to $4.62. However, under the hedging program, the net cost of gas for that month was $12.76. That extreme price variation occurred because the physical volume of gas purchased was only 25 percent of the design volumes. The first one-third of the hedging program, which was designed to purchase futures contract to protect against rising prices was itself 35 percent larger than the physical volumes used so that losses on that portion of the hedge were amplified. In effect, Aquila had 160,000 mmBtu in costly hedge positions spread over only 58,939 mmBtus physically used to produce steam.[39]

44. Throughout the years in question, Aquila's forecasted/budgeted natural gas usage far exceeded the actual amounts burned for steam production.[40] That

[37] Johnstone Direct, Ex. 1, Page 18, Lines 15-18.

[38] Johnstone Direct, Ex. 1, Page 20, Lines 6-10.

[39] Johnstone Direct, Ex. 1, Page 21, Lines 1-12.

[40] Johnstone Rebuttal, Ex. 2, Page 22, Chart Reb-2.

variation and its devastating effect on the hedging program is sufficient to demonstrate a serious doubt as to the prudence of Aquila's operation of that hedging program. Thus, the initial presumption of prudence is overcome, and the burden shifts to Aquila to dispel those doubts and prove that the hedging program was operated prudently. Aquila has failed to meet that burden.

45. Aquila explained that its forecast for the volumes of steam it would need to produce, and thus the amount of natural gas it would hedge was based on information submitted by its customers. Aquila had only a handful of large industrial steam customers, so the company simply asked its customers to estimate how much steam they would need in the future. An Aquila employee, Joseph Fangman, periodically spoke with the customers about their anticipated need for steam.[41] Fangman then passed that raw information on to another Aquila employee, Tim Nelson, who did the actual forecasting.[42] The record does not indicate how Tim Nelson prepared his forecasts because he did not testify.

46. AGP offered Aquila reasonably accurate estimates of its steam usage, but the estimates Aquila obtained from some of its other steam customers were described by Fangman as "soft" and "fuzzy", less reliable.[43] In fact, those other customers significantly overestimated the amount of steam they would use.[44]

47. Aquila was aware that its customer's estimates of steam usage were unreliable. In his testimony Fangman described one industrial customer that always

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[41] Transcript, Page 279, Lines 4-12.

[42] Fangman Direct, Ex. 103, Page 4, Lines 13-20.

[43] Transcript, Page 289, Lines 1-22.

[44] Ex. 9.

expected to be ramping up production in the next month, thus requiring more steam, but which never actually increased production as planned.[45]

48. Aquila would place the blame for its inaccurate forecasts squarely on its customers, arguing that as the sole available supplier of steam, it has an obligation to plan to meet all the needs of its customers.[46] While certainly Aquila had an obligation to meet the needs of its customers, it was Aquila's responsibility to determine the reasonableness of its customer's estimates. Aquila knew that those customer estimates were not reliable and had an obligation to structure its hedging program to account for the uncertainty of volumes of gas, yet there is nothing in the record to indicate that it did so. Aquila has not met its burden of proving that it operated its hedging program in a prudent manner.

Conclusions of Law

The Missouri Public Service Commission has arrived at the following conclusions of law.

Burden of Proof

A. In form, this is a complaint brought by AGP against Aquila/KCPL-GMO. Normally in a complaint brought before the Commission, the burden of proof would be on AGP, the complainant, as the party asserting the affirmative on the issue of the utility's imprudence.[47] However, this case is more complicated than a straight-forward complaint.

[45] Fangman Direct, Ex. 103, Page 10, Lines 11-19.

[46] Transcript, Page 294, Lines 11-16.

[47] *State ex rel. GS Technologies Operating Co. v. Pub. Serv. Comm'n*, 116 S.W. 3d 680, 693 (Mo. App. W.D. 2003).

B. An approved stipulation and agreement that resolved Aquila's 2005 steam rate case (HR-2005-0450) established a Quarterly Cost Adjustment mechanism that allowed Aquila to make quarterly rate adjustments to reflect 80 percent of the change in its actual fuel costs above or below an established base amount.[48]

C. That stipulation and agreement also establishes a method by which the prudence of Aquila's fuel purchase decisions can be reviewed. The Commission's Staff is required to conduct an initial, first-step, prudence review to determine "that no significant level of imprudent costs is apparent." If it determines a further review is necessary, Staff may also proceed, as a second-step, with a full prudence review.[49]

D. However, the stipulation and agreement also allows any Aquila steam customer, including AGP, to file a complaint to initiate the second-step full prudence review, even if Staff chooses not to pursue such a review.[50] It is just such a complaint that AGP has currently brought before the Commission.

E. Because this is actually a full prudence review of Aquila's fuel purchasing decisions rather than an ordinary complaint, AGP is not saddled with the burden of proof throughout the proceeding. Instead, the Commission's modified prudence standard of review is applicable.

F. Under that standard of review, which the Commission established in a 1985 decision, a utility's expenditures are presumed to be prudently incurred, but, if some other participant in the proceeding creates a serious doubt as the prudence of the expenditure, then the utility has the burden of dispelling those doubts and proving the

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[48] Clemens Direct, Ex. 101, Schedule GLC-1, Page 4 of 16.

[49] Clemens Direct, Ex. 101, Schedule GLC-1, Pages 6-8, of 16.

[50] Clemens Direct, Ex. 101, Schedule GLC-1, Page 8 of 16.

questioned expenditure to have been prudent.[51] The Commission's standard of review regarding prudence decisions has subsequently been accepted by reviewing courts.[52]

G. Based on its findings of fact, the Commission has concluded that AGP has demonstrated serious doubt about the prudence of Aquila's decisions regarding its gas-cost hedging program. Therefore, Aquila/KCPL-GMO must shoulder the burden of proving that those decisions were prudent.

Appropriate Relief

H. The approved stipulation and agreement also affects the degree of relief that is appropriate in this case. In a typical complaint case, the Commission would grant relief only to the party that brought the complaint. Since AGP is the only steam customer that filed a complaint, it would be the only customer that received relief. However, as previously indicated this is not a typical complaint.

I. As the Commission previously concluded in section D of these conclusions of law, the approved stipulation and agreement that resolved Aquila's 2005 steam rate case allowed AGP to initiate a full prudence review of Aquila's fuel purchasing decisions by filing this complaint. Thus, this action took on the character of a prudence review rather than a complaint that would be limited to AGP's specific concerns.

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[51] *In the matter of the determination of in-service criteria for the Union Electric Company's Callaway Nuclear Plant and Callaway rate base and related issues. And in the matter of Union Electric Company of St. Louis, Missouri, for authority to file tariffs increasing rates for electric service provided to customers in the Missouri service area of the company*, 27 Mo. P.S.C. (N.S.) 183 (1985).

[52] *State ex rel. Associated Natural Gas v. Pub. Serv. Comm'n*, 954 S.W.2d 520, 528-29 (Mo. App. W.D. 1997).

J. Since this action is a full prudence review, it applies to all of Aquila's steam customers. The Commission found that Aquila did not act prudently with regard to all its steam customers, not just with regard to AGP. Therefore, the relief ordered by the Commission should apply to all of Aquila's steam customers.

Decision

The positions and arguments of all of the parties have been considered by the Commission in making this decision. Failure to specifically address a piece of evidence, position or argument of any party does not indicate that the Commission has failed to consider relevant evidence, but indicates rather that the omitted material was not dispositive of this decision. After applying the facts as it has found them to its conclusions of law, the Commission has reached the following decision.

The evidence showed that Aquila hedged the purchase price of far more natural gas than it actually needed to use to produce steam to serve its customers. By doing so, Aquila operated a hedging program that actually increased rather than reduced price volatility. AGP amply demonstrated serious doubt about the prudence of Aquila's operation of the hedging program. Therefore, Aquila had the burden of proving that it operated the hedging program in a prudent manner. Aquila failed to meet that burden.

Aquila collected net hedging costs from its steam customers amounting to $931,968 for 2006 and $1,953,488 for 2007. The record is not clear about how much net hedging costs Aquila would have incurred if it had properly forecast the amount of natural gas it needed to purchase to supply steam to its customers. Perhaps it would have incurred some costs even if it has been completely accurate in its forecasting.

Neither party presented any evidence that would allow the Commission to make that determination.

However, it appears that net hedging costs would have been small if the required amount of natural gas had been accurately forecast. As AGP's witness, Donald Johnstone, explained, small changes in volumes would have only small effects on the hedging program. Because of the previously described amplification effect, large variations in volumes result in very large problems.[53]

In any event, Aquila had the burden of proving that it operated its hedging program in a prudent fashion. It failed to establish that any part of the cost of operating that program was prudently incurred. Therefore, the Commission finds that Aquila's entire net cost of operating its natural gas price hedging program for steam production in 2006 and 2007 was imprudently incurred and must be refunded to its steam customers through operation of the QCA.

THE COMMISSION ORDERS THAT:

1. KCP&L Greater Missouri Operations Company shall refund to its steam customers, through operation of the Quarterly Cost Adjustment, the net cost of operating its natural gas price hedging program for steam production in the amount of $931,968 for 2006 and $1,953,488 for 2007.

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[53] Transcript, Page 110, Lines 2-6.

2. This order shall become effective on October 8, 2011

BY THE COMMISSION

Steven C. Reed
Secretary

(S E A L)

Gunn, Chm., Davis, Jarrett, and
Kenney, CC., concur;
and certify compliance with
Section 536.080, RSMo 2000.

Dated at Jefferson City, Missouri,
on this 28th day of September, 2011.

CONCISE STATEMENT OF ISSUES BEING APPEALED

The general issue that is being appealed is the Commission's determination that KCP&L Greater Missouri Operations Company's ("GMO" or "Company") predecessor Aquila, Inc. was imprudent in the administration of its steam hedging program and that a refund of costs arising out of that program therefore is due to its steam customers.

The Commission's Report and Order is unlawful and unreasonable because: (1) the Commission erroneously shifted the burden of proof to GMO; (2) even if the Commission did not improperly shift the burden of proof to GMO, the Company met its burden of proof and Aquila appropriately administered the hedging program at issue in the case; (3) even if the Commission did not improperly shift the burden of proof to GMO, the Commission improperly sustained the objection to proper rebuttal testimony offered by the Company; (4) the Commission improperly calculated the measure of damages; (5) the Commission improperly and unlawfully expanded the scope of Ag Processing Inc.'s Complaint to other steam customers; and (6) the Commission improperly failed to grant the Company's Motion to Dismiss.

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