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**

REPLY BRIEF OF RESPONDENT
KCP&L GREATER MISSOURI OPERATIONS COMPANY

Respondent KCP&L Greater Missouri Operations Company, formerly Aquila, Inc., ("GMO" or "Company"),[1] pursuant to the Commission's January 20, 2010 Order Granting Joint Motion for Extension of Time, submits this Reply Brief.

I. Prudence Standard and Burden of Proof

Complainant Ag Processing, Inc. ("AgP") erroneously characterizes the complaint case that it has brought as if it were a rate making proceeding initiated by GMO. The Quarterly Cost Adjustment ("QCA") process commenced in March, 2006, as a result of the Stipulation and Agreement that occurred in Aquila's 2005 Steam Rate Case filed in Case No. HR-2005-0450 ("Steam Rate Case"). However, the pending proceeding was initiated by AgP as a complaint, pursuant to Section 8 found on Tariff Sheet 6.4 of the QCA Rider, attached as Appendix A to the Complaint.

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[1] The Company will also be referred as "Aquila" when appropriate, as was done in the Initial Brief of Respondent.

Section 8 provides:

> 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.

Although this provision is the basis for the filing of the Complaint, AgP has erroneously concluded: "Thus, the QCA process is explicitly a ratemaking process and the Associated rule as to burden of proof of prudence is fully applicable and GMO has the burden of proof." See AgP Initial Brief at 7.

To the contrary, the rule in State ex rel. Associated Natural Gas Co. v. PSC, 954 S.W.2d 520, 529 (Mo. App. W.D. 1997), does not put the burden of proof upon the respondent. Under longstanding Missouri law, the Commission presumes that the actions of the utility are prudent unless a party raises "a serious doubt" concerning the prudence of its actions. State ex. rel. Public Counsel v. PSC, 274 S.W.3d 569, 578, 587 (Mo. App. W.D. 2009); 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).

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." State ex rel. Public Counsel v. PSC, 274 S.W.3d at 586.

Therefore, the burden is upon AgP and, as discussed below and in the Company's Initial Brief, AgP has failed to create any serious doubt.

II. The QCA Does Not Provide the Protection of a Hedging Program, Which is Why AgP Requested Such a Program

AgP continues to argue that because the QCA mechanism spread the effects of price changes, it was therefore a "price volatility mitigation mechanism" that made Aquila's natural gas hedging program superfluous. See AgP Brief at 7-12. The Company explained in detail in its Initial Brief at pages 9-11 and pages 21-26 how the hedging program through the use of its

One-Third Strategy mitigated upward price volatility. The Aquila steam hedge program permitted it to avoid purchasing all of its natural gas requirements when the cost of natural gas spiked. This price mitigation tool is entirely absent from the QCA's simple cost-sharing and cost-spreading mechanism. Consequently, Aquila was not imprudent in implementing the 2006-2007 steam hedging program in light of the QCA mechanism.

AgP disregards the Direct Testimony of both GMO witnesses William Edward Blunk and Gary Gottsch who discussed in detail not only the reasons why a hedging program mitigates price volatility, but additionally why the One-Third Strategy in this case addressed the particular needs of both Aquila and its customers.

AgP also ignores the fact that its expert witness in the 2005 Steam Rate Case, Maurice Brubaker, testified that "it is appropriate for the effects of the [Aquila] hedging program to be reflected in determining the fuel and purchased power costs properly chargeable to consumers . . . ." See Ex. 105, Schedule WEB-6 at 7. Mr. Brukaker's endorsement of the program was based on his view that "the main purpose" of Aquila's "hedging program is to dampen the price swings in the market and to otherwise protect consumers from increases in price." Id. at 6-7.

Both Mr. Brubaker and AgP's expert witness in this case, Mr. Johnstone, 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 specifically. At that hearing, the following colloquy occurred:

> COMMISSION CLAYTON: Does Aquila have a hedging program or a gas purchasing program in the steam operation which would be similar to its gas operations?
>
> MR. CLEMMONS: Yes.

COMMISSIONER CLAYTON: And the $6.70, how far out does that go where you can identify 6.70 as the price? When I say "how far out," is -- how far out in the future is Aquila hedged at that price?

MR. CLEMMONS: We're not hedged at that price.

COMMISSIONER CLAYTON: You're not?

MR. CLEMMONS: No. No.

COMMISSIONER CLAYTON: What price are you hedged at? Is that public?

MR. CLEMMONS: It's $8.42 is what we're hedged in for 2006. That's only for two-thirds of our gas. We still have another third that we aren't hedged.

* * *

CHAIRMAN DAVIS: . . . And we've already heard some testimony from you that you're about, was it two-thirds hedged for natural gas for '06; is that correct?

MR. CLEMMONS: That's correct. That's the current plan.

CHAIRMAN DAVIS: Okay. So is there any way -- way feasible that you can beat this $3 per million Btu amount?

MR. CLEMMONS: Well, the other third gas that we have not hedged, we are in the process of buying that at a lower rate just through efficiencies. And if we can burn more coal at the plant, that would lower the ratio. If we can burn higher than the 2.1 that's built into the rate, that would give an opportunity for us. It gives us incentive to try to be efficient on the --

CHAIRMAN DAVIS: On the coal side.

MR. CLEMMONS: -- on the coal side, yeah.

See Ex. 108 at 57, 77-78.

It is clear from this discussion that the Aquila hedging program and the aspects of its One-Third Strategy were not only discussed in the presence of the customers' consultants and counsel, but on the record before this Commission and other parties to the 2005 Steam Rate Case. See Ex. 108 at 36 (both Mr. Brubaker and Mr. Johnstone noted as present at the on-the-record presentation).

Consequently, all parties including AgP understood that the One-Third Strategy of hedging had been adopted by Aquila, and that its performance would be reflected in the QCA mechanism.

III. The Hedge Program Was Properly Designed

Although AgP argues that the hedge program was not properly designed, the Company's evidence demonstrated conclusively that the One-Third Strategy had been developed carefully over several years, was presented to Staff and other interested parties as early as 2004 in an Integrated Resource Planning session, and was an appropriate program to apply to Aquila's steam operations at the St. Joseph Lake Road Plant.

Company witness Gary Clemens noted that he and Andrew Korte (the Aquila vice president who approved the design of the steam hedge program), as well as others, had made presentations to Staff and others in 2004 about the One-Third Strategy hedge program as it applied to Aquila's electric operations. See Ex. 101 (Clemens Direct) at 5-6 & Sched. GLC-2 at 2-6, 13-14. As Vice President of Energy Resources, Mr. Korte and his group authored the memorandum that explained the reasoning behind the One-Third Strategy. See Ex. 101, Sched. GLC-2 at 2-6. More importantly, Mr. Gottsch testified that he personally explained the One-Third Strategy to AgP's consultant and expert witness, Mr. Brubaker, as the 2005 Steam Rate Case was reaching settlement. (Tr. at 174, 197 [Clemens]; 253-54 [Gottsch]).

As discussed in the Company's Initial Brief at pages 15-17, if AgP had any reservations about the program and was concerned about any alleged oversight by Aquila to consider gas as a "swing" fuel, AgP remained silent until late 2007. When AgP did request that Aquila suspend its natural gas hedging program for steam operations, Aquila promptly complied, ending the program effective November 1, 2007. (Ex. 101 at Schedule GLC-6).

IV. The Hedge Program Was Properly Administered

A. Neither Staff nor any other Party has Claimed Imprudence.

The QCA tariff in this case provides for a prudence review of its operations by Staff. The Step One process calls for Staff 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." See Tariff Sheet 6.4 (attached to Exhibit A to the Complaint). As GMO witness Tim Rush stated in his Direct Testimony, the Staff has performed extensive audits regarding the QCA, including its operation and mechanics, as well as the prudence of the costs incurred. Staff has submitted and the Company has responded to numerous data requests investigating all aspects of the QCA. See Rush Direct Testimony at 18. Staff has never submitted any reports to the Commission alleging imprudence with regard to the QCA or any other irregularity. Id.

The QCA tariff also provides that Staff may proceed "with Step Two, a full prudence review, if deemed necessary." Mr. Rush confirmed that such a prudence review has never been initiated, and that no party except AgP has brought a complaint to the Commission regarding allegations of imprudence. Id. at 5.

The fact that Staff has raised no issue with the operation of the QCA is significant because an element of the QCA cost recovery/refund mechanism is hedge costs. Exhibits 106 and 107 are the filings that Aquila made on July 14, 2006 and October 16, 2006, respectively. A specific cost item in each of these exhibits (page 4 of Exhibit 106 and pages 4 and 5 of Exhibit

107) set forth specific hedge costs that were incurred in 2006. The Commission took administrative notice of the other filings of a similar nature that occurred in 2007 in these cases. See Tr. 74. No one except AgP has objected to these costs.

B. Aquila Communicated with Customers and Accepted their Estimates.

AgP continues to complain that Aquila's forecasts were excessive, but fails to acknowledge that Aquila's estimates of load were based upon its regular communications with customers who assured the Company of their load requirements. Company witness Joe Fangman, who worked for Aquila at the time and served as the chief liaison between Aquila and its customers, testified that he regularly talked with steam customers about their operations and load requirements. (Tr. [Fangman] at 268-79).

As noted in Mr. Fangman's Direct Testimony, assurances by Aquila's steam customers with regard to their load 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. at 229-30, 252 [Gottsch]; Tr. at 274, 285-86 [Fangman]; Ex. 102 at 13; Ex. 102 at Schedule GLG-2). Such efforts by both Mr. Fangman and Mr. Gottsch continued into 2007, as noted on page 24 of the Company's Initial Brief.

C. Puts were Sold to Mitigate Losses and to Benefit Customers.

AgP continues to assert without basis that Aquila sold puts for profit during this period of time, improperly engaging in speculation. This argument ignores the clear explanation provided by Company witness Blunk in his Direct Testimony. See Ex. 105 at 18-20. He explained that when Aquila constructed price collars by purchasing call options and selling put options, "it protected itself and its customers from upward price movement. Aquila then committed to buy gas that it fully expected to need at prices that were below market at the time the deal was made. That is not speculation." Id.

Mr. Blunk concluded that "Aquila's sold or wrote put options and turned some of the call options it had purchased into collars as a means of mitigating the hedge program's premium expense." Id. at 19. The monetary benefit that accrued to customers is demonstrated by Schedule GLG-3 to Mr. Gottsch's Direct Testimony. In the Company's Response to AgP Data Request 15 in Case No. HR-2007-0028, the first QCA filing, it provided a detailed spreadsheet that set forth the results of each month of the hedge program in 2006 and 2007: The NYMEX Swaps, the Calls and the Puts. See Ex. 102, Schedule GLG-3 at 3 through 16.

The summary page for 2006 (Sched. GLG-3 at 4) under the box labeled "Puts" shows a loss of $36,320, while the summary page for 2007 Puts (Sched. GLG-3 at 12) shows a gain of $75,260. In total, the steam hedge program produced a net gain of $38,940, of which 80% or $31,152 were passed through the QCA to steam customers to reduce the cost of the program.

As such, the put sales did exactly what the Commission's 2006 Joint Report on Natural Gas Market Conditions said they should do. They reduced the cost of the hedge program. See Ex. 105 (Blunk Direct) at 19-20.[2] Aquila's actions were not imprudent.

D. The Aquila Steam Hedge Program was Flexible.

AgP also fails to recognize that the steam hedge program's One-Third Strategy had the capacity to manage downward volume risk of 66%. As explained in the Company's Initial Brief at pages 24-26, only the one-third consisting of fixed-price futures contracts locked Aquila into

[2] The Commission's Joint Report on Natural Gas Market Conditions, PGA Rates, Customer Bills & Hedging Efforts of Missouri's Natural Gas Local Distribution Companies, Case No. GW-2006-0110 (Feb. 24, 2006) stated at page 12 that under this strategy "the premium received for the put option offsets part of the premium paid for the call option."

gas purchases. If volumes fell, the Company was not required to exercise its options contracts and the remaining third was left open for as-needed purchases on the spot market.

Thus, Aquila protected 66% of its customers' estimated load requirements against upward price volatility with futures and options contracts, but provided for the chance of falling prices and reduced load as well. While the cost of the premiums associated with the options contracts could not be avoided, the One-Third Strategy properly managed any variance between steam customers' projected load requirements and actual usage.

E. A Comparable Hedge Program Would have Produced Greater Losses.

If there is any question whether the One-Third Strategy employed by Aquila was prudent, any doubt is dispelled by comparing the results of that program with a similar gas hedging program administered by an independent hedge company known as Kase & Company. It operated a program called EZ Hedge that could have been used by Aquila in 2006 and 2007.

When Company witness Gottsch, who at the time worked for Aquila, compared the One-Third Strategy program with EZ Hedge, his analysis showed that EZ Hedge would have lost $1,457,660 for 2006 and $3,686,720 for 2007. Given that these losses totaled over $1.5 million more than the Aquila One-Third Strategy losses during those same years, it is clear that the Aquila program was not imprudent. See Ex. 102 (Gottsch Direct) at 17 and Schedule GLG-8.

V. AgP Ignores the Influence of Natural Gas Prices

AgP makes not one mention in its lengthy Initial Brief of the dramatic and historic volatility in the natural gas market during 2006 and 2007. As Company witness Blunk described in detail, after Hurricanes Katrina and Rita struck the Gulf Coast in late August and mid-September 2005, natural gas production dropped to levels not seen since 1989.

Analysts in late 2005 and early 2006 were predicting that the United States was entering a multi-year period of hurricanes like Katrina and Rita that would disrupt natural gas production and trigger even more price uncertainty. See Ex. 102 (Gottsch Direct) at 14-15 & Sched. GLG-4 through GLG-6; Ex. 105 (Blunk Direct) at 21-28 and Sched. WEB-11. AgP's expert witness in the 2005 Steam and Electric Rate Cases agreed. In his October 5, 2005 testimony, Mr. Brubaker observed that after Hurricanes Katrina and Rita, "natural gas gathering and processing facilities were severely damaged" and "prices have escalated substantially." Although he stated that these high prices were not "permanent," Mr. Brubaker testified: "However, I believe gas prices will stay high until there is better visibility with respect to the restoration of these volumes to the market." See Sched. WEB-6 at 5.

Accordingly, when Aquila found an opportunity in mid-February to lock in what then appeared to be reasonable prices for the near future, it did so, based upon current estimates of expected steam requirements from customers and an appropriate assessment of the natural gas market at the time. See Ex. 102 (Gottsch Direct) at 14-15.

As detailed in the Company's Initial Brief at pages 3-6, as well as in its Proposed Findings of Fact 110-123, the natural gas market had experienced unprecedented volatility at the time the hedge program was initiated. The market was then dramatically affected by the unexpected development of gas from the Marcellus Shale Field, as well as the growth in demand at the Lake Road Plant.

Given all of these variables, the only reasonable conclusion is that the steam hedging program was properly administered at the time, given the volatility of the natural gas markets and the customers' anticipated gas volumes.

VI. AgP Can Only Assert Claims on Behalf of Itself

Although AgP is the only complainant in this proceeding, it continues to seek to recover the net costs of the hedging program in both 2006 and 2007, which would include costs that were paid without protest by the other customers on the Lake Road Plant's steam system. See AgP Initial Brief at 57.

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 (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.

Respectfully submitted,

/s/ Karl Zobrist

Karl Zobrist MBN 28325
Lisa A. Gilbreath MBN 62271
SNR Denton US LLP
4520 Main Street, Suite 1100
Kansas City, MO 64111
(816) 460-2400
(816) 531-7545 (fax)
karl.zobrist@snrdenton.com
lisa.gilbreath@snrdenton.com

Roger W. Steiner MBN 39586
Corporate Counsel
Kansas City Power & Light Company
1200 Main Street
Kansas City, MO 64105
Telephone: (816) 556-2314
Email: Roger.Steiner@kcpl.com

Attorneys for KCP&L Greater Missouri Operations Co.

Certificate of Service

A copy of the foregoing has been emailed this 9th day of February 2011 to all counsel of record.

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