Exhibit No.
Issue: Risk Management Policy
Witness: Robert W. Sager
Type of Exhibit: Surrebuttal Testimony
Sponsoring Party: The Empire District Electric Co.
Case No. EO-2017-0065
Date Testimony Prepared: July 2017

**Before the Public Service Commission
of the State of Missouri**

**Surrebuttal Testimony**

**of**

**Robert W. Sager**

**July 2017**

Empire District
A Liberty Utilities Company

TABLE OF CONTENTS
SURREBUTTAL TESTIMONY OF
ROBERT W. SAGER
ON BEHALF OF
THE EMPIRE DISTRICT ELECTRIC COMPANY
BEFORE THE
MISSOURI PUBLIC SERVICE COMMISSION
CASE NO. EO-2017-0065

**SUBJECT** **PAGE**

SURREBUTTAL TESTIMONY
OF
ROBERT W. SAGER
THE EMPIRE DISTRICT ELECTRIC COMPANY
BEFORE THE
MISSOURI PUBLIC SERVICE COMMISSION
CASE NO. EO-2017-0065

## I. INTRODUCTION

**Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

A. Robert W. Sager, 602 Joplin Street, Joplin, Missouri, 64801.

**Q. ARE YOU THE SAME ROBERT W. SAGER THAT PROVIDED REBUTTAL TESTIMONY IN THIS MISSOURI PUBLIC SERVICE COMMISSION ("COMMISSION") CASE ON BEHALF OF THE EMPIRE DISTRIC ELECTRIC COMPANY ("EMPIRE" OR "COMPANY")?**

A. Yes, I am.

**Q. PLEASE EXPLAIN THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY.**

A. The purpose of my surrebuttal testimony is to respond to the rebuttal testimonies of the Office of the Public Counsel ("OPC") witnesses John Riley and Charles Hyneman. My testimony will address positions OPC has taken regarding Empire's Risk Management Policy ("RMP") and Risk Management Operations Committee ("RMOC").

**Q. PLEASE PROVIDE A SUMMARY OF YOUR SURREBUTTAL TESTIMONY.**

A. Empire has maintained a consistent and comprehensive RMP for over 15 years, providing flexibility and allowing the Company to address various areas of risk including, but not limited to, price volatility, credit exposure, and volume. No specific instances of imprudence on the part of Empire have been identified or quantified by OPC in this proceeding. In addition, OPC has disregarded risk factors other than price and deemed Empire's entire RMP to be imprudent due to hedging "losses" incurred during the audit period. Empire's RMP was never intended to provide the lowest price, but, consistent with the direction provided by the Commission, is intended to reduce risk for the Company and its customers.

**Q. WHAT ACTIONS DOES EMPIRE RECOMMEND THAT THE COMMISSION TAKE IN THIS PROCEEDING?**

A. Empire recommends the Commission 1) reject OPCs position that all hedging should be eliminated, 2) find Empire's hedging during the audit period to be prudent, 3) find the continuation of hedging is prudent due to the unknown future of the natural gas market, and 4) provide a path for an annual stakeholder review and approval of hedging plans to prevent imprudence allegations related to market conditions.

## II. OPC'S MISREPRESENTATION OF EMPIRE'S RMP AND RMOC

**Q. ON PAGE 19 OF HIS REBUTTAL TESTIMONY, MR. HYNEMAN STATES THAT EMPIRE'S RMP IS "…INFLEXIBLE AND THEREFORE IMPRUDENT…THIS IS THE ESSENCE OF OPC'S POSITION IN THIS CASE." DOES HE PROVIDE EVIDENCE OR EXAMPLES SUPPORTING THIS OPINION?**

A. No. The essence of OPC's position as to the RMP's "inflexibility" is not supported with actual examples or proposals where Mr. Hyneman believes more flexibility could be added.

**Q. PLEASE EXPLAIN WHY OPC'S LABELING OF EMPIRE'S RMP AS "INFLEXIBLE" IS INCORRECT.**

A. OPC and Mr. Hyneman have characterized the existence of minimum and maximum volumes to hedge as inflexible. In reality, however, setting a range of parameters provides flexibility, and, in this instance, also addresses volumetric risk, which may be encountered if no minimums are required and gas is only hedged if some pre-determined price was available. Under Empire's RMP, a wide range of approved hedging tools are available to meet the minimum volume requirements. Hedges may include physical forward contracts, financial contracts such as NYMEX futures, calls, puts, or any of the approved mechanisms defined in the RMP. This allows for ample discretion – and flexibility - when evaluating markets and price, while ensuring volume risk is managed.

**Q. PLEASE CONTINUE WITH YOUR EXPLANATION OF THE FLEXIBILITY OF EMPIRE'S RMP.**

A. The volume minimums in Empire's RMP are set for a 12-month period. Hedges can be utilized in greater size in high volume months, with nothing hedged in the shoulder months of spring and fall. Significant planned outages may also be considered and managed by effectively placed natural gas hedges. In summary, the minimum and maximum ranges, variety of approved hedging instruments, and annual targets allow many opportunities for discretion and market consideration when implementing the RMP.

**Q. ON PAGE 17 OF HIS REBUTTAL TESTIMONY, MR. HYNEMAN STATES "EMPIRE'S RMOC HAS BEEN IMPRUDENT" IN ITS OVERSIGHT. DO YOU AGREE WITH THIS ASSESSMENT?**

A. No. Mr. Hyneman ignores the fact that during the 2009 to 2016 timeframe, the RMOC met approximately 62 times, an average of nearly 8 occasions per year, reviewed over 400 Gas Position Reports, and made several RMP revisions as described on page 3, lines 17-19, of my rebuttal testimony.

**Q. PLEASE CONTINUE WITH YOUR EXPLANATION OF THE INACCURACIES OF MR. HYNEMAN'S STATEMENT REGARDING EMPIRE'S RMOC.**

A. Mr. Hyneman has also ignored the fact RMOC has reviewed price trends and market conditions multiple times a year, as is evidenced in the RMOC meeting minutes provided in response to OPC DR 1005.

**Q. IS THERE ANY EVIDENCE TO SUPPORT MR. HYNEMAN'S STATEMENT REGARDING THE RMOC?**

A. No, there is no evidence to support Mr. Hyneman's position regarding the prudency of the RMOC's oversight. As presented in Aaron Doll's rebuttal testimony, figure AD-2, recorded financial hedging "losses" over the 16-year life of the RMP have netted approximately $3 million and has reduced exposure to price spikes and volatility while providing price predictability for the Company and its customers. Hedging losses on financial positions were recorded during the audit period, pursuant to Generally Accepted Accounting Principles ("GAAP"). However, despite these recorded losses, Empire was able to take advantage of the low market and reduce fuel costs for each FAC adjustment filed during the audit period, reduce the base fuel rate in its rate case (File No. ER-2016-0023), and manage natural gas procurement risks by operating within the guidelines established in the RMP. The realization of low fuel costs while managing risks indicate the RMP is sound and that the RMOC is providing the appropriate oversight.

## III. PRUDENCY AND CUSTOMER PROTECTIONS AND BENEFITS

**Q. OPC ASSERTS THAT EMPIRE'S FUEL ADJUSTMENT CLAUSE ("FAC") COSTS DURING THE AUDIT PERIOD ARE IMPRUDENT DUE TO RECORDED HEDGING LOSSES. PLEASE EXPLAIN "HEDGING LOSSES."**

A. Hedging losses are recorded, as required by Generally Accepted Accounting Principles ("GAAP"), when financial hedging instruments settle at a price below the contract price which was paid. As an example, assume a hedge needs to be placed for 10,000 Dth for June 2018 and today is October 15, 2017. It is determined a NYMEX futures contract is the most appropriate hedging mechanism to utilize based on available prices. Please note a futures contract is a financial hedge. No delivery of physical gas is implied when purchased. The price of the June 2018 contract is $3.15/Dth. Fast forward to May 28, 2018. The future contracts expire for June 2018 at $3.00. This means a $0.15/Dth loss, or $1500, is recorded as per GAAP. Likewise, if the June 2018 contract expired at $3.30, a $.15 or $1500 "gain" would have been recorded. This process is referred to as mark to market.

**Q. IS THE SAME PROCESS USED FOR PHYSICAL HEDGES?**

A. No. Physical forward contacts, in which Empire would take delivery of the gas, are exempted per GAAP from mark to market calculations. This is because the purchase of physical gas is a normal purchase and used in the ordinary course of business. Therefore, physical gas purchases are not included in calculations to determine hedging gains and losses.

**Q. MR. HYNEMAN STATES ON PAGE 19, LINES 20-22, OF HIS REBUTTAL TESTIMONY THAT THE ONLY PRUDENT AND APPROPRIATE OBJECTIVE OF FUEL HEDGING POLICY IS TO PROTECT CUSTOMERS FROM RAPID INCREASES IN UTILITY COSTS DUE TO RAPID INCREASES IN FUEL COSTS. DO YOU AGREE WITH THAT STATEMENT?**

A. No. As stated in Empire's RMP, and pursuant to the guidance provided by the Commission, a risk management plan ought to include "an organizational structure for effectively assessing and managing risk associated with the Company's natural gas supply for fuel, commodity sales and wholesale power activities. It provides a framework for effective control, audit, and reporting. The procedures set forth allow for the management of operational risks without placing undue restrictions on the operations of the Company." Mr. Hyneman has not considered other risks associated with fuel procurement, such as volumetric risk or counterparty risk. To state that protection from rapid price increases ought to be the only objective of a risk management plan seems myopic and perilous.

**Q. TO WHAT ARE YOU REFERRING WHEN YOU MENTION COMMISSION GUIDANCE REGARDING HEDGING THAT IS CONTRARY TO OPC'S ASSERTIONS IN THIS PROCEEDING?**

A. Generally speaking, I am referring to the fact that Empire's fuel costs and hedging practices have been before the Commission numerous times, including in rate cases and FAC prudence reviews, with no imprudence on the part of Empire being alleged. Also, in 2012, the Commission opened an investigatory docket, File No. EW-2013-0101, regarding hedging practices.

**Q. WHY DID THE COMMISSION OPEN THE HEDGING DOCKET?**

A. According to a report filed by the Staff of the Commission, the Commission opened the working docket "in response to a suggestion made by KCP&L Greater Missouri Operations Company . . . during the third prudence review of GMO's fuel adjustment clause." Staff continued by explaining that, in the GMO prudence review case, "the Commission denied Staff's allegation that, among other things, GMO imprudently relied on an 'overly rigid, market-insensitive cross hedging strategy' and should therefore return nearly $15 million to customers." The Staff report also noted that, during GMO's prudence review, GMO suggested that the Commission "provide additional guidance regarding the use of natural gas hedging, and implement a process to avoid similar disputes over its hedging programs in the future." Staff stated that the Commission "found this request reasonable and ordered this investigatory docket: '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.'"

**Q. WHO PARTICIPATED IN THE HEDGING DOCKET, WHAT WAS ASKED OF THE UTILITIES, AND WHAT WAS THE RESULT?**

A. The Commission directed that all investor-owned gas local distribution companies and all investor-owned electric utilities participate. Some of the questions directed to the electric utilities were as follows: "How active should electric utilities be in changing hedging positions or strategy based on new market conditions and new information? How have changes in the natural gas market since 2009 affected the benefits, for both utilities and their customers, of hedging natural gas? Should electric utilities change or modify their strategy in response to changes in the natural gas market since 2009?" Empire, like the other Missouri electric utilities, presented the details of its hedging program to the Commission at that time. When the Commission issued its order closing the hedging docket, the Commission stated as follows: "The Commission assures KCPL/GMO that Staff's recommendation simply expresses the views of Staff and does not change Commission policy."

**Q. HAS THE COMMISSION PROVIDED ANY OTHER GUIDANCE REGARDING HEDGING THAT IS CONTRARY TO OPC'S ASSERTIONS IN THIS PROCEEDING?**

A. Yes. The purposes of hedging have also been addressed in Commission decisions and in a Commission rule. For example, in a KCPL proceeding, File No. ER-2014-0370, the Commission concluded that hedging programs "help to avoid volatility in the coal market and limit exposure to natural gas market price risk." 2015 Mo. PSC

Lexis 789, p. 70. Commission Rule 4 CSR 240-40.018, pertaining to hedging by gas utilities, specifically notes that "(p)art of a natural gas utility's balanced portfolio may be higher than spot market price at times, and this is recognized as a possible result of prudent efforts to dampen upward volatility."

**Q. ON PAGE 21 OF HIS REBUTTAL TESTIMONY, MR. HYNEMAN DISCUSSES EMPIRE'S HEDGING IN RELATION TO THE FAC AND STATES: "THE FAC TRANSFERRED ALL RISK OF HEDGING LOSSES FROM EMPIRE'S OWNERS TO EMPIRE'S CUSTOMERS." IS THIS AN ACCURATE STATEMENT?**

A. No. Empire's FAC mechanism allows for 95% of the fuel costs to be passed to its customers, leaving 5% which will affect the Company's bottom line. In addition, Empire rejects the premise of OPCs statement which assumes cost is all that matters. Price stability and predictability provide value to all customers; however, customers on a fixed or limited income could be significantly affected by a rapid rise in natural gas prices if unprotected by a hedging program.

**Q. ON PAGE 21 OF HIS REBUTTAL TESTIMONY, MR. HYNEMAN STATES, "THE HEDGING LOSSES ARE PASSED ON TO THE RATEPAYER WHILE PROVIDING NO RATEPAYER BENEFIT AT ALL." IS THIS AN ACCURATE STATEMENT?**

A. No. Once again, OPC is only considering one aspect of natural gas procurement risks in its evaluation - price. Empire's hedging practices insulate customers from price volatility. Even in the relatively stable market of the past few years, price spikes still occur, as evidenced during the polar vortex in March of 2014. In addition, credit risks are managed to insure the financial stability of counterparties. As discussed later in this testimony, volumetric concerns are also important to manage to ensure Empire is able to offer their efficient natural gas generators into the Southwest Power Pool ("SPP") Integrated Marketplace ("IM") and potentially avoid elevated market prices due to higher priced generation from other market participants. It is not possible to guarantee the lowest price to customers, without perfect knowledge of the future. This is not possible, and, of course, has never been the purpose of the RMP. Prior to implementation of the FAC, Empire's overall goal was to have a diverse generation mix to mitigate rapid uncontrolled utility rates because of a spike in fuel commodity prices. That philosophy continues with the generation resources Empire has today. The RMP and the hedging program are intended to provide a framework for Empire to work within to create some price predictability, so our customers do not experience wild swings in their bills related to fuel. This concept has not changed since the implementation of the FAC.

**Q. ON PAGE 5 OF HIS REBUTTAL TESTIMONY, MR. RILEY STATES THE "COMPANY BUYS FOR VOLUME" PURPOSES. HAS MR. RILEY CONSIDERED ALL RELEVANT FACTORS WHEN LOOKING AT EMPIRE'S HEDGING PRACTICES, INCLUDING BUYING FOR VOLUME PURPOSES?**

A. No. While his statement is partially correct, Mr. Riley has neglected to recognize that many other factors need to be considered to ensure fuel is available to operate generation assets. If Empire was only concerned about volume, the hedging program would consist of forward purchases at index, rather than a mix of instruments that allow for both price and volume hedging objectives to be achieved.

**Q. PLEASE EXPLAIN WHY VOLUME IS IMPORTANT TO NATURAL GAS HEDGING.**

A. Volume has always been an important component, as evidenced especially in recent years with the IM being implemented in the SPP. Empire has a significant amount of natural gas generation, as Mr. Riley alluded to, and these units are some of the most economic units in the SPP based on recent gas prices, heat factors, etc. Empire's customers have benefitted with lower fuel costs, because these units run frequently in the SPP. To operate the natural gas generation units, natural gas must be available. Mr. Riley does not take into consideration that the "spot market" for natural gas has limited availability, particularly during high gas usage periods. Generation volumes in relation to peak seasons are also important. The winter peak creates competition for available volumes due to the heating season which can cause constraints in the supply chain. Certain hedging transactions can provide mitigation of supply chain (volume) risks. Suppliers and counter party credit risks also must be considered to ensure the volumes and pricing of transactions can be realized. Each of these risk factors must be considered when administering a hedging program, as is done by Empire, and consideration of only one, such as pricing, as is suggested by OPC, may be considered imprudent.

**Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?**

A. Yes, it does.

## AFFIDAVIT OF ROBERT W. SAGER

**STATE OF MISSOURI )**
**) ss**
**COUNTY OF JASPER )**

On the 28th day of July, 2017, before me appeared Robert W. Sager, to me personally known, who, being by me first duly sworn, states that he is the VP of Finance and Admininistration of The Empire District Electric Company and acknowledges that he has read the above and foregoing document and believes that the statements therein are true and correct to the best of his information, knowledge and belief.

Robert W. Sager
Robert W. Sager

Subscribed and sworn to before me this 28th day of July, 2017.

Sherri J. Blalock
Notary Public

My commission expires: Nov. 16, 2018

SHERRI J. BLALOCK
Notary Public - Notary Seal
State of Missouri, Newton County
Commission # 14969626
My Commission Expires Nov 16, 2018