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.	)	

STATEMENT OF POSITION OF RESPONDENT

COMES NOW Respondent KCP&L Greater Missouri Operations Company, formerly Aquila, Inc., ("GMO") and, pursuant to the Commission's scheduling Order of July 16, 2010, hereby files its Statement of Position on the issues identified in the List of Issues, Witnesses, and Order of Cross-Examination filed by GMO on November 5, 2010.

A. Was GMO imprudent in implementing the 2006-07 steam hedging program in light of the QCA mechanism contained in the Stipulation and Agreement approved in Case No. HR-2005-0450?

No. The parties to the Nonunanimous Stipulation and Agreement ("Stipulation") in Case No. HR-2005-0450 ("2005 Steam Rate Case"), particularly Aquila, Inc. ("Aquila") and Ag Processing Inc. ("Ag Processing"), contemplated that a hedging program would be an integral part of the overall Quarterly Cost Adjustment ("QCA") mechanism. The QCA Rider is attached hereto as Exhibit A. The element of the QCA that called for 80% of the quarterly costs of natural gas to be spread over twelve months, described in Sections 8, 8.3, and 8.6 of the Stipulation and Original Sheet Nos. 6.1–6.3 of the QCA Rider, was not itself designed to be a hedging program. Nor does this element mitigate price volatility as would a hedging program. This is demonstrated by the language of the Stipulation.

Section 8.1 of the Stipulation specifies that the cost of natural gas "will include the cost of physical gas deliveries and financial instruments, when settled, associated with gas delivered in the quarterly period [emphasis added]." As financial instruments, the hedges that were purchased in the form of futures and options contracts were a separate part of the QCA. The 80% cost-sharing mechanism (where 20% of the costs were borne by Aquila) and the twelve-month cost-spreading mechanism are set forth in different sections of both the Stipulation and the QCA Rider.

The QCA filings submitted to the Commission, pursuant to the tariffs that were approved in the 2005 Steam Rate Case, included the calculation of the new QCA rate. Beginning in July 2006, each such filing specified "hedge costs" as a separate item within the accumulation of the quarterly fuel costs. Clearly, the QCA contemplated and incorporated a hedging program.

Furthermore, the QCA 80% cost-sharing mechanism and the twelve-month cost-spreading mechanism were not designed to mitigate price volatility as would a hedging program. While Section 8.3 of the Stipulation specifies that quarterly rate adjustments are calculated by dividing fuel costs by the preceding twelve-month determinants, this provision merely spreads the effects of price changes, but does nothing to mitigate upward price volatility. All gas requirements are still purchased at full cost in a rising market without a hedging program.

Aquila's One-Third Hedging Program mitigated the risk of rising natural gas prices, whereas the QCA merely spreads 80% of the gas costs over twelve months. Under the One-Third Hedging Program, described by GMO witnesses Wm. Edward Blunk and Gary L. Gottsch: (1) one-third of the portfolio floated with the spot market; (2) one-third of the portfolio was hedged with fixed price futures contracts; and (3) one-third of the portfolio was hedged with options contracts. Thus, two-thirds of the portfolio is hedged with fixed price contracts and with

options that benefit the purchaser in a market where natural gas prices are rising. In a falling market, Aquila and its customers benefit with the one-third of the budgeted volumes that are left to float with the market in addition to the one-third of the budgeted volumes covered in options, minus the premium being paid for the call. Thus, Aquila's steam hedging program mitigated upward price volatility, as not all gas requirements are purchased at full cost in a rising market.

Furthermore, the Commission has already determined that "Ag Processing has cited no law or order of the Commission which would prohibit a prudent hedging program." See Order Denying Motion to Dismiss, Case No. HC-2010-0235, at 2 (July 21, 2010). The Commission found that Original Sheet No. 6.2 of the QCA Rider tariff states that the cost of natural gas will include the "financial instruments associated with gas delivered in the quarterly period," and that the Stipulation contains no provision prohibiting hedging. Id.

Thus, not only was the QCA specifically designed to include a hedging program and not designed to mitigate upward price volatility as would a hedging program, but the Commission has already found in this case that GMO did have authority to conduct a hedging program. Aquila's One-Third Hedging Program addressed the risk of rising natural gas prices by permitting Aquila to avoid purchasing all of its natural gas requirements when the cost of natural gas spiked. This price mitigating mechanism is entirely absent in the QCA's mere cost-spreading mechanism. GMO therefore was not imprudent in implementing the 2006-07 steam hedging program in light of the QCA mechanism contained in the Stipulation in the 2005 Steam Rate Case.

B. Did GMO discuss a steam hedging program and the use of financial instruments with its steam customers in 2005-06 before implementing a hedging program?

Yes. In his Direct Testimony, GMO witness Gary L. Clemens addresses Aquila's discussions regarding Aquila's hedging program and the use of financial instruments with its steam customers in 2005-06 before implementing its steam hedging program. Ag Processing was fully engaged in the negotiations and drafting of the Stipulation in the 2005 Steam Rate Case, which included financial instrument costs in the QCA. Ag Processing played an integral part in the development of the QCA in that case, which was designed to include a program for natural gas hedging separate and apart from its cost-spreading mechanism, and was a signatory party to the Stipulation. Furthermore, as Mr. Clemens states in his Direct Testimony, Aquila would not have implemented a natural gas hedging program for its steam operations if Ag Processing had not requested that it do so.

C. Was the 2006-07 steam hedging program implemented by GMO imprudent in its design?

No. Aquila's hedging program was designed to mitigate upward price volatility by limiting exposure to upward market prices, and provided some opportunity to take advantage of market price declines. The prudence of the design of Aquila's One-Third Hedging Program is described in the Direct Testimonies of Mr. Blunk and Mr. Gottsch.

Pursuant to Aquila's One-Third Hedging Program, the one-third of the volume that was hedged using fixed price instruments changed the risk from exposure to upward market prices to relatively certain prices but with no volume flexibility. The one-third that was hedged using options or collars changed the risk from the uncertainty of market prices to limited price exposure and limited volume flexibility. The remaining one-third that was left to float with the

market did not change the risk, but it helped mitigate the new risks of being committed to a fixed price should the market fall below that price and the exposure to lower than expected volumes.

Aquila implemented this program during a dip in prices from the unprecedented high prices of mid-December 2005, following the devastation of Hurricanes Katrina and Rita on the infrastructure of the natural gas grid. Not only were market observers predicting that natural gas prices would remain near record levels, but the general consensus was that natural gas prices would be high for the foreseeable future. Mr. Blunk and Mr. Gottsch testify that, by hedging two-thirds of the steam customers' total exposure, Aquila's steam hedging program was designed to protect customers against the upward volatility in natural gas prices that was predicted to continue for the foreseeable future.

Furthermore, should prices drop, two-thirds of Aquila's steam customers' total exposure was protected against downward price moves, as 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.

As such, Aquila's One-Third Hedging Program had the capacity to manage downward volume risk of as much as 66%. One-third of the forecast volume requirements was not hedged. In other words, while it floated with the market, it also floated with fuel requirements. One-third of the forecast volume was hedged using options that also could float with fuel requirements.

D. Was GMO imprudent in how it acted upon information that it received from its steam customers in carrying out the 2006-07 steam hedging program?

No. Fuel budget and forecast information is necessarily based on customer input. While customers are in the best position to determine their steam load requirements, GMO has a duty to its customers to ensure reliable steam service. In his Direct Testimony, GMO witness Tim M.

Rush describes GMO's longstanding efforts to provide Ag Processing and the other steam customers with highly reliable steam service, given their operational needs and their lack of alternative steam resources. Because reliability is one of the most critical factors for steam customers, GMO (and its predecessor Aquila) representatives spend a great deal of time with the customers in order to gain an understanding of their needs, as described in the Direct Testimony of GMO witness Joseph G. Fangman. If customers advise of an anticipated significant increase in their steam load and GMO does not meet it, all steam customers could suffer because GMO did not meet the needs of the system. GMO must therefore budget its fuel requirements according to the volume requirements its steam customers anticipate they will need.

The steam hedging program was prudently administered, given the expected volume information that was provided to Aquila by its steam customers at the time. Hedge positions were based upon those anticipated volume budgets supplied by customers, and hedge positions were modified when feasible. Aquila updated its budget information during the 2006-07 steam hedging program at least annually to reflect changes in its steam customers' anticipated needs and periodically revised its forecast as well.

In response to these annual budget updates or periodic forecast revisions, Aquila adjusted volumes and hedge plans accordingly. These adjustments are described by Mr. Gottsch in his Direct Testimony. Increases were reflected as ratable increases in purchases for the balance of the buying cycle. Decreases were implemented by unwinding existing positions or by ratable decreases in purchases for the balance of the buying cycle. For example, the February 15, 2006 forecast revision resulted in the volumes to which Aquila managed the hedges placed on February 16, 2006. Aquila's remaining hedge purchases were adjusted to meet the new budgeted volumes updated in June 2006 and 2007.

E. Was GMO otherwise imprudent in administering the 2006-07 steam hedging program?

No. In early 2006, the market was just coming down from the unprecedented high prices of mid-December 2005, following Hurricanes Katrina and Rita. Experts were predicting another active hurricane season in 2006. The United States was expected to be in a supply-limited environment with a number uncertainties concerning that supply. Consequently, it was expected that average 2006 prices would be similar to 2005 prices. With a dip in prices in early 2006, Aquila saw an opportunity to lock in natural gas at a satisfactory price level, and accordingly made its 2006-07 hedge purchases.

Furthermore, when Aquila constructed price collars by purchasing call options and selling put options, it protected itself and its customers from the upward price movement that experts predicted for the foreseeable future. As described in the Direct Testimonies of Mr. Blunk and Mr. Gottsch, the selling of puts is part of a well-known option strategy referred to by some as a "collar" and others as a "fence." Aquila sold put options and turned some of the call options it had purchased into collars as a means of reduing the hedge program's premium expense. Combining financial instruments in such a manner is a practice commonly used to balance price risk or reduce the overall cost of hedging.

F. What is the measure of damages, if any?

While GMO maintains that the Aquila steam hedging program was prudent, should the Commission find imprudence, Ag Processing is entitled to no more than 80% of its percentage of total steam sales during 2006-07, pursuant to the QCA. Thus, while Ag Processing states the entire sum of losses during 2006 and 2007 in its Complaint, were the Commission to find imprudence, Ag Processing would be entitled to no more than the sum of the losses for each

year, factored by the QCA 80% sharing mechanism, and factored by Ag Processing's percentage of total steam sales during each year.

Respectfully submitted,

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Certificate of Service

A copy of the foregoing has been served by e-mail this 12th day of November 2010 upon counsel of record in this proceeding.

/s/ Lisa A. Gilbreath
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