BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

AG PROCESSING INC., A COOPERATIVE,	)	
	)	
Complainant,	)	
	)	
v.	)	**Case No. HC-2010-0235**
	)	
KCP&L GREATER MISSOURI OPERATIONS COMPANY,	)	
	)	
Respondent.	)	

INITIAL BRIEF OF RESPONDENT KCP&L GREATER MISSOURI OPERATIONS COMPANY

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Respondent KCP&L Greater Missouri Operations Company, formerly Aquila, Inc., ("GMO" or "Company"),[1] pursuant to the Commission's November 22, 2010 Order, submits this Initial Brief.

I. Introduction.

A. The Complaint.

The Complaint[2] of Ag Processing, Inc. ("AgP") asks this Commission to second-guess a hedging program that Aquila implemented in February 2006, pursuant to the Nonunanimous Stipulation and Agreement that resolved Aquila's 2005 Steam Rate Case, No. HR-2005-0450. AgP alleges that Aquila's use of a hedging program to mitigate natural gas price volatility for its steam operations was "imprudent" during the 2006 and 2007 Quarterly Cost Adjustment ("QCA") periods covered by those proceedings. The QCA process, as well as the hedging program, were implemented as pursuant to the 2005 Steam Rate Case stipulation.

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[1] The Company will also be referred to as "Aquila" since the subject matter of the Complaint relates to the steam hedging program implemented by Aquila in 2006 and 2007.

[2] AgP filed its Complaint in Case Nos. HR-2007-0028 and HR-2007-0399 on January 28, 2010. Subsequently, the Commission severed the complaint from these cases and filed the Complaint in the subject docket, Case No. HC-2010-0235 on February 11, 2010.

AgP seeks an order from the Commission requiring GMO to refund that portion of the cost of the hedging program borne by the steam customers at the Lake Road Plant in St. Joseph during these two years, even though no other customer has joined this complaint. (Transcript ["Tr."] (Rush) at 297).[3] It is an extraordinary request, given the long-standing policy of this Commission to encourage hedging programs. See, e.g., Order Finding Necessity For Rulemaking, In re Proposed Rulemaking Concerning Mitigation of Natural Gas Price Volatility, Case No. GX-2002-478 (Apr. 16, 2002); 4 CSR 240-40.018(1)(A) & (C) (hedging programs designed to "mitigate upward natural gas price spikes" could result in higher than spot market prices, but "this is recognized as a possible result of prudent efforts to dampen upward volatility" [emphasis added]); Joint Report on Natural Gas Market Conditions, PGA Rates, Customer Bills & Hedging Efforts of Missouri's Natural Gas Local Distribution Companies at 3, In re Investigation into Status of Missouri's Natural Gas Local Distribution Companies' Compliance with 4 CSR 240-40.018, Case No. GW-2006-0110 (Feb. 24, 2006) ("hedging strategies that obtain price certainty in lieu of price variability may not result in the lowest costs").[4]

Unfortunately, AgP understands neither how a hedging program mitigates upward price volatility, nor the fact that a prudent hedging program does not always result in savings to net fuel costs. As is apparent from the testimony of its expert and sole witness Donald Johnstone, who has no experience designing, administering, or executing a hedging program (Tr. [Johnstone] at 62-63), AgP bases its belief that the design and execution of Aquila's steam

[3] AgP seeks the sum of $931,968 and $1,953,488, with interest, for all steam customers for whose benefit the hedging program was adopted in the 2006 and 2007 QCA periods. Under the QCA, this represents 80% of the hedge costs, Aqila having absorbed the cost of the remaining 20% of the program under the sharing mechanism set forth in the Stipulation.

[4] See also Order Approving Unanimous Stipulation and Agreement, Office of the Public Counsel v. Southern Mo. Gas Co., L.P., Case No. GC-2006-0180 (Apr. 11, 2006) (Unanimous Stipulation and Agreement mandated the utility to enter into a hedging program requiring a minimum of 55% of winter heating gas supply be purchased at fixed prices or otherwise hedged against market exposure no later than October 1, 2006 and each year thereafter).

hedging program was imprudent upon mistaken contentions: (1) that the QCA initiated in March 2006, pursuant to the Stipulation in the 2005 Steam Rate Case, Case No. HR-2005-0450, mitigates upward price volatility, as does a hedging program, and thus Aquila's steam hedging program was either improperly designed or simply unnecessary; and (2) that Aquila's steam hedging program was imprudently administered because the volumes that were hedged were based on anticipated rather than actual volumes used by steam customers. (Ex. 1 [Johnstone Direct] at 5-8, 11, 15-19, 28-30; Ex. 2 [Johnstone Rebuttal] at 4-10, 15-22).

These conclusions mischaracterize the QCA process and are at odds with the facts in evidence. First, the QCA fails to mitigate projected spikes in the price of natural gas, as does a hedging program. While the QCA spreads the cost of natural gas over a period of twelve months, Aquila's steam hedging program actually mitigates upward price volatility by allowing Aquila, and therefore its steam customers, to lock in natural gas purchases at a fixed level and avoid purchasing natural gas at a spiked price. In light of the projected upward volatility of natural gas prices for the foreseeable future, Aquila's steam hedging program was prudently designed. It was also reviewed by Ag Processing before its implementation and requested by Ag Processing. Furthermore, Aquila properly and prudently hedged to the most accurate volumes possible, volumes that it received directly from steam customers and that steam customers were assuring Aquila they would require. Aquila's steam hedging program was therefore also prudently administered.

B. The Natural Gas Market in 2006 and 2007.

It is important to recognize the historical context in which Aquila began its steam hedging program. The Company implemented the hedging program at the request of Ag Processing at a time when analysts were predicting rising natural gas prices for the foreseeable future. Given the expectations of increased prices, this was a prudent action.

Since about 2000, the level of price uncertainty for natural gas increased significantly. (Ex. 105 [Blunk Direct] at Schedule WEB-12). The price of natural gas in December 2004 was about $6.83/MMBtu. In December 2005 it reached a peak of $15.378/MMBtu, then dropped to $4.120/MMBtu in September 2006. These moves represented a price spike of 125%, followed by a decline of 73%. By July 2008 natural gas had returned to $13.58, but then dropped 82% to $2.508, a price level that the markets had not seen since March 2002. (Ex. 105 [Blunk Direct] at 23-24).

Production uncertainty was also on the rise in 2005 and 2006. The United States was expected in 2006 to be in a supply-limited environment given a number of uncertainties. (Ex. 105 at 21-22). Following Hurricanes Katrina and Rita, which made landfall on August 28, 2005 and September 19, 2005, respectively, natural gas production dropped to levels not seen since September 1989. (Ex. 105, Schedule WEB-11). Analysts in 2005 and 2006 were predicting that 2005 was the beginning of a decades-long season of hurricanes like Katrina and Rita, predictions which further increased the uncertainty of natural gas production and drove even more price uncertainty. (Ex. 105 at 27-28).

Experts in early 2006 were predicting another active hurricane season for 2006 (Ex. 102 [Gottsch Direct] at 14 & Schedules GLG-4, GLG-5), which would result in a spike in natural gas prices over the course of that year (Tr. [Gottsch] at 251). Consequently, analysts in January and early February 2006, including market experts from Bear Sterns and Raymond James, were predicting gas prices to remain high for the foreseeable future. (Ex. 102, Schedule GLG-6 at 1, 8).

Because the natural gas market was just coming down from the unprecedented high prices of mid-December 2005 in early 2006, the general consensus was that there was opportunity in early 2006 to lock in natural gas at a satisfactory price level, and that prices would

thereafter rise throughout the year. (Tr. [Gottsch] at 251; Ex. 102 at 14-15, 27). The U.S. Energy Information Administration ("EIA") had predicted in its February 7, 2006 update an average Henry Hub 2006 price of $8.87. (Ex. 102 at 14).

In the midst of this anticipated market turmoil, Aquila's purchases for steam customers in 2006 were reasonable: (a) $8.15 for future contracts, (b) an average strike price of $8.71 for call option purchases, and (c) the sale of puts at a $6.00 average (nearly $3 below market projection). (Ex. 102 [Gottsch Direct] at 4-15).

In short, at the end of 2005 and in 2006, it was widely agreed that natural gas prices were on the rise for the foreseeable future, and would likely continue to spike due to active hurricane seasons for the foreseeable future. Aquila prudently limited its customers' exposure to projected market price spikes by obtaining price certainty in lieu of price variability. What no one could have predicted in 2006, when Aquila was making its hedge purchases for 2006 and 2007, was the development of shale gas.

Finally, the unexpected development of shale gas has changed the fundamental outlook for natural gas and resulted in a tremendous increase in natural gas reserves. (Ex. 105 at 29). In 2002, the U.S. Geological Survey calculated that the Marcellus Shale Field contained an estimated undiscovered resource of about 1.9 trillion cubic feet of gas. (Ex. 105 at 30). Estimates in 2008 were that the Marcellus Shale Field might contain more than 500 trillion cubic feet of natural gas, an estimate that is 250 times the 2002 estimate. (Ex. 105 at 30). In June 2009 the Potential Gas Committee released the results of its year-end 2008 assessment of the nation's natural gas resources, indicating that the United States possesses a total resource base of 1,836 trillion cubic feet, which is a 39% increase over the 2006 assessment. (Ex. 105 at 30). The development of shale gas has resulted in a precipitous drop in natural gas prices, which could not have been predicted in early 2006, especially after the price increases seen in the aftermath of Hurricanes Katrina and Rita.

(Ex. 105 at 34). The subsequent advancements in shale gas technology and the sudden appearance of such resources could not have been anticipated in late 2005 or early 2006. (Ex. 105 at 35).

C. Steam Customer Expansions at the Lake Road Plant.

At the same time that analysts were predicting continued upward price volatility for natural gas, customer demand at Aquila's Lake Road Plant was growing significantly.

Based on the projections provided by customers in 2005, the load of Aquila's steam customers was expected to grow considerably in fewer than two years. (Ex. 103 at 5-10; Ex. 104 at 10). This was due to the addition of Triumph Foods, LLC, a major pork processing facility, and the expansion of the operations of AgP, Albaugh, and Nestlé. (Tr. [Johnstone] at 84-85; Ex. 104 at 10). Because the growth in the load requirements of these customers was new load, Aquila did not have historical load data upon which to judge its customers' needs. (Tr. [Johnstone] at 85). Given the expected volume information that was provided to Aquila by its steam customers at the time, Aquila prudently managed its steam hedge purchases based on the customers' anticipated volumes. This limited its customers' exposure to projected market price spikes by obtaining price certainty for their growth.

II. Prudence Standard and Burden of Proof.

A. The Prudence Standard in Missouri is a Reasonableness Standard.

The Commission applies a reasonableness standard to determine whether a utility's conduct is prudent. In re Union Electric Co., 27 Mo. PSC (N.S.) 183, 193 (1985). This standard is to be judged based on the utility's conduct at the time:

> [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.

Thus, the Commission measures prudence by the standard of reasonable care "based on the circumstances that existed at the time the challenged item occurred, including what the utility management knew or should have known." In re Missouri-American Water Co., Report and Order, Case No. WR-2000-0281 (Aug. 31, 2000). 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).

Based on the circumstances that existed at the time Aquila made natural gas hedge purchases for its steam operations during the 2006 and 2007 QCA periods -- including what Aquila knew or should have known about (a) the volatile price of natural gas, (b) the anticipated short supply of natural gas, (c) the expected sharp rise in natural gas price for the foreseeable future, and (d) the increase in load from Aquila's steam customers -- Aquila's steam hedge program was prudently designed and administered.

B. Ag Processing Bears the Burden of Proof.

In applying this reasonableness standard, the Commission presumes that the utility's costs were prudently incurred. Union Electric, 27 Mo. PSC (N.S.) at 193. See also GS Technologies, 116 S.W.3d at 693-94; Associated Natural Gas, 954 S.W.2d at 528. Indeed, the United States Supreme Court held in its landmark prudence case that every investment is assumed to have been made in the exercise of reasonable judgment, unless the contrary is shown. Missouri ex rel. Southwestern Bell Tel. Co. v. Missouri PSC, 262 U.S. 276, 289 n.1 (1923). Thus, the Commission must begin its analysis of the prudence of Aquila's steam hedge program with the presumption that the hedge costs for the 2006 and 2007 QCA periods were prudently incurred.

Because the Commission presumes prudence on the part of the utility, "the parties challenging the conduct, decision, transaction or expenditures of a utility have the initial burden of showing inefficiency or improvidence, thereby defeating the presumption of prudence accorded the utility." In re Missouri-American Water Co., Report and Order, Case No. WR-2000-0281 (Aug. 31, 2000). GMO "need not demonstrate in its case-in-chief that all expenditures are prudent." In re Missouri Gas Energy, Case No. GR-2003-0330, Report & Order at 16-17 (Oct. 2, 2007).

Only where a challenger "creates a serious doubt as to the prudence of an expenditure" does a utility "have the burden of dispelling these doubts and proving the questioned expenditure to have been prudent." Union Electric, 27 Mo. PSC (N.S.) at 193. See also State ex rel. Public Counsel v. PSC, 274 S.W.3d 569, 586 (Mo. App. W.D. 2009); GS Technologies, 116 S.W.3d at 693-94; Associated Natural Gas, 954 S.W.2d at 528-29; In re Kansas City Power & Light Co., 28 Mo. PSC (N.S.) 228, 279-82 (1986). However, mere speculation does not create serious doubt and does not overcome the legal presumption of prudence. In re AmerenUE, Case No. ER-2007-0002, Report & Order at 69, aff'd State ex rel. Public Counsel v. PSC, 274 S.W.3d 569, 587 (Mo. App. W.D. 2009).

As demonstrated by the evidence in this case, Aquila's steam hedge program was prudently designed and administered, particularly in light of the anticipated short supply of natural gas, the anticipated sharp rise in natural gas price for the foreseeable future, and the anticipated increase in load from Aquila's steam customers. While AgP has done no more than speculate as to what it would consider a prudent hedge program to be, and has not created the serious doubt necessary to overcome the presumption of prudence, Aquila has demonstrated to the Commission that its steam hedge costs for the 2006 and 2007 QCA periods were prudently incurred.

III. The Stipulation in the 2005 Steam Rate Case and the QCA.

The parties to the Nonunanimous Stipulation and Agreement ("Stipulation") in Case No. HR-2005-0450 ("Steam Rate Case"), particularly Aquila and AgP, contemplated that a hedging program would be an integral part of the overall QCA mechanism. (Ex. 101 [Clemens Direct] at 3). This mechanism was first initiated in March, 2006. (Ex. 104 [Rush Direct] at 17). The Stipulation that was agreed to by AgP provided for a natural gas hedging program and the recovery of its costs. (Ex. 101 at 3, 5). Section 8.1 of the Stipulation provided: "The cost of gas in Account 501 will include the cost of physical gas deliveries and financial instruments, when settled, associated with gas delivered in the quarterly period [emphasis added]." (Tr. [Clemens] at 197-98; Ex. 101, Schedule GLC-1 at 5).

There is no requirement in the Stipulation that Aquila obtain prior approval from any signatory party before it purchased any financial instruments or with regard to any particular purchases that it made. (Tr. [Johnstone] at 65).

Furthermore, at no time during the development of the Stipulation did Mr. Johnstone, as AgP's consultant, communicate what kind of steam hedging program Aquila should implement. Id. at 95. At the time the Stipulation was agreed to in the Steam Rate Case, Ag Processing had not recommended a specific hedging program to be used in the QCA. Id. at 100. Nevertheless, AgP complains that Aquila's hedge program is imprudent.

AgP makes much of the 80% cost-sharing mechanism (where 20% of the costs are borne by Aquila) and the 12-month cost-spreading mechanism, which are set forth in different sections of both the Stipulation and the QCA Rider. It alleges that these mechanisms accomplish the same goal as a hedge program, thereby making any additional hedge program duplicative or unnecessary. (Ex. 1 [Johnstone Direct] at 5-8, 11; Ex. 2 [Johnstone Rebuttal] at 3-7). However, these mechanisms, described in Sections 8, 8.3, and 8.6 of the Stipulation and in Original Sheet

Nos. 6.1-6.3 of the QCA Rider, were not designed to be a hedging program and certainly do not accomplish the same goal as a hedge program.

While Section 8.3 of the Stipulation specifies that quarterly rate adjustments are calculated by dividing fuel costs by the preceding 12-month determinants, this provision merely spreads the effects of price changes, but does nothing to mitigate upward price volatility. (Tr. [Clemens] at 161-62). All gas requirements are still purchased at full cost in a rising market without a hedging program. Thus, these QCA mechanisms cannot and do not mitigate or dampen the price of natural gas that is purchased, as they do not affect the price paid for natural gas purchased. Id. at 161-62, 176.

Conversely, hedging is "the management of a natural gas portfolio to mitigate adverse upward price volatility." See Joint Report on Natural Gas Market Conditions, PGA Rates, Customer Bills & Hedging Efforts of Missouri's Natural Gas Local Distribution Companies ("Joint Report"), Case No. GW-2006-0110 (Feb. 27, 2006) at 8, cited in Ex. 105 [Blunk Direct] at 4. The "goal of hedging is not to 'beat the market' but rather to mitigate upward price volatility." See Joint Report at 8. See also 4 CSR 240-40.018 (hedging programs are designed to "mitigate upward natural gas price spikes"). By purchasing financial instruments at fixed costs, hedge programs such as that employed by Aquila, mitigate upward price volatility because not all gas requirements are purchased at full cost in a rising market.

Furthermore, the Commission has already determined that "Ag Processing has cited no law or order of the Commission which would prohibit a prudent hedging program." See Order Denying Motion to Dismiss at 2, Case No. HC-2010-0235 (July 21, 2010). It found that Original Sheet No. 6.2 of the QCA Rider tariff states that the cost of natural gas will include the "financial instruments associated with gas delivered in the quarterly period," and that the Stipulation contains no provision prohibiting hedging. Id. Thus, not only was the QCA specifically

designed to include a hedging program, but the Commission has already found that Aquila did have authority to conduct a hedging program. AgP admits that the parties to Steam Rate Case discussed and understood the term "financial instruments" to mean futures contracts and option contracts. (Tr. [Johnstone] at 64). Clearly, the QCA's 80% cost-sharing mechanism and the 12-month cost-spreading mechanism do not duplicate a hedge program.

AgP's allegation that these mechanisms accomplish the same goal as a hedge program is inconsistent with its role in the development of the QCA in the 2005 Steam Rate Case. (Ex. 101 [Johnstone Direct] at 2). Mr. Johnstone himself circulated a proposal on January 16, 2006 which contained a proposed Section 4.1 that stated: "The cost of gas will include the cost of physical gas deliveries and financial instruments associated with gas delivered in the quarterly period." (Ex. 101 at Schedule GLC-3). This language is nearly identical to that which was adopted in the final Stipulation as Section 8.1: "The cost of gas in Account 501 will include the cost of physical gas deliveries and financial instruments, when settled, associated with gas delivered in the quarterly period." (Tr. [Clemens] at 197-98; Ex. 101, Schedule GLC-1 at 5).

Aquila's steam hedge program, described in detail below, addressed the risk of rising natural gas prices by permitting Aquila to avoid purchasing all of its natural gas requirements when the cost of natural gas spiked. This price mitigating mechanism is entirely absent in the QCA's simple cost-sharing and cost-spreading mechanisms. Aquila therefore was not imprudent in implementing the 2006-2007 steam hedging program in light of the QCA mechanism contained in the Stipulation in the Steam Rate Case.

IV. Aquila's Steam Hedging Program: The One-Third Strategy.

A. Aquila's Steam Hedging Program Was Prudently Designed.

Aquila's hedging program was developed to address the predictions of continued record price levels by market observers after Hurricanes Katrina and Rita (Tr. [Gottsch] at 213-14; Ex.

102 [Gottsch Direct] at 17-18; Ex. 105 [Blunk Direct] at 7, 27-29). It also was developed in response to "a substantial forecasted increase in Natural Gas requirements to cover steam generation for new and existing customers at the Lake Road facility." (Ex. 102, Schedule GLG-1). In the face of rising natural gas prices and the increasing load requirements of Lake Road customers, Aquila implemented its steam hedge program in February 2006 to take advantage of the significant decline in price for natural gas in early 2006. (Gottsch testimony p.252 at 5-17). According to the American Gas Association, while hedging tools do not guarantee that a utility pays the lowest possible price for gas, procuring gas supplies throughout the year as part of a hedging program "is the responsible thing to do." (Ex. 102 Schedule GLG-7 at 7).

Aquila's approach for hedging natural gas was its One-Third Strategy. Pursuant to this approach, Aquila procured:

(1) One-third of the monthly forecast quantity through fixed price New York Mercantile Exchange ("NYMEX") futures contracts;

(2) One-third in option contracts (straight calls or fences); and

(3) One-third at the then prevailing spot market (the daily or monthly market indexes). (Ex. 102 [Gottsch Direct] at 3; Ex. 105 [Blunk Direct] at 7-8).

Aquila's one-third procurement of option contracts involved the selling of puts, which is part of a common hedge cost management strategy referred to as a "collar" or a "fence." (Ex. 102 at 7; Ex. 105 at 5-6, 19-20). The premiums gained from selling the puts were used to offset premium costs for the calls that were purchased. (Tr. [Gottsch] at 236; Ex. 102 at 7, 9; Ex. 105 at 19). The goal of Aquila's One-Third Strategy was to mitigate price volatility. (Ex. 102 at 4).

When gas prices rose, this approach accomplished that goal by protecting two-thirds of the total exposure against upward price moves because one-third of the monthly forecast quantity was procured through fixed price NYMEX contracts and one-third in option contracts. (Tr.

[Johnstone] at 82-83; Ex. 102 [Gottsch Direct] at 6; Ex. 105 [Blunk Direct] at 11). By hedging two-thirds of the steam customers' total exposure, Aquila was protecting the customers against the upward volatility in natural gas prices that was predicted to continue for the foreseeable future. (Ex. 102 at 18). Aquila employed this approach for procuring natural gas hedges for both its steam operations and the electric operations of Aquila Networks-MPS. (Tr. at 136 [Clemens], 243 [Gottsch]; Ex. 105 at 10 & Schedules WEB-4, WEB-5).

When gas prices fell, the One-Third Strategy further allowed Aquila's customers to participate in a falling market because one-third of the monthly forecast quantity was procured through option contracts (which need not be exercised), and because one-third was left to float with the market. Thus, price drops affected two-thirds of the total exposure, minus the premium that was paid for the call option contracts. (Ex. 102 at 6).

This One-Third Strategy also had the capacity to manage downward volume risk of as much as 66%. (Ex. 105 [Blunk Direct] at 18). Because one-third of the forecast volume requirements was not hedged, that one-third of the forecast floated with fuel requirements. The one-third of the forecast volume that was hedged using options could also float with fuel requirements since options did not need to be exercised. (Ex. 105 at 18). Thus, the One-Third Strategy accommodated the possibility that as much as 66% of its steam customers' anticipated load requirements would not materialize.

The Stipulation in the 2005 Steam Rate Case did not prohibit any particular kind of financial instruments being purchased by Aquila. (Tr. [Johnstone] at 75). Nor did it prohibit Aquila taking the One-Third Strategy it had used in its electric operations and using it in its steam operations. (Johnstone testimony p.75 at 12-16). Free to initiate a hedge program using any combination of financial instruments, Aquila designed a prudent steam hedge program that utilized a combination of financial instruments to address the anticipated short supply of natural

gas, the predicted sharp rise in natural gas price for the foreseeable future, and the expected increase in load from Aquila's steam customers. Additionally, the One-Third Program accounted for the possibility that the market would fall or that steam customers' anticipated load requirements would not materialize.

1. AgP Reviewed and was Aware of Aquila's One-Third Program.

Not only was Aquila's One-Third Strategy prudently designed to address the anticipated upward price volatility, but AgP also reviewed Aquila's One-Third Strategy and requested that Aquila implement a hedge program for its steam operations. (Ex. 101 at 4; Ex. 105 & Schedule WEB-6 at 7).

AgP is a sophisticated corporation that engages in its own hedging (Tr. [Johnstone] at 98). It even has its own Vice President of Hedging. Id. at 99-100; Ex. 110 [Excerpt from AgP 2008 Annual Report]). During the development of the Stipulation in the 2005 Steam Rate Case, Aquila and AgP representatives had numerous discussions during which Aquila representatives explained the One-Third Strategy hedge program to AgP. (Tr. at 174, 196-98 [Clemens]; 253-54 [Gottsch]). During one phone call at that time, GMO witness Gary Gottsch specifically explained Aquila's One-Third Strategy to AgP's consultant and expert witness in that rate case, Maurice Brubaker. (Tr. at 174, 197 [Clemens]; 253-54 [Gottsch]). Mr. Brubaker had specifically noted Aquila documents that explained the One-Third Strategy in his Direct Testimony filed in the 2005 Steam Rate Case. (Tr. [Clemens] at 173, 196; Ex. 101 at 3 & Schedule GLC-2).

Based on this exchange of information, it is clear that AgP had reviewed Aquila's One-Third hedging strategy. What's more, AgP not only raised no objection to Aquila's use of its One-Third Strategy for its steam operations at this time, but Ag Processing also unmistakably

requested that Aquila apply its hedge program to its steam operations. (Tr. [Clemens] at 174-75, 196-98).

In his Direct Testimony filed on behalf of AgP in the 2005 Steam Rate Case, Mr. Brubaker stated:

> Especially in light of the high and volatile gas prices currently being faced, it is appropriate for the effects of the hedging program to be reflected in determining the fuel and purchased power costs properly chargeable to consumers.... The fuel and purchased power prices that are the result of the hedging program should be used to determine the cost chargeable to customers, to the extent of the hedge. (Ex. 105 at Schedule WEB-6 at 7 [emphasis added]).

Thus, it is clear that Aquila and AgP discussed and understood the term "financial instruments" to mean the One-Third Strategy of futures contracts and option contracts that had been used in Aquila's natural gas hedging program for its electric operations, and that AgP knew or should have known that it would be used for Aquila's steam operations in St. Joseph. (Ex. 101 [Clemens Direct] at 3, 7, & Schedule GLC-1 at 5).

Furthermore, AgP had numerous opportunities shortly after Aquila implemented its One-Third Strategy for its steam operations to object to this program, but did not. AgP failed to object as early as February 2006, the same month in which Aquila's steam hedge purchases were first made. AgP representatives were present at the February 27, 2006 on-the-record presentation in the 2005 Steam Rate Case where Aquila's One-Third Strategy hedge program for its steam operations was discussed. (Tr. [Johnstone] at 77-79). Despite the clear discussion that Aquila's Gary Clemens conducted with both Commissioners Davis and Clayton about the One-Third hedging strategy (Ex. 108 at 57, 77), neither Mr. Johnstone nor AgP's counsel raised any objection to Aquila's use of that strategy. (Tr. [Johnstone] at 95-96 at 1-4).

AgP also did not object to Aquila's steam hedge program upon receipt and review of each filed quarterly cost adjustment in Case Nos. HR-2007-0028 and HR-2007-0399. (Tr. 74

[Official notice taken of QCA filings in HR-2007-0028 and HR-2007-0399; Ex. 104 at 17). Each of Aquila's QCA filings included the calculation of the new QCA rate which specified gas hedging costs as a separate item, titled "Hedge Costs," within the accumulation of the quarterly fuel costs. (Tr. [Johnstone] at 66, 69; Ex. 101, Schedule GLC-4 & GLC-5; Ex. 106 (QCA July 2006 filing); Ex. 107 (QCA October 2006 filing).

AgP received and reviewed these QCA filings containing the line item for hedge costs but raised no objection to these costs at the time of review or shortly thereafter. (Tr. [Johnstone] at 66, 68-70). Despite specifically noticing the hedge costs that were listed in the QCA filing for July, August, and September 2006, Mr. Johnstone did not have any communication with Ag Processing about hedge costs in October 2006 (Id. at 70), nor did Mr. Johnstone object to Aquila's steam hedge program at that time (Id. at 81).

Despite having reviewed Aquila's One-Third Strategy during the development of the Stipulation in the 2005 Steam Rate case, despite having specifically witnessed the Commission's February 2006 on-the-record discussion of Aquila's implementing the One-Third Strategy, and despite numerous opportunities to object to the One-Third Strategy after its implementation and the QCA filings explicitly disclosing hedging costs, AgP was mum until late 2007. At the request of Ag Processing, Aquila then suspended its natural gas hedging program for its steam operations effective November 1, 2007. (Ex. 101 at Schedule GLC-6).

AgP comes to the Commission 1,123 days after the end of the 2006 QCA period and 758 days after the end of the 2007 QCA with its complaint of imprudence regarding the same program on which it was well briefed prior to implementation and which it knew Aquila had launched. Aquila was not imprudent in implementing the 2006-07 steam hedging program in light of that program's review by and request of its steam customers, who were reasonably

concerned with "the high and volatile gas prices currently being faced" (Brubaker Direct, Schedule WEB-6 at 7, Ex. 105) and thus eager for Aquila to implement its hedge program.

2. Third Parties Favorably Reviewed Aquila's One-Third Strategy.

Other parties have also favorably reviewed Aquila's One-Third Strategy for hedging natural gas. Commission Staff has assessed Aquila's One-Third Strategy, and has not made any allegations of imprudence. Aquila presented its One-Third Strategy to Commission Staff and the Office of the Public Counsel at a July 9, 2004 resource planning update meeting. (Ex. 101, Schedule GLC-2 at 5-20; Ex. 105, Schedule WEB-5 at 3, n. 2). Aquila provided an update to its hedging strategy in a February 25, 2005 memorandum entitled "Missouri Natural Gas & Purchase Power Hedge Strategy – Implementing the Market Neutral Approach – Update," as disclosed in Aquila's August 10, 2005 response to Staff's Data Request No. MPSC-0266 in the 2005 Steam Rate Case. (Ex. 101, Schedule GLC-2). On February 27, 2006, Aquila made an on-the-record presentation to the Commission in the 2005 Steam Rate Case, during which it explained its steam hedge program. (Ex. 108 at 57, 77-79). Commission Staff has reviewed each QCA, which include a line item for hedge costs, with a recommendation for approval. (Ex. 104 at 17). Staff has never submitted any reports to the Commission alleging imprudence with regard to the QCA. (Ex. 104 at 17-18).

The Kansas Corporation Commission ("KCC") reviewed and approved Aquila's One-Third Strategy gas hedging program for electric operations, just months before its implementation for Aquila's steam operations at its Lake Road Plant. (Ex. 105 at 7-8; Ex. 105 at Schedule WEB-1). KCC Staff filed a memorandum in support of a proposed Stipulation and Agreement that would approve Aquila's One-Third Strategy, stating: "This program is designed to reduce, but not eliminate the volatility of [Aquila's] monthly ECA [energy cost adjustment] prices. It is Staff's opinion the proposed program would work as designed." (Ex. 105 at Schedule WEB-2 at 5). In an

Order issued December 27, 2005, the KCC approved the Stipulation, finding that it was "reasonable, in the public interest, and should be approved." (Ex. 105 at Schedule WEB-3).

Significantly, after AgP raised questions about the One-Third Strategy, Aquila ran a comparison study of what the results would have been if a gas hedging program administered by Kase & Company known as EZ Hedge had been used in 2006 and 2007. (Ex. 102 at 17). EZ Hedge would have lost $1,457,660 for 2006 and $3,686,720 for 2007. Both of these amounts are significantly higher -- in total, over $1.5 million higher -- than Aquila's One-Third Strategy losses for those same years. (Ex. 102 at Schedule GLG-8).

None of these third-party reviews has even suggested that the design or administration of Aquila's steam hedging program was imprudent. Indeed, AgP is the only steam customer of Aquila that has filed a complaint alleging that Aquila's steam hedge program was imprudent. (Tr. [Johnstone] at 104).

B. Aquila's Steam Hedging Program Was Prudently Administered.

AgP alleges that Aquila's steam hedging program was imprudent because the forecasted natural gas requirements of its customers were not realized. (Ex. 1 at 5, 23-25, 28-30). However, the facts show that Aquila acted properly. 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. Second, because customers are in the best position to determine their steam load requirements, Aquila has a duty to them to ensure reliable steam service and fulfilled that duty through the steam hedge program. Third, Aquila adjusted its forecasts and hedge purchases in light of customer requirements. 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.

1. Aquila Maintained Regular Communication With Its Customers, Who Assured Aquila of their Load Requirements.

Fuel budget and forecast information is necessarily based on customer input. For this reason, Aquila, particularly through the efforts of Joe Fangman, maintained regular contact with its steam customers in order to assess their load requirements. (Ex. 103 at 4-7). When an Aquila steam customer expected a significant change in its steam load requirements, the steam customer contacted Mr. Fangman, the liaison between Aquila and its customers. (Tr. [Fangman] at 268-69). Since Mr. Fangman was the primary contact at Aquila for any customer who had a change in steam load needs (Ex. 103 at 6-7), Aquila steam customers knew to contact Mr. Fangman regarding any changes in their steam load (Tr. [Fangman] at 269). Mr. Fangman also talked with his steam customers about their operations and load requirements. (Id. at 269, 279). As is demonstrated by these frequent customer communications, Aquila gathered the most accurate information regarding its steam customers' requirements.

Steam customers assured Aquila that that they would increase volumes to forecasted levels. (Ex. 102 at 11; Ex. 103 at 6-10). Aquila's Gary Gottsch's was aware of these forecasts as a result of his daily conversations with plant personnel (Ex. 102 at 11). Mr. Fangman's knowledge was based on monthly, if not more frequent, contact with Aquila's steam customers. (Ex. 103 at 5 & Schedules JGF-1, JGF-2). These assurances continued throughout 2005, 2006, and 2007. (Ex. 103, Schedule JGF-3-17).

Because customers maintained that they would indeed require the load they predicted, the load requirements communicated to Mr. Fangman did not significantly vary from month-to-month during 2006 and 2007. (Ex. 103, Schedule JGF-1 at 85, 90-97, 101-105 & Schedule JGF-2 at 9-21). Nor did their anticipated steam load requirements vary significantly from 2006 to 2007. (Ex. 103, Schedule JGF-1 at 85, 90-97, 101-105 & Schedule JGF-2 at 9-21).

When steam customers advised Aquila of load changes, Aquila was able to, and did in February 2006, update its forecast to reflect such changes. As stated in Aquila's response to AgP's Data Request No. AGP-0013 in HR-2007-0028: "If variations [between budget and actual natural gas volumes] are expected to be temporary, no changes in the program are taken. If long-term and significant, these revisions may be reflected in either a forecast revision (AGP-0009) or incorporated into the next budget." (Ex. 11). As explained in Aquila's response to Ag Processing's Data Request No. AGP-0009, "forecasts may be prepared upon request to reflect significant changes." (Ex. 13).

Mr. Fangman passed the information he received from steam customers regarding anticipated load requirements to Tim Nelson, Aquila's Electric System Analyst and a member of the Resource Planning Group at Aquila, to develop and update the forecast. (Tr. [Fangman] at 276-77; Ex. 103 at 4, 7). Mr. Fangman would review Mr. Nelson's forecasts for reasonableness, based on the information steam customers had given Mr. Fangman regarding their anticipated steam load requirements. He 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). Furthermore, Mr. Nelson discussed budget information with Mr. Gottsch, who made Aquila's hedge purchases, every month or two. (Tr. [Gottsch] at 252). However, because the volume requirements communicated to Aquila were not significantly changing, there was no reason and no data upon which to change Aquila's forecast or hedge purchases outside of its annual update other than the forecast update that occurred in February 2006.

2. Aquila's Hedging Program Assured the Critical Reliability Needs of Steam Customers.

While customers are in the best position to determine their steam load requirements, Aquila has a duty to its customers to ensure reliable steam service. Reliability is one of the most critical factors for the steam customers, including Ag Processing. (Ex. 104 [Rush Direct] at 7-8). Aquila's steam customers have no backup source of steam should Aquila not be able to meet their needs. (Tr. [Fangman] at 294; Ex. 103 at 5-10; Ex. 104 at 11). For this reason, if customers advise of an anticipated significant increase in their steam load and Aquila does not meet it, all steam customers could suffer. (Ex. 104 at 11). As Mr. Rush explained, even though forecasts by customers of their needs have been erratic over the history of the Lake Road Plant, both Aquila and its predecessor St. Joseph Light & Power Co. made investments in boilers and other systems to meet these predictions of load. (Tr. [Rush] at 311-13). Any interruption in steam service can cause significant problems for steam customer operations, both in time and production costs. (Ex. 104 at 7-8).

Because it is critical to the operations of its steam customers that Aquila meet their capacity and operational needs (Tr. [Fangman] at 294), Aquila has an obligation to pay attention to the anticipated load growth of its steam customers. (Tr. [Johnstone] at 85). Consequently, Aquila spent a great deal of time with the customers in order to gain an understanding of their needs. (Ex. 103 [Fangman Direct] at 4-7). Aquila further has an obligation to pay attention to the market and analysts' concerns regarding the supply of natural gas. See MO. REV. STAT. § 393.130.1 (obligation to provide "safe and adequate" service and facilities).

Aquila did so, and entered into its steam hedge program during a time in which analysts were expecting the United States to be in a supply-limited environment filled with uncertainties. (Ex. 105 [Blunk Direct] at 21-22). Aquila's purchase of financial instruments in its steam hedge

program provided assurances of the delivery of natural gas. (Tr. [Rush] at 307-08). As a result, the purchase of financial instruments in the hedge program helped to maintain the reliability of Aquila's steam service. Id.

3. Aquila's Forecasts and Purchases Were Adjusted Prudently, in Light of Customer Requirements.

During the second quarter of each year, Mr. Nelson developed sales forecasts for the subsequent three-year period. (Ex. 103 [Fangman Direct] at 3). Those forecasts were based upon sales history, when available, and on customer projections for the loads that Mr. Fangman received from the five industrial steam customers. (Ex. 103 at 3-5). Once the sales forecast was developed, the fuel resource budget was developed, also based on both sales history and customer projections. (Tr. [Fangman] at 271; Ex. 103 at 3). Mr. Nelson would then give the volume budget to Mr. Gottsch, who purchased a proportional quantity of fixed-price futures and options contracts during each month of the subsequent three years. (Ex. 102 [Gottsch Direct] at 11).

When there was a significant change in steam customer anticipated load requirements, however, the forecast and hedge purchases were adjusted. In 2005, Mr. Fangman was in contact with officials at Triumph Foods shortly after the October 12, 2005 fire at its facility regarding updates on its anticipated startup schedule. (Ex. 103 at Schedule JGF-4). Mr. Fangman provided Mr. Nelson with updated information from Triumph Foods regarding its anticipated load growth following the October 2005 fire (Tr. [Fangman] at 275), although the fire did not have a substantial effect on supply issues in 2006 (Ex. 103 at 9-10 & Schedules 4, 8, 14-16). Mr. Fangman also provided Mr. Nelson with an update on steam load projections for Albaugh Chemicals and Nestlé/Purina PetCare in October 2005. (Tr. [Fangman] at 275; Ex. 103 at 8).

On February 6, Mr. Fangman initiated conversations with all Lake Road Plant steam customers regarding their plans for the next few years. (Ex. 103 at Schedule JGF-5). On February 7, 2006 and February 15, 2006, Mr. Fangman sent updates regarding the steam customers' expected load growth to Aquila's John Modlin, Mike Smith, and Tim Nelson, as well as others. (Tr. [Fangman] at 275; Ex. 103 at Schedule JGF-6). This included information from Ag Processing that it was looking into the possibility of expanding its St. Joseph facility, and that this expansion would require additional steam service from Aquila. (Ex. 103 at Schedule JGF-7 & Schedule JGF-11). The February 15, 2006 volumes were updated volumes for all of Aquila's steam customers. (Tr. [Fangman] at 275).

Mr. Gottsch made Aquila's 2006 hedge purchases on February 16, 2006 using the best available volume estimates that had just been updated the day before. (Tr. at 229-30, 252 [Gottsch]; Tr. at 274, 285-86 [Fangman]; Ex. 102 at 13; Ex. 102 at Schedule GLG-2). Aquila's hedge purchases for 2006 were thus made with the most recent volume information possible that had been updated outside of Aquila's annual forecast and budget process.

Upon receiving the annual updated volumes from Tim Nelson and the Resource Planning Group in 2006 and 2007, Mr. Gottsch adjusted hedge purchases to meet the new budgeted volumes. His actions reflected volume increases as ratable increases in purchases for the balance of the buying cycle and accounted for volume decreases by unwinding existing positions or by reducing purchases for the balance of the buying cycle. (Tr. [Gottsch] at 230; Ex. 102 [Gottsch Direct] at 12 & Schedule GLG-3).

In June 2006, Mr. Fangman provided Mr. Nelson with an update on the steam load projections for three Lake Road steam customers: Triumph Foods, Albaugh, and Silgan Containers. (Ex. 103 at Schedule JGF-8). When the annual budget was released in July 2006, Mr. Gottsch adjusted the 2007 hedge positions to reflect the new budget information. (Tr.

[Gottsch] a 230, 239-40). Indeed, Aquila's steam hedge program had a positive value in July 2006. Id. at 251-52).

In June 2007, Mr. Fangman reviewed the Nelson steam forecast and provided Mr. Nelson with an update on Ag Processing's growth in 2007 and 2008. (Ex. 103 at Schedule JGF-13). When the annual budget was released in July 2007, Mr. Gottsch adjusted the 2008 hedge positions, liquidating positions to meet the budgeted volumes. (Tr. [Gottsch] at 253).

Aquila had no incentive not to run its hedge program according to the best information it had regarding expected volumes. Id. [Gottsch] at 247. It therefore purchased hedges according to the most up-to-date data that it was receiving from customers. Aquila annually reviewed and updated its forecast in 2006 and 2007, adjusting its hedge purchases upon release of the annual forecast to reflect that forecast. It also adjusted its forecasts when there was a significant change in steam customer anticipated load requirements one day before any hedges were purchased. Mr. Nelson further discussed budget information with Mr. Gottsch every month or two, ensuring that the hedged volumes accurately reflected the volumes that steam customers were telling Aquila they would require. Id. [Gottsch] at 252.

4. Aquila's One-Third Strategy Accommodated Uncertainty in Volumes.

Because one-third of the forecast volume requirements was not hedged and one-third of the forecast volume that was hedged using options, 66% of the forecast had the ability to float with fuel requirements. (Ex. 105 at 18). As shown in Exhibit A, attached hereto, Aquila's steam hedge program performed quite well in protecting its steam customers from upward volatility of the price of natural gas while managing the variance between the steam customers' projected load requirements and actual usage.

Exhibit A shows that for the period of April 2006 through December 2007, actual hedged amounts were 2,020,000 MMBtus, consisting of 1,010,000 in futures contracts and 1,010,000 in

options contracts (puts and calls). The one-third of the 2006-2007 steam hedges that was purchased using futures contracts fell well within the actual burn of steam customers, as did the exercised put options for the same time period. The remainder of the actual burn was protected by Aquila's options contracts, which do not need to be exercised above the actual burn. Additionally, the one-third of Aquila's forecast that was covered by the spot market need not be purchased if natural gas is not required. Thus, Aquila protected 66% of its steam customers' anticipated load requirements against upward price volatility with futures and options contracts, but when actual load did not meet forecasted load, Aquila did not need to exercise its remaining options contracts or purchase natural gas on the spot market.

Furthermore, Exhibit A demonstrates that Aquila's steam customers were far better protected from upward price volatility than they would have been had Aquila made hedge purchases based upon historical volumes, as has been suggested by Ag Processing. (Tr. [Johnstone] at 84). This is largely due to the fact that the steam load of Aquila's steam customers was expected to grow considerably in fewer than two years, with the addition of Triumph Foods and the expansion of the plant facilities of Ag Processing, Albaugh, and Nestlé. (Tr. [Johnstone] at 84-85; Ex. 103 [Fangman Direct] at 5-10; Ex. 104 [Rush Direct] at 10). Because this load growth was new, Aquila lacked historical load data upon which to judge its customers' expanding needs. (Tr. [Johnstone] at 85). Furthermore, historical levels are not necessarily a better predictor of requirements than is a deliberate effort by Aquila to use up-to-date information provided by its steam customers.

Aquila's steam hedging program was prudently administered because: (a) Aquila was in frequent contact with its steam customers regarding their load requirements; (b) Aquila hedged according to these anticipated load requirements so as to ensure highly reliable steam service; (c)

Aquila properly adjusted forecasts and hedge purchases where needed; and (d) Aquila's steam hedging program managed the risk of actual burn below forecasted volumes.

V. Conclusion

Since February 2006 when Aquila's steam hedge program began and the Commission issued its Order Regarding Stipulation and Agreement in Case No. HR-2005-0450 (Feb. 28, 2006), neither this Commission nor its Staff has claimed that Aquila's hedging for steam operations was imprudent or that any other aspect of the QCA process was imprudent. (Ex. 105 at 8).

Based on the circumstances that existed when Aquila's steam hedging program was in effect -- including what Aquila knew or should have known about the volatile price of natural gas, the anticipated short supply of natural gas, the anticipated sharp rise in natural gas price for the foreseeable future, as well as the anticipated increase in load from Aquila's steam customers -- Aquila's steam hedge program was prudently designed and administered.

As a result, there is no credible, factual basis for second-guessing the operation of Aquila's steam hedging program, particularly given the time during which it operated. The Complaint should be dismissed.

Respectfully submitted,

/s/ Karl Zobrist

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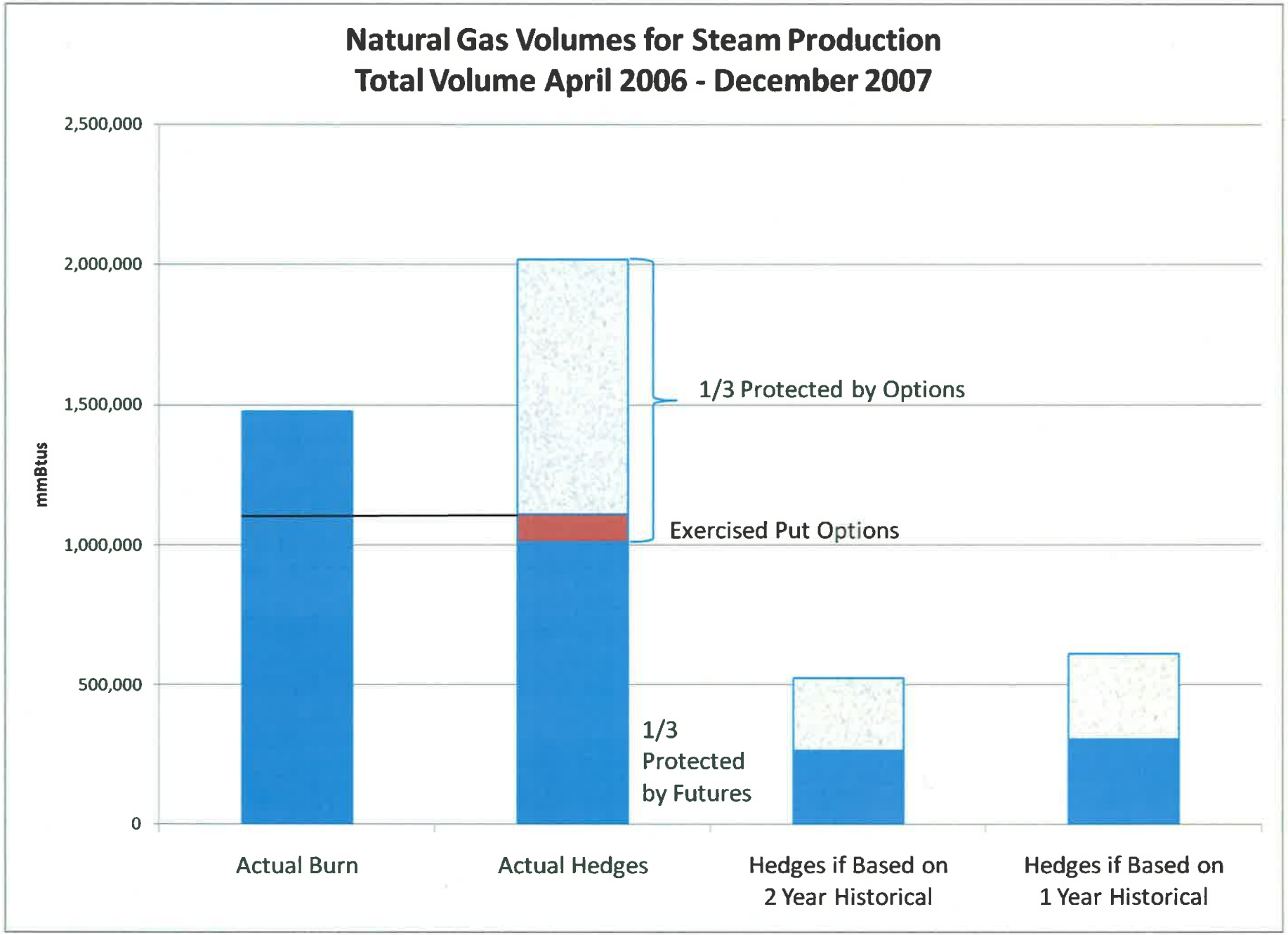
Certificate of Service

A copy of the foregoing has been emailed this 11th day of January 2011 upon counsel of record in this proceeding.

/s/ Karl Zobrist
Attorneys for KCP&L Greater Missouri Operations Co.

EXHIBIT A


Natural Gas Volumes for Steam Production
Total Volume April 2006 - December 2007
2,500,000
2,000,000
1,500,000
1,000,000
500,000
0
mmBtus
1/3 Protected by Options
Exercised Put Options
1/3 Protected by Futures
Actual Burn
Actual Hedges
Hedges if Based on 2 Year Historical
Hedges if Based on 1 Year Historical