BEFORE THE PUBLIC SERVICE COMMISSION
STATE OF MISSOURI

In the Matter of a Working Docket to	)	
Address the Hedging Practices of Electric	)	File No. EW-2013-0101
Utilities used to Mitigate the Rising Costs of Fuel	)	

KANSAS CITY POWER & LIGHT COMPANY AND KCP&L GREATER MISSOURI OPERATIONS COMPANY'S RESPONSE TO STAFF'S REPORTS

COME NOW Kansas City Power & Light Company ("KCP&L") and KCP&L Greater Missouri Operations Company ("GMO") (collectively, the "Company") and hereby submits their response to the Missouri Public Service Commission ("MPSC" or "Commission") Staff's ("Staff") reports.

1. On September 5, 2012, the MPSC opened File No. EW-2013-0101 "to review policies or procedures with regard to electric companies' hedging programs that will hopefully assist the utilities with developing effective hedging programs that serve the public interest by mitigating the rising costs of fuel." On April 8, 2013, Staff filed a report ("April 8 Report") and on January 31, 2014, filed an Additional Staff Report ("Additional Report" or "January 31 Report") regarding its investigations into the hedging practices of Missouri's investor-owned electric utilities. Subsequent to Staff filing the January 31 Report, the Commission issued an Order Inviting Responses to Staff's Reports Regarding Hedging Practices of Missouri's Electric Utilities by no later than April 1, 2014.

I. THE HEDGING ISSUE

2. On page 14 of the April 8 Report, Staff's conclusion provides a good characterization of the hedging issue.

> Hedging is a complex process that can be beneficial for utility customers, but nevertheless presents challenges for both utilities and regulators. Successful hedging is not a one-size-fits-all proposition—what works for one utility in one market may not work for others. Hedging policy requires open communication

> among all stakeholders to make sure electric utilities use emerging power markets and financial instruments in ways that serve the public interest.

3. Missouri utilities have been using futures, options, and collars to hedge since before 1998. The Commission has encouraged hedging through its Natural Gas Price Volatility Mitigation Rule (4 CSR 240-40.018) which states that "natural gas local distribution companies should undertake diversified natural gas purchasing activities as part of a prudent effort to mitigate upward natural gas price volatility…" That rule goes on to delineate call options, collars, futures contracts, financial swaps, options and other instruments as tools for managing price and/or usage volatility. KCP&L began hedging natural gas price risk in 2001. GMO has been hedging natural gas price risk and using natural gas derivatives to cross hedge electricity price risk for purchased power since 2004.

4. The Commission has conducted multiple inquiries into natural gas market price risk. The most recent was in 2005 in response to the Office of the Public Counsel's ("OPC") request that the Commission "ensure that natural gas utilities have done everything in their power to mitigate price spikes and keep rates stable." The Commission expressed its concern regarding "gas acquisition strategies that will ameliorate price spikes" and agreed to "take evidence on this issue as requested by Public Counsel." On February 24, 2006 the Commission received Staff's 44-page "Joint Report on Natural Gas Market Conditions, PGA Rates, Customer Bills & Hedging Efforts of Missouri's Natural Gas Local Distribution Companies", which was described by Staff as a "consensus document" submitted by the parties to the proceeding. *See* Joint Report, File No. GW-2006-0110 (Feb. 27, 2006).

5. The Joint Report noted that Commission Rule 4 CSR 240-40.018 contained the following purpose statement: "This Rule represents a statement of Commission policy that natural gas local distribution utilities should undertake diversified natural gas purchasing

activities as part of a prudent effort to mitigate upward natural gas price volatility and secure adequate natural gas supplies for their customers." In this context, the Joint Report concluded:

> **A central question is what is an appropriate hedging strategy? The answer depends on your view of hedging's objectives, benefits, costs and risks**. Hedging strategies that obtain price certainty in lieu of price variability may not result in the lowest costs. If a utility sets an objective to achieve the lowest delivered cost to customers, and if market prices stay at, or increase from, current levels, then the lower the percentage of market price exposure, the better. If market prices drop significantly, the opposite will be true. If a utility has targeted its hedging strategy at limiting exposure to market price spikes, the appropriate level of hedging for that utility will depend on its perception of forecasted market price trends and the benefits, costs and risks of relative hedging mechanisms. [emphasis added]

6. The Commission's Natural Gas Price Volatility Mitigation Rule which is directed to Local Distribution Companies ("LDC") is instructive in identifying the Commission's concern about the impact of energy market price volatility on utility customers. The State's LDCs pass natural gas costs through a purchased gas adjustment ("PGA") to their customers. GMO and other electric utilities pass natural gas and purchased power costs through a fuel adjustment clause ("FAC") to their customers.[1]

7. The Commission has other rules that encourage electric utilities to hedge. The electric utility rules are not as specific as the LDCs' but they do convey the Commission's concern regarding rate volatility and its understanding that fuel and purchased power are key drivers in rate volatility. Specifically the Commission's rule about filing and submission requirements for Electric Utility Fuel and Purchased Power Cost Recovery Mechanisms as specified in 4 CSR 240-3.161(2) and 4 CSR 240-3.161(3)(K) require "A complete explanation of any rate volatility mitigation features designed in the proposed RAM" (Rate Adjustment Mechanism). The Electric Utility Fuel and Purchased Power Cost Recovery Mechanisms as specified in 4 CSR 240-20.090(2)(H) states, "Any party to the general rate proceeding may

[1] KCP&L does not currently have a FAC.

propose a cap on the change in the FAC, reasonably designed to mitigate volatility in rates, provided it proposes a method for the utility to recover all of the costs it would be entitled to recover." Taken together, these two rules show that the Commission is concerned about mitigating the impact of fuel and purchased power market volatility on customers in a way that allows the utility to recover all of the costs of fuel, purchased power, and rate volatility mitigation measures.

8. Missouri's electric utilities which participated in the hedging workshops agreed on the purpose of hedging. As Staff's January 31 Report noted at page 4, the IOUs agreed and consistently held "that the purpose of hedging is to protect against *price volatility* – not to *reduce* price." Moreover, hedging "should be expected to carry with it a premium just as other forms of insurance do."

II. STAFF'S RECOMMENDATIONS

9. Staff's January 31 Report concluded with the following recommendations:

> a. Staff suggests periodic, informal, free discussions with the IOUs constitutes the most viable course of action at this time. As in its April 8 Report, Staff continues to recommend that, similar to presentations currently provided by LDCs, each electric utility under the Commission's jurisdiction schedule a yearly confidential meeting between the IOU, Staff, and OPC to discuss the past performance and future goals, policies and strategies of its individual hedging program(s). Such presentations should include review and discussion of the effectiveness of cross-hedging policies.
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> b. Given the recent developments and expected changes in the market, Staff also recommends that the IOUs develop and implement hedging policies based on the most prudent strategies to address current and reasonably expected circumstances for the company and its customers – not based on past activities or perceived directives or orders by the Staff or the Commission.
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> c. Staff has done all it can within the context of the present docket, given the current circumstances facing the industry; therefore, Staff recommends the Commission allow interested stakeholders an opportunity to respond to this report, particularly to the Conclusions / Recommendations set forth above, or in the alternative, issue an order closing this file. Should future hedging activities or the annual IOU meetings highlight concerns to be brought to the Commission's attention, Staff will respond accordingly at that time.

10. Staff's first recommendation concerning yearly confidential meetings can be an important part of the open communication needed to ensure hedging is serving the public interest. Therefore, the Company agrees with Staff's recommendation for periodic, informal, confidential, free discussions regarding our hedging program(s).

11. The following portion of Staff's second recommendation contradicts the above recognized need for open communication among all stakeholders.

> …that the IOUs develop and implement hedging policies based on the most prudent strategies to address current and reasonably expected circumstances for the company and its customers – not based on past activities or perceived directives or orders by the Staff or Commission.

Therefore, the Company will address the various parts of this second recommendation and offer alternatives concerning prudence, the need for communicating policy, and consistency with the Commission's prior determinations.

III. KCP&L AND GMO'S RESPONSE TO STAFF'S SECOND RECOMMENDATION

12. To facilitate the Company's response to the second recommendation in the January 31 Report the Company has separated the second recommendation into the following elements:

a. the IOUs develop and implement hedging policies

b. based on the most prudent strategies

c. to address current and reasonably expected circumstances

d. for the company and its customers

e. not based on past activities or perceived directives or orders by the Staff or Commission.

a. the IOUs develop and implement hedging policies

13. The Company agrees with the need to manage risk implied by this part of Staff's recommendation. However without first identifying the purpose for hedging it is not likely that a hedge program will achieve the desired results.

14. Staff's conclusion in its April 8, 2013, report stated, "hedging is not a one-size-fits-all proposition—what works for one utility in one market may not work for others." The Company believes that even the need to hedge is not a one-size-fits-all proposition. For example, KCP&L and GMO have different risk exposures. Less than 8% of KCP&L's energy came from natural gas fired generation or purchased power in 2013. On the other hand, 33% of GMO's energy came from natural gas-fired generation or purchased power likely priced as natural gas-fired generation. Consequently the two companies have different exposures to natural gas market price risk.

15. Staff's report briefly discussed the potential for the FAC mechanism to serve as a price risk mitigation mechanism. "They [the IOUs] agree that their fuel adjustment clauses (FAC), although perhaps not intended to be a price mitigation tool, have the practical effect of mitigating price volatility for customers." Depending on the design of the FAC mechanism and nature of the costs the utility would recover through the FAC, it could be a very cost effective price volatility mitigation device but it is definitely not a "one-size-fits-all" solution. Before the FAC mechanism could be relied on as the exclusive price volatility mitigation device instead of a more traditional hedge program it would require further investigation and a determination that it was in the public interest.

b. based on the most prudent strategies

16. The Company has two major issues with the phrase "most prudent". First, the phrase "most prudent" suggests there is a measure for prudence that results in a score or metric that can be

optimized. Second, the phrase appears to be at odds with the Commission's established standard for prudence.

17. Optimization requires a clearly defined objective. That is, optimization requires identifying what metric is being maximized (or minimized). As discussed elsewhere, the last part of Staff's recommendation would eliminate existing indications regarding the objective or purpose of hedging leaving the utility with no metric by which to compare hedge strategies. Assuming there was a clearly defined objective for the hedge program(s), there is another less obvious issue with requiring the adoption of a strategy that maximizes (or minimizes) that objective. That optimal strategy may not be sufficiently robust to manage the full range of uncertainty. The purpose of a hedge strategy is to manage uncertainty. To be effective a hedge strategy must be sufficiently robust to accommodate the uncertainty it is to manage.

18. To determine if a utility's conduct was prudent, the Commission looks at whether the utility's conduct was reasonable at the time, considering that the company had to solve its problem prospectively rather than in reliance on hindsight. The Company's concern with the phrase "most prudent" is how it might push away from a standard which looks at whether the utility's conduct was reasonable at the time to one that relies on hindsight. More specifically, it would require the utility to have chosen the best performing strategy based on a metric determined after the fact.

c. to address current and reasonably expected circumstances

19. The purpose of hedging is to protect against undesirable future uncertainty. History is replete with examples of market prices spiking beyond expectations. For example, the 50% run up in natural gas prices from January 9th to February 19th earlier this year was not expected. The NYMEX futures contract for March 2014 had not traded above $5.00 in the two years prior to January 2014. In the months leading up to February, none of the forecasts that the

Company subscribes to were predicting prices above $6.00. That is, the price run up from $3.98 on January 9th to $6.14 on February 19th was not expected. A hedger focused on "expected circumstances" might have reasonably determined there was no need to incur the cost of protecting against such a price run up. It is the unexpected nature of the future that gives rise to the desire to hedge.

d. for the company and its customers

20. Staff's April 8 Report cited the National Regulatory Research Institute's ("NRRI") report *Natural Gas Hedging: Should Utilities and Regulators Change Their Approach?*[2] by Ken Costello. At 2 Mr. Costello states,

> The best plan for a utility and its customers depends on may factors, including the utility's hedging objectives, market conditions, the efficacy and availability of hedging tools available, the regulator's policy on hedging and the costs and availability of physical and financial hedges.

21. Mr. Costello goes on at 12 by saying,

> Before considering the merits of a utility hedging plan or taking up any application for cost recovery under such a plan, regulators should establish and publish guidelines—"rules of the road" for hedging—for its review of a proposed hedging strategy, of hedging results, and of utility management performance. These guidelines will help regulators and utilities alike ensure that under any hedging activity utility customers will not be asked to pay for costs that are imprudently incurred. Such an approach, with the regulator involved at all stages, should assure both the utility and its customers that any hedging plan and its execution will be consistent with public policy goals and with a "no surprises" approach to cost recovery.

22. And at 13,

> This "guideline" approach is meant to provide sufficient direction to the utility such that the regulator's preapproval of a hedging plan—an action the utility might prefer—would be unnecessary. By defining hedging plan elements and guidelines while avoiding plan pre-approval, the regulator retains greater latitude to take appropriate action if it determines later that the utility acted imprudently. This approach seems appropriate, since the regulator typically lacks market and other information the utility may possess. This approach falls somewhere

[2] http://www.nrri.org/pubs/gas/NRRI_gas_hedging_May11-10.pdf

> between the poles of (a) regulatory preapproval of a utility's hedging plan, and (b) offering no upfront guidance to the utility. Preapproval of a hedging plan by the regulator may have the negative effect of inducing the utility to adhere too strictly to the letter of a hedging plan as a means to avoid later cost disallowances while avoiding prudent actions—e.g., a proposed departure from the plan to take advantage of a market shift—that would benefit customers. The "no guidance" approach simply leaves the utility at sea and likely to act too conservatively.

23. The Company believes that by stating that the purpose of hedging by electric utilities is price volatility mitigation and that hedging is not a price speculation tool and adopting Staff's first recommendation for an annual review the Commission will balance the company's and customers' interests. On the other hand, the "no guidance" approach incorporated in Staff's second recommendation will likely lead to hedge programs that are too conservative and hence more costly than necessary.

e. not based on past activities or perceived directives or orders by the Staff or Commission

24. The phrase "not based on past activities or perceived directives or orders by the Staff or Commission" eliminates a very important piece of information from the hedging issue. It eliminates the Commission's policy as established through its prior decisions. As discussed above, this is problematic. Because it appears that Staff's intent was to emphasize the desire for "strategies to address current and reasonably expected circumstances" the Company's alternative recommendation is phrased accordingly.

IV. CONCLUSION AND RECOMMENDATIONS

25. A critical element to the success of any hedging program is to define the purpose of the program. Generally a risk management program changes a risk that is deemed undesirable into one that is more acceptable. For example, a buyer that finds market price volatility undesirable can use a variety of instruments to "fix" or "cap" the market price. By "fixing" the price the risk is changed from uncertainty about "what price will be paid" to "will the price be

higher than market." On the other hand, if the buyer's objective was to be "at market" they may adopt a very different strategy. This second buyer would find a fixed price undesirable and if they had a fixed price supply contract or inventory which acted like a fixed price supply, they could hedge to make their price float with the market. You can only determine if a hedging program is successful after defining success.

26. The Company presents the following recommendations to replace those contained in Staff's January 31 Report.

a. The Commission state or affirm that the purpose of hedging by electric utilities is price volatility mitigation[3] and that hedging is not a price speculation tool. This statement would be consistent with the LDC "Natural Gas Price Volatility Mitigation" rule[4] and the utilities' current practices[5].

b. Each electric utility under the Commission's jurisdiction schedule a yearly confidential meeting between the IOU, Staff, and OPC to discuss the past performance and future goals, policies and strategies of its individual hedging program(s).

c. The Commission allows its prior decisions, existing rules and regulations to continue to serve as guidance regarding hedging prudence. That is, where the costs and benefits of hedging would flow through a Rate Adjustment Mechanism the purpose of hedging is to mitigate volatility and there are various ways to achieve that objective.

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[3] Electric utilities face price risks in more markets than just natural gas. A general policy statement such as the one recommended here can provide guidance regarding the public policy good for managing the price risks in those different markets.
[4] Natural Gas Price Volatility Mitigation Rule (4 CSR 240-40.018)
[5] Additional Staff Report, page 4

d. If the Commission wants to investigate the potential for using the FAC mechanism as a cost effective energy market price risk mitigation tool, either continue this docket or establish another for that purpose.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I do hereby certify that a true and correct copy of the foregoing document has been hand-delivered, emailed or mailed, postage prepaid, this 1st day of April, 2014 to all counsel of record in this case.

/s/ Roger W. Steiner

Roger W. Steiner