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.	)	

RESPONDENT'S PROPOSED FINDINGS OF FACT AND CONCLUSIONS OF LAW AND PROPOSED ORDER

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Respondent KCP&L Greater Missouri Operations Company, formerly Aquila, Inc., ("Aquila," "GMO" or "Company"), pursuant to the Commission's November 22, 2010 Order, submits its Proposed Findings of Fact and Conclusions of Law and Proposed Order.

I. Findings of Fact

A. The QCA Mechanism in the HR-2005-0450 Stipulation and Agreement

1. The Quarterly Cost Adjustment ("QCA") was first initiated in March, 2006, as an outcome of Aquila's 2005 steam rate proceeding, Case No. HR-2005-0450 ("Steam Rate Case"). (Ex. 104 [Rush Direct] at 17).

2. Ag Processing played an integral part in the development of the QCA in the Steam Rate Case. (Ex. 101 [Clemens Direct] at 2).

3. Ag Processing consultant and expert witness Donald Johnstone 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).

4. The Nonunanimous Stipulation and Agreement ("Stipulation") that was agreed to by Ag Processing in the Steam Rate Case provided for a natural gas hedging program and the recovery of its costs. (Ex. 101 at 3). 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." (Tr.[1] [Clemens] at 197-98; Ex. 101 at Schedule GLC-1 at 5).

5. Ag Processing was a signatory to each of the stipulations that resolved the 2005 Steam Rate Case and 2005 Electric Rate Case. (Ex. 101 at 3, 5).

6. The parties to Steam Rate Case discussed and understood the term "financial instruments" to mean futures contracts and option contracts. (Tr. [Johnstone] at 64; July 21, 2010 Order Denying Motion to Dismiss).

7. The parties to Steam Rate Case discussed and understood the term "financial instruments" to mean the futures contracts and option contracts that had been used in Aquila's natural gas hedging program that Aquila had used for certain of its electric operations, and that would be used for its steam operations in St. Joseph. (Ex. 101 at 3, 7; Ex. 101 at Schedule GLC-1 at 5).

8. There is no requirement in the Stipulation for Aquila to obtain prior approval from any signatory party before Aquila purchased any financial instruments. (Tr. [Johnstone] at 65 at lines 7-13).

9. There is no requirement in the Stipulation for Aquila to obtain prior approval from Staff, the Office of Public Counsel, Ag Processing, or anyone else before Aquila purchased any financial instruments. (Id., lines 14-19).

[1] "Tr." refers to the Transcript of Proceedings in this case, mainly the evidentiary hearing conducted on November 18-19, 2010.

10. At no time during the development of the Stipulation did Ag Processing consultant and expert witness Mr. Johnstone communicate what kind of steam hedging program that Aquila should implement. (Id. at 95, lines at 6-11).

11. 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. (Tr. [Johnstone] at 100, lines 12-20).

12. The QCA spreads the cost of natural gas purchases over a 12-month period. (Tr. [Clemens] at 161-62; Sections 8, 8.3, and 8.6 of the Stipulation and Original Sheet Nos. 6.1–6.3 of the QCA Rider).

13. The QCA does not affect the price paid for natural gas purchased. (Tr. [Clemens] at 162, lines 12-16; 176 at lines 7-12).

14. Thus, the QCA cannot and does not mitigate or dampen the price of natural gas that is purchased. (Id. at 161-62, 176).

15. On February 24, 2006 the Commission received from Commission Staff the Joint Report on Natural Gas Market Conditions, PGA Rates, Customer Bills & Hedging Efforts of Missouri's Natural Gas Local Distribution Companies ("Joint Report"), which defined hedging as "the management of a natural gas portfolio to mitigate adverse upward price volatility" and stated that the "goal of hedging is not to 'beat the market' but rather to mitigate upward price volatility." See Case No. GW-2006-0110 (Feb. 27, 2006) at 8; Ex. 105 [Blunk Direct] at 4.

16. Since the QCA's establishment, Aquila, now GMO, has filed quarterly cost adjustments with the Commission for approval. The cases in which the QCAs were filed are: HR-2007-0028; HR-2007-0399; HR-2008-0340; HR-2010-0028; HT-2010-0288. (Tr. at 74, administrative notice of QCA filings in HR-2007-0028 and HR-2007-0399 taken. See also Ex. 104 [Rush Direct] at 17).

17. Each QCA has been reviewed by Staff with a recommendation for approval and none of which has been rejected or found deficient in any way. (Ex. 104 at 17).

18. 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 at Schedules GLC-4 and GLC-5; Ex. 106 [QCA tariff effective Sept. 1, 2006]; Ex. 107 [QCA tariff effective Dec. 1, 2006]).

19. Ag Processing received and reviewed these QCA filings. (Tr. [Johnstone] at 66, 68-69).

20. In October 2006, Ag Processing consultant and expert witness Mr. Johnstone saw the hedge costs that were listed in the QCA filing for July, August, and September 2006. (Id. [Johnstone] at 69-70).

21. Despite noticing these hedge costs in the QCA, Ag Processing consultant and expert witness Mr. Johnstone did not have any communication with Ag Processing about hedge costs in October 2006. (Id. [Johnstone] at 70).

22. In 2006, after the QCA filings were made and reviewed by Ag Processing, Ag Processing consultant and expert witness Mr. Johnstone did not object to Aquila's steam hedge program. (Id. [Johnstone] at 81).

23. The Staff has not submitted any reports to the Commission alleging imprudence with regard to the QCA. (Ex. 104 [Rush Direct] at 18).

B. Steam Customer Expansions at Lake Road

24. Customer demand and, accordingly, the Company's steam sales have grown significantly since 2005 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. 104 at 10).

25. Based on the projections provided by customers in 2005, the steam load of Aquila's steam customers was expected to grow considerably in fewer than two years. (Ex. 103 [Fangman Direct] at 5-10; Ex. 104 [Rush Direct] at 10).

26. Because this growth in the anticipated requirements of Aquila's steam customers was new load, Aquila did not have historical load data upon which to judge its customers' needs. (Tr. [Johnstone] at 85).

27. If customers advise of an anticipated significant increase in their steam load and Aquila does not meet it, all steam customers could suffer because Aquila did not meet the needs of the system. (Ex. 104 at 11). Customers do not have an alternative if Aquila is unable to serve their needs. (Tr. [Fangman] at 294, lines 1-16; Ex. 103 [Fangman Direct] at 5-10; Ex. 104 [Rush Direct] at 11).

C. Design of the Steam Hedge Program

28. Aquila's hedging strategy for steam generation was developed to address the predictions of continued record price levels by market observers after Hurricanes Katrina and Rita struck the Gulf Coast in 2005. (Tr. [Gottsch] at 213-14; Ex. 102 [Gottsch Direct] at 17-18; Ex. 105 [Blunk Direct] at 7, 27-29).

29. Aquila's hedging strategy for steam generation was also 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).

30. Aquila's steam hedge program was implemented in February 2006 to take advantage of the significant decline in price for natural gas in early 2006. (Tr. [Gottsch] at 252).

31. 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).

32. 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, lines 7-11).

33. Aquila's approach for hedging natural gas was its One-Third Strategy. This approach was to procure one-third of the monthly forecast quantity through fixed price New York Mercantile Exchange ("NYMEX") futures contracts, one-third in option contracts (straight calls or fences), and the remaining 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).

34. Aquila's one-third procurement in 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 was used to help offset premium costs for the calls that were purchased. (Tr. [Gottsch] at 236, lines 13-16; Ex. 102 at 7, 9; Ex. 105 at 19).

35. Aquila's program for hedging regarding its steam operations was similar to a program that Aquila established for the electric operations of Aquila Networks-MPS; both programs employed the One-Third Strategy for procuring natural gas hedges. (Tr. [Clemens] at 136, lines12-21; Tr. [Gottsch] at 243, lines 17-23; Ex. 105 [Blunk Direct] at 10, Schedule WEB-4 and Schedule WEB-5).

36. There is no prohibition in the Stipulation in the 2005 Steam Rate Case on Aquila taking the One-Third Strategy it had used in its electric operations and using it in its steam operations. (Tr. [Johnstone] at 75, lines 12-16).

1. Purpose of the 1/3 Strategy

37. The goal of Aquila's One-Third Strategy for hedging natural gas was to mitigate price volatility. (Ex. 102 [Gottsch Direct] at 4). This goal is consistent with the Joint Report's definition of hedging as "the management of a natural gas portfolio to mitigate adverse upward

price volatility" and statement that the "goal of hedging is not to 'beat the market' but rather to mitigate upward price volatility." See Case No. GW-2006-0110 (Feb. 27, 2006) at 8; Ex. 105 [Blunk Direct] at 4).

38. Aquila's One-Third Strategy mitigates upward price volatility by protecting two-thirds of Aquila's customers' total exposure against upward price moves, as one-third of the monthly forecast quantity is 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).

39. By hedging two-thirds of the steam customers' total exposure, Aquila protected its steam customers against the upward volatility in natural gas prices that were predicted to continue for the foreseeable future. (Ex. 102 at 18).

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

2. Management of Volume Inaccuracy and Uncertainty

41. It is common for actual marginal or swing fuel volumes to be different than budget. (Tr. [Rush] at 311-13; Ex. 105 [Blunk Direct] at 18).

42. By design, Aquila's One-Third Strategy had the capacity to manage downward volume risk of as much as 66%. (Ex. 105 at 18). One-third of the forecast volume requirements was not hedged, so floated with fuel requirements. One-third of the forecast volume that was hedged using options could also float with fuel requirements. (Id.).

3. Review by Third Parties

43. 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 related to its electricity operations. (Ex. 101, Schedule GLC-2 at 5–20; Ex. 105, Schedule WEB-5 at 3, n. 2).

44. Aquila provided an update to its hedging strategy in a memorandum entitled "Missouri Natural Gas & Purchase Power Hedge Strategy – Implementing the Market Neutral Approach – Update" which had been prepared on February 25, 2005, as shown 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).

45. The Kansas Corporation Commission ("KCC") reviewed and approved Aquila's One-Third Strategy gas hedging program for electric operations. (Ex. 105 [Blunk Direct] at 7-8 and Schedule WEB-1).

46. 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.
> Aquila-WPK submitted a well developed Application and the presentation of its 'preferred hedge plan' is the best Staff has ever seen. Aquila should be commended. (Ex. 105, Schedule WEB-2 at 5).

47. 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, Schedule WEB-3).

48. On February 27, 2006, Aquila made an on-the-record presentation to the Commission in the 2005 Steam Rate Case. This presentation included a specific discussion of Aquila's steam hedge program. (Ex. 108). Both of Ag Processing's expert witnesses Mr.

Johnstone (Id. at 36, 95-96) and Mr. Brubaker (Id. at 36) were present, as was Ag Processing's counsel.

49. Aquila also 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 [Gottsch Direct] 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 than Aquila's One-Third Strategy losses for those same years. (Ex. 102, Schedule GLG-8).

4. Review and Request by Ag Processing

50. Aquila implemented its One-Third gas hedging strategy for its steam operations at the request of or with the consent and/or express knowledge of Ag Processing. (Ex. 101 [Clemens Direct] at 4; Ex. 105 [Blunk Direct] at 15-17 and Schedule WEB-6 at 7; Ex. 108).

51. Aquila's response to Commission Staff's Data Request No. MPSC-0266 describes Aquila's gas hedging program. (Ex. 101, Schedule GLC-2). This response includes the July 9, 2004 presentation of Aquila's gas hedge program to Staff of the Commission and to the Office of Public Counsel. (Ex. 101, Schedule GLC-2 at 5-20). This response is referenced in the Direct Testimony that Maurice Brubaker filed on behalf of Ag Processing on October 14, 2005 in both the 2005 Steam Rate Case and the 2005 Electric Rate Case. (Tr. [Clemens] at 173, 196; Ex. 101 at 3).

52. In his Direct Testimony filed on behalf of Ag Processing, Inc. in Aquila's 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, Schedule WEB-6 at 7 [emphasis added]).

53. Mr. Johnstone also expressed a concern about high natural gas prices in testimony filed in HR-2005-0450 when he stated, "The high prices and volatility in the natural gas costs and markets are a concern." (Ex. 105, Schedule WEB-7 at 11).

54. Ag Processing engages in its own hedging. (Tr. [Johnstone] at 98, lines 3-8).

55. Ag Processing has a Vice President of Hedging. (Tr. [Johnstone] at 99-100; Ex. 110 [2008 Ag Processing Annual Report, noting Daryl Dahl as Vice President of Hedging in Management Staff section]).

56. Aquila and Ag Processing representatives had numerous discussions during the development of the Stipulation in the 2005 Steam Rate Case during which Aquila representatives explained Aquila's One-Third Strategy hedge program to Ag Processing. (Tr. [Clemens] at 174, 196-98; Tr. [Gottsch] at 253-54).

57. Based on these discussions, Aquila reasonably believed that Ag Processing had no objection to Aquila's use of its One-Third Strategy for its steam operations. (Tr. [Clemens] at 174-75, 196-98).

58. Ag Processing 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 77-80).

59. Ag Processing representatives raised no objection to Aquila's use of its One-Third Strategy for its steam operations at or shortly after the February 2006 on-the-record presentation before the Commission concerning the same. (Tr. [Johnstone] at 95-96).

60. Ag Processing received and reviewed Aquila's QCA filings containing a 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).

61. Ag Processing is the only Aquila steam customer that has filed a complaint alleging that Aquila's steam hedge program was imprudent. (Tr. [Johnstone] at 104, lines 15-23).

D. Execution of the Steam Hedge Program

1. Customer Communication

62. Aquila's steam customers assured Aquila that that they would increase volumes to budgeted levels. (Ex. 102 [Gottsch Direct] at 11; Ex. 103 [Fangman Direct] at 6-10).

63. These assurances came in GMO witness Gary Gottsch's daily conversations with plant personnel (Ex. 102 at 11) and GMO witness Joe Fangman's monthly, if not more frequent, contact with Aquila's steam customers. (Ex. 103 at 5 and Schedules JGF-1 and JGF-2).

64. When an Aquila steam customer expected a significant change in its steam load requirements, the steam customer contacted Mr. Fangman, an Aquila customer liaison between Aquila and its customers. (Tr. [Fangman] at 268-69).

65. Aquila steam customers knew to contact Mr. Fangman regarding changes in anticipated steam load. (Tr. [Fangman] at 269, lines 3-6). Mr. Fangman was the steam customers' primary contact at Aquila if any steam customer had a change in steam load needs. (Ex. 103 at 6-7).

66. Mr. Fangman also contacted steam customers regarding any changes in their anticipated steam load requirements. (Tr. [Fangman] at 269, 279).

67. Mr. Fangman maintained regular contact with the steam customers to monitor their activities that could affect load. (Ex. 103 at 4-7).

68. Throughout 2005, 2006, and 2007, steam customers continued to assure Aquila that their anticipated steam loads would be met. (Ex. 103, Schedules JGF-3-17).

69. Aquila's steam customers' anticipated steam load requirements communicated to Mr. Fangman did not significantly vary from month-to-month during 2006 and 2007. (Ex. 103, Schedules JGF-1 at 85, 90-97, 101-105 and JGF-2 at 9-21).

70. The information Mr. Fangman received from steam customers regarding anticipated load requirements was the information that Mr. Fangman passed along to Tim Nelson, an Aquila System Analyst and a member of the Resource Planning Group at Aquila, to develop and update the forecast. (Ex. 103 [Fangman Direct] at 4, 7).

71. Mr. Nelson prepared and updated the forecast based on input from Mr. Fangman and Mike Smith, the Plant Manager of the Lake Road Generating Station. (Tr. [Fangman] at 276-77; Ex. 103 at 4).

72. 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. (Tr. [Fangman] at 276-77, 288).

73. Mr. Fangman would make sure that steam customers' anticipated load requirements were reflected in the forecasts and would make adjustments to Mr. Nelson's forecasts if needed. (Tr. [Fangman] at 288; Ex. 103, Schedules JGF-2 at 9-14, JGF-3, and JGF-13).

74. Mr. Nelson discussed budget information with Mr. Gottsch every month or two. (Tr. [Gottsch] at 252, lines 13-18).

2. Reliability Needs of Customers

75. Reliability is one of the most critical factors for the steam customers, including Ag Processing. (Ex. 104 [Rush Direct] at 7-8).

76. Aquila's steam customers have no backup source of steam should Aquila not be able to meet their needs. (Tr. [Fangman] at 294, lines 1-13).

77. Any interruption in steam service can cause significant problems for steam customer operations, both in time and production costs. (Ex. 104 [Rush Direct] at 7-8).

78. It is therefore critical to the operations of its steam customers that Aquila meet the capacity and operational needs of those steam customers. (Tr. [Fangman] at 294, lines 11-16).

79. Aquila has an obligation to pay attention to the anticipated load growth of its steam customers. (Tr. [Johnstone] at 85, lines 19-24).

80. Aquila entered into is steam hedge program during a time in which analysts expected the United States to be in a supply-limited environment with a number uncertainties concerning that supply. (Ex. 105 [Blunk Direct] at 21-22).

81. The purchase of financial instruments in a hedge program provides assurances of the delivery of natural gas and, therefore, is linked to the reliability of Aquila's steam service. (Tr. [Rush] at 307-08).

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

82. Typically in the second quarter of each year, Aquila developed for its steam business the sales forecasts for the subsequent three-year period. (Ex. 103 [Fangman Direct] at 3). Those forecasts were prepared based on sales history and on customer projections for large industrial loads. (Ex. 103 at 3, 4).

83. Once the steam sales forecast was developed, the fuel resource budget was developed, also based on both history and on customer projections as it was developed from the steam sales forecast. (Tr. [Fangman] at 271, lines 2-14; Ex. 103 at 3).

84. After receiving volumes from the Resource Planning Group, Mr. Gottsch purchased a proportional quantity of fixed-price and options contracts during each month of the subsequent three years that is sufficient to have fully procured the one-third volumes of fixed and options by October 31st of the calendar year immediately proceeding the calendar year of need

(e.g., purchase of calendar 2009 monthly fixed needs in equal quantities during the 28 months from July 2006 through October 2008). (Ex. 102 [Gottsch Direct] at 11).

85. Purchases occur on the day the spot contract expires to reduce volatility risk within the month. (Ex. 102 at 11).

86. In 2005, Mr. Nelson updated the 2006–2008 steam budget based on information Mr. Fangman obtained from steam customers in March and April of 2005. (Ex. 103 [Fangman Direct], Schedule JGF-3).

87. 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, Schedule JGF-4).

88. 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, lines 1-5).

89. The fire at the Triumph facility did not have a substantial effect on supply issues in 2006. (Ex. 103 at 9-10 and Schedules JGF-4, 8, 14-16).

90. In October 2005, Mr. Fangman provided Mr. Nelson with an update on steam load projections for Triumph Foods, Albaugh Chemicals, and Nestlé/Purina PetCare. (Tr. [Fangman] at 275; Ex. 103 at 8).

91. In December 2005 and January 2006, Ag Processing informed Mr. Fangman 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, Schedules JGF-7 and JGF-11).

92. On February 6, Mr. Fangman initiated conversations with all Lake Road steam customers regarding their plans for the next few years. (Ex. 103, Schedule JGF-5).

93. On February 7, 2006 and February 15, 2006, Mr. Fangman sent updates regarding the steam customers' expected steam load growth to John Modlin, Mike Smith, and Mr. Nelson, as well as other Aquila employees. (Tr. [Fangman] at 275; Ex. 103, Schedule JGF-6).

94. 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, Schedule JGF-8).

95. In June 2007, Mr. Fangman reviewed Mr. Nelson's steam forecast and provided Mr. Nelson with an update on Ag Processing's growth in 2007 and 2008. (Ex. 103, Schedule JGF-13).

96. Mr. Gottsch received updated volumes from Mr. Nelson and the Resource Planning Group in February 2006, June 2006, and July 2007. (Ex. 102 [Gottsch Direct], Schedule GLG-2).

97. Mr. Nelson discussed budget information with Mr. Gottsch every month or two. (Tr. [Gottsch] at 252, lines 13-18).

98. Upon receiving updated volumes from Mr. Nelson, Mr. Gottsch adjusted volumes and hedge plans, reflecting increases as ratable increases in purchases for the balance of the buying cycle and implementing decreases by unwinding existing positions or by ratable decreases in purchases for the balance of the buying cycle. (Ex. 102 at 12).

99. Aquila's 2006 hedge purchases were made on February 16, 2006. (Tr. [Gottsch] at 230, lines 9-12; Ex. 102 at 13).

100. Aquila's 2006 hedge purchases were made using volumes that had been updated the day before, February 15, 2006. (Tr. [Gottsch] at 229-30, 252; Tr. [Fangman] 274, 285-86; Ex. 102 at 13 and Schedule GLG-2). The February 15, 2006 volumes were updated volumes for all of Aquila's steam customers. (Tr. [Fangman] at 275, lines 6-25).

101. Aquila's remaining hedge purchases were adjusted to meet the new budgeted volumes released in 2006 and 2007. (Tr. [Gottsch] at 230, lines 18-23; Ex. 102, Schedule GLG-3).

102. When the annual budget was released in July 2006, Mr. Gottsch adjusted the 2007 hedge positions. (Tr. [Gottsch] at 230, lines 20-23 and at 239, lines 13-19).

103. Mr. Gottsch sufficiently adjusted 2007 hedge positions to reflect the new budget information released in July 2006. (Tr. [Gottsch] at 240 at lines 10-19).

104. Aquila's steam hedge program had a positive value in July 2006. (Tr. [Gottsch] at 251-52).

105. When the annual budget was released in July 2007, Mr. Gottsch adjusted the 2008 hedge positions. (Tr. [Gottsch] at 253). Mr. Gottsch adjusted the 2008 hedge positions by liquidating positions to meet the new budgeted volumes. Id.

106. Aquila had no incentive to not run its hedge program to the best budgeted volumes it had in its possession at the time. (Tr. [Gottsch] at 247, lines 7-15).

107. Aquila did not imprudently sell puts. As explained by Mr. Blunk, put options were sold to mitigate the hedge program's premium expense. See Ex. 105 (Blunk Direct Testimony) at 18-20. Reference to the data produced by the Company to AgP shows that while in 2006 the sale of puts produced a loss of $36,320, in 2007 such sales produced a gain of $75,260. Therefore, the total gain during the 2006-07 Steam Hedge Program yielded a gain of $38,940, of which 80% or $31,152 was flowed back to steam customers under the QCA mechanism. See Sched. GLG-3 at 4, 12, attached to Ex. 102 (Direct Testimony of Gary Gottsch).

4. Aquila's Steam Hedge Program Was Prudently Administered and Was Suspended at the Request of Ag Processing

108. Since February 2006 when the 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 Quarterly Cost Adjustment process was imprudent. (Ex. 105 [Blunk Direct] at 8).

109. Aquila suspended the gas hedging program as it related to its steam operations effective November 1, 2007 at the request of Ag Processing. (Ex. 101 [Clemens Direct], Schedule GLC-6).

E. The Natural Gas Market

110. Since about 2000, the level of uncertainty increased significantly for natural gas. (Ex. 105, Schedule WEB-12). 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 at 23-24).

111. Hurricanes Katrina and Rita made landfall on August 28, 2005 and September 19, 2005, respectively, resulting in a drop in natural gas production levels not seen since September 1989. (Ex. 105, Schedule WEB-11).

112. Following Hurricanes Katrina and Rita, predictions based on long-range weather trends were that 2005 was the beginning of a decades-long season of hurricanes like Katrina and Rita. Those predictions further increased the uncertainty of natural gas production and drove even more price uncertainty. (Ex. 105 at 27-28).

113. In early 2006, experts were predicting another active hurricane season for 2006. (Ex. 102 [Gottsch Direct] at 14 and Schedules GLG-4 and GLG-5).

114. An active hurricane season creates a spike in natural gas prices. (Tr. [Gottsch] at 251, lines 18-23).

115. The U.S. also was expected in 2006 to be in a supply-limited environment with a number uncertainties concerning that supply. (Ex. 105 at 21-22).

116. Consequently, analysts in January and early February 2006, including Bear Sterns and Raymond James, were predicting gas prices to remain high for the foreseeable future. (Ex. 102, Schedule GLG-6 at 1, 8).

117. In early 2006, the natural gas market was just coming down from the unprecedented high prices of mid-December 2005 due to the active 2005 hurricane season. (Tr. [Gottsch] at 251, lines 5-17; Ex. 102 [Gottsch Direct] at 14; Ex. 105 [Blunk Direct] at 27). On December 14, 2005 the Henry Hub cash mid-point averaged $15.395 and the price of gas on the Southern Star Central pipeline (which fed Aquila's plants) averaged $13.55. (Ex. 102 at 14).

118. The Energy Information Agency ("EIA") had predicted in its February 7, 2006 update an average Henry Hub 2006 price of $8.87. (Ex. 102 at 14). Aquila's average hedge purchases for all of 2006 for steam customers was $8.15 for future contracts, an average strike price of $8.71 for call option purchases, and it sold puts at a $6.00 average (nearly $3 below market projection). (Ex. 102 at 4-15).

119. Aquila's hedging purchases for 2006 were made in February 2006, at a time when 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 rise throughout the balance of the year. (Tr. [Gottsch] at 252, lines 5-17; Ex. 102 at 15).

120. While October was the worst performing month of the hedge positions in 2006, at the time of the purchase of October hedges in February 2006, the October contract had fallen nearly 30% from its highs just two months prior, and these positions were still in the money as late as July 31, 2006 when October futures settled the day at $8.45. (Ex. 102 at 15). Aquila's October fixed purchases were made at a $7.93 average. (Id.).

121. In 2005, the Commission opened an investigation in Case No. GW-2006-0110 in response to the Office of the Public Counsel's request that the Commission "ensure that natural gas utilities have done everything in their power to mitigate price spikes and keep rates stable." (Ex. 105 at 30-31).

122. On February 24, 2006 the Commission received from Commission Staff the 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. (Ex. 105 [Blunk Direct at 31). This Joint Report noted that "hedging strategies that obtain price certainty in lieu of price variability may not result in the lowest costs." (Ex. 105 at 32). It went on to note that, "[i]f 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." (Id.).

123. Since January 2006, the unexpected development of shale gas has changed the fundamental outlook for natural gas and resulted in a tremendous increase in natural gas reserves that are now perceived as economically recoverable. (Ex. 105 at 29). In 2002, the United States 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. (Id.). 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. (Id.).

II. Conclusions of Law

A. The Prudence Standard in Missouri

1. 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). According to the Commission, 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.

2. 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).

3. 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).

B. The Burden of Proof

4. 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 may be assumed to have been made in the exercise of reasonable judgment, unless the contrary is shown. Missouri ex rel. Southwestern Bell Tel. Co. v. PSC, 262 U.S. 276, 289 n.1 (1923).

5. 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). Thus, the Commission recognizes that "a utility's costs are presumed to be prudently incurred, and that a utility 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).

6. 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.). 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).

C. Aquila's Natural Gas Hedging Program was Prudent

7. The Commission presumes that the costs of Aquila's steam hedge program were prudently incurred.

8. The Commission has examined the circumstances that existed at the time Aquila made natural gas hedge purchases for its steam operations during the 2006 and 2007 QCA periods. These circumstances included 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 prices for the foreseeable future, and (d) the projected increase in load communicated to Aquila by the steam customers.

9. Ag Processing has failed to create serious doubt as to the prudence of Aquila's steam hedge program and the expenditures that were incurred under the program. Additionally, Aquila has dispelled any reasonable doubt as to the prudence of the steam hedge program and its costs, and has shown that the program was prudently designed and administered.

III. Proposed Order

THE COMMISSION ORDERS THAT:

1. Based on the circumstances that existed at the time Aquila's steam hedge program was in operation, it was prudently designed and administered.

2. Ag Processing's Complaint is dismissed.

Respectfully submitted,

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Certificate of Service

A copy of the foregoing has been emailed this 9th day of February 2011 upon counsel of record in this proceeding.

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