**BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI**

In the Matter of the Sixth Prudence Review of Costs Subject to the Commission-Approved Fuel Adjustment Clause of The Empire District Electric Company	)))	Case No. EO-2017-0065

THE EMPIRE DISTRICT ELECTRIC COMPANY'S STATEMENT OF POSITIONS

COMES NOW The Empire District Electric Company ("Empire" or "Company"), by and through counsel, and respectfully files its Statement of Positions in the above-captioned case. In this regard, Empire states as follows to the Missouri Public Service Commission ("Commission"):

Issue 1: Was Empire's natural gas hedging policy that caused costs to be incurred for the period of March 1, 2015 through August 31, 2016 imprudent?

No. Empire's hedging policy, and all costs flowed through Empire's Fuel Adjustment Clause ("FAC") for the period of March 1, 2015 through August 31, 2016, were prudent. Total net fuel and purchased costs for the review period were $217,448,739, with total energy costs of $193,631,266 flowed through the FAC for the review period.

The Commission's FAC rule defines fuel and purchased power costs as "prudently incurred and used fuel and purchased power costs, including transportation" and states that "(p)rudently incurred costs do not include any increased costs resulting from negligent or wrongful acts or omissions by the utility." Rule 4 CSR 240-20.090(1)(B). To evaluate prudence, Staff reviews "whether a reasonable person would find both the information the decision-maker relied on and the process the decision-maker employed when making the decision under review was reasonable based on the circumstances at the time the decision was made, i.e. without the benefit of hindsight." *See* Staff's Sixth Prudence Audit Report (emphasis added), February 28, 2017, Staff Report, p. 1. "If either the information relied upon or the decision-making process employed was imprudent, then Staff examines whether the imprudent decision caused any harm to ratepayers. Only if an imprudent decision resulted in harm to ratepayers will Staff recommend a refund." *Id.*

Staff's prudence audit procedure is in line with the prudence standard advanced by the courts. A utility's conduct "should be judged by asking whether the conduct was <u>reasonable at the time</u>, under all the circumstances, considering that the company <u>had to solve its problem prospectively rather than in reliance on hindsight</u>. In effect, our responsibility is to determine how reasonable people would have performed the tasks that confronted the company." *State ex rel. Associated Natural Gas Co. v. Public Service Commission*, 954 S.W.2d 520, 529 (Mo.App. W.D. 1997) (internal citations omitted) (emphasis added).

The Commission, pursuant to RSMo. 386.266 and Commission Rule 4 CSR 240-20.090, first authorized a FAC for Empire in Case No. ER-2008-0093. The Commission approved continuation of Empire's FAC, with certain modifications, in Case Nos. ER-2010-0130, ER-2011-0004, ER-2012-0345, ER-2014-0351, and ER-2016-0023. In those rate cases, it is determined what cost categories shall be included in Empire's FAC. Prudence reviews of costs flowed through the FAC are also required every 18 months. In this case, the costs flowed through Empire's FAC from March 1, 2015 through August 31, 2016 (the 14th, 15th, and 16th six-month FAC accumulation periods) are subject to review.

Five prior prudence reviews have occurred, all with no findings of imprudence on the part of Empire. As in the prior five reviews, the Staff of the Commission ("Staff") found no imprudence on the part of Empire in this sixth prudence review. The Office of the Public Counsel ("OPC"), on the other hand, takes issue, in this sixth prudence review, with (1)

"Empire's financial hedging decisions which appear to utilize inflexible natural gas hedge purchasing policies" and (2) "Empire's natural gas physical hedging activities as reflected by the above-market prices of its long-term natural gas supply purchases." Motion for Evidentiary Hearing, p. 2.

OPC has failed to provide evidence of imprudence on the part of Empire with regard to its FAC costs, including those related to its hedging program. Instead of reviewing Empire's hedging decisions based on the information available at the time hedges were placed, OPC evaluates Empire's hedging program based on "perfect information." In its analysis, OPC disregards risks associated with attempts to purchase large volumes on the spot market, such as volume availability, credit limits, adverse price movement, and credit exposure. OPC points to hedging "losses," while apparently not understanding that "losses" and "gains" are relative terms used in comparison to a settled market price and are not proper tools for evaluating a hedging program. OPC also appears to misunderstand the fact that one may maintain a consistent overall hedging program or plan, while making particular hedging decisions based on the current market conditions and the information then available.

Empire employs a balanced approach to managing the risks associated with supplying fuel to its natural gas generators, a task requiring consideration of many factors. With regard to the audit period, and all other times, Empire has employed, and maintained compliance with, a prudent Risk Management Policy ("RMP"). Empire's RMP allows the Company to address various areas of risk including, but not limited to, price volatility, credit exposure, and volume. Empire's RMP was designed to (1) provide structure and guidance, (2) allow flexibility and offer a variety of approved tools and strategies to accommodate various market conditions, and (3) effectively managing all risks, rather than singularly focus on price risks. Empire's RMP was used to protect Empire from price volatility and other natural gas risks prior to the implementation of its FAC and has been kept in place to protect Empire's customers from the potential of large unpredicted price swings.

The oversimplification of the review process by OPC dismisses the value and purpose of the hedge, which is to protect against exposure to risk. While a dollar to dollar comparison may result in the recording of a loss or gain for financial hedges, Empire's customers continue to benefit from Empire's RMP, which effectively manages risks and provides price stability. It has never been, nor should it be, the goal of the RMP to ensure the lowest possible price for fuel, a price no one can predict. Instead, the RMP is designed to identify and mitigate risks, including the impact of price volatility over time. This concept has been recognized by the Commission and codified in Rule 4 CSR 240-40.018, pertaining to hedging by gas utilities ("Part 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.").

For the audit period, as well as the preceding years, Empire has maintained compliance with its RMP and has effectively managed its natural gas risks through various market conditions, resulting in prudent FAC costs.

Issue 2a: If the Commission finds that Empire's hedging policy was imprudent, should the Commission order a refund to Empire's customers?

No. Empire's hedging policy, and all costs flowed through Empire's FAC for the period of March 1, 2015 through August 31, 2006, were prudent. In the event the Commission determines that Empire's hedging policy was imprudent, a refund to customers would still not be warranted.

No specific instances of imprudence on the part of Empire regarding its FAC costs have been identified or quantified by OPC in this proceeding. Rather, OPC has deemed Empire's entire RMP to be imprudent due to an allegedly inflexible hedging policy. This is despite general support of Empire's hedging policy from Staff and the Commission, and the lack of objection from OPC, in previous proceedings. OPC has also failed to demonstrate, or even address, the overall impact of Empire's hedging program.

Issue 2b: If so, what should be the amount of the refund?

As stated above, there is no basis for the Commission to order a refund. Additionally, OPC has failed to offer testimony which would demonstrate the proper amount for any refund. OPC has looked only at hedging "losses," something that can be determined only after the fact, has failed to judge Empire's actions based on the information available to Empire at the time hedges were placed, and has failed to account for the overall impact of Empire's hedging program on the costs flowed through Empire's FAC for the audit period.

Issue 3: Should Empire change its hedging policy (as set forth in its Risk Management Policy)? If so, what changes should be made? Should Empire cease all hedging activities at this time? If Empire is directed to cease hedging at this time, under what circumstances should Empire resume hedging activities?

These questions do not need to be answered in this proceeding, in order for the Commission to reject OPC's allegations and determine that Empire's FAC costs were prudent. Additionally, Empire's management decisions are just that – decisions of Empire's management, and they should not be taken away from the company and placed in the hands of the Commission or OPC. That being said, however, direction from the Commission on these points could greatly benefit Empire's customers, as is discussed in more detail below.

In Direct Testimony, OPC asked Charles Hyneman if he believes "that Empire should suspend its natural gas hedging activities until the natural gas market experiences significant price fluctuations as it did in the period 2000 through 2008. Hyneman Direct, p. 19, lines 1-3. OPC witness Hyneman replied, "Yes." He continued by stating:

> As noted above for KCPL, while not directly related to the issue of imprudence in this audit period, it is significant that the Commission approved rate case Stipulations and Agreements in the KCPL and GMO 2016 rate cases that require KCPL and GMO to suspend their natural gas hedging activities on a going forward basis. In these agreements, OPC, Staff, KCPL, and GMO all agreed that KCPL and GMO would suspend natural gas hedging activities unless and until there is a change in the natural gas market that requires the utilities to restart hedging activities.
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> * * *
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> It is now time for Empire to stop hedging in Missouri.

Hyneman Direct, p. 19, lines 4-14.

Empire stands behind its hedging program, as defined in the RMP. Empire is always willing to listen to alternative policy suggestions, including those regarding hedging and the mitigation of various risks. Empire would, however, have grave concerns regarding the cessation of its hedging program, as suggested by OPC, and the exposure Empire's customers would then face.

Issue 4: Should a mechanism be put in place to allow stakeholders and/or the Commission to review and approve a utility's hedging plan prior to implementation?

Again, this question does not need to be answered in this proceeding, in order for the Commission to reject OPC's allegations and determine that Empire's FAC costs were prudent. A mechanism to allow stakeholders and/or the Commission to review and approve a utility's hedging plan prior to implementation, however, could benefit Empire's customers and conserve the resources of all stakeholders.

As noted above, the Commission first authorized a FAC for Empire in Case No. ER-2008-0093, and the Commission approved continuation of Empire's FAC, with certain modifications, in Case Nos. ER-2010-0130, ER-2011-0004, ER-2012-0345, ER-2014-0351, and ER-2016-0023. Empire's RMP, which is now being attacked by OPC on the basis of its allegedly inflexible structure, was in place during all of those rate case proceedings, as well as the first five FAC prudence reviews where no imprudence on the part of Empire was found.

Advanced approval of a hedging program or plan would not replace the need for prudence reviews of hedging decisions, but it could eliminate disputes like the one currently before the Commission. The Commission was faced with a somewhat similar situation approximately five years ago.[1] In a KCP&L Greater Missouri Operations Company ("GMO") prudence review, File No. EO-2011-0390, Staff alleged that GMO imprudently relied on an "overly rigid, market-insensitive cross hedging strategy" and should, therefore, return nearly $15 million to customers.

In that proceeding, 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. The Commission rejected Staff's position, found in favor of GMO, and did not order any disallowances. The Commission found that "(y)ou cannot determine the success or failure of a hedging program by looking only at the futures market transaction" and also found:

> Hedging is an activity similar to purchasing insurance. Losses in a hedging program are not unanticipated and do not suggest that the hedging program is unreasonable or imprudent. Hedging losses are recognized as a possible result of prudent efforts to dampen upward volatility. . . . Hedging losses cannot be known until "after the fact," or in hindsight.

Report and Order issued September 4, 2012, effective September 14, 2012, pp. 23, 28. The Commission concluded as follows:

> Because all of Staff's studies were totally in hindsight, or else a mixed hindsight and prospective study, none are relevant to the Commission's determination.

[1] Staff's concern in the GMO case was regarding cross-hedging, the practice of linking natural gas future contracts to on-peak purchases of power. Empire does not engage in cross hedging and did not engage in cross hedging prior to or during the audit period.

* * *

> The Commission's Staff has failed to provide substantial controverting evidence to rebut the presumption of the prudence of GMO's hedging practices. The Commission's Staff has failed to meet its burden, by a preponderance of the evidence, of proving that GMO was imprudent with its hedging practices during the prudence review period . . .

Id., pp. 47, 65.

Stemming from the GMO prudence review, the Commission opened an investigatory docket, 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." With the conclusion of the working docket, the Commission did not establish a pre-approval process for hedging programs, but the Commission, addressing a concern that "the words Staff used in the recommendation section of its report might signal a change in the Commission's views about hedging practices and the prudence of hedging decisions," assured the utilities that it was not chancing its policy on the prudence of hedging.

WHEREFORE, Empire respectfully submits this statement of its positions on the issues presented to the Commission in this matter. Empire requests such relief as is prudent under the circumstances.

BRYDON, SWEARENGEN & ENGLAND P.C.

By:
/s/ Diana C. Carter__________

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CERTIFICATE OF SERVICE

I hereby certify that the above and foregoing document was filed in EFIS on this 17th day of August, 2017, with notice of the same being sent to all counsel of record.

/s/ Diana C. Carter_________