

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

In the Matter of a Working Docket to Address the)
Hedging Practices of Electric Utilities Used to) File No. EW-2013-0101
Mitigate the Rising Costs of Fuel)

**THE EMPIRE DISTRICT ELECTRIC COMPANY'S
RESPONSES TO STAFF'S QUESTIONS**

COMES NOW The Empire District Electric Company ("Empire"), by and through counsel, and in response to the Notice of Staff's Questions filed herein by the Staff of the Missouri Public Service Commission ("Staff") on May 31, 2013, Empire respectfully states as follows:

1. By order issued the 5th day of September, 2012, the Commission opened 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." Thereafter, Staff filed a Notice of Staff's Questions herein and requested that each Missouri investor-owned electric utility provide responses to Staff's 12 questions by making a filing in this docket no later than July 3, 2013.

2. With regard to each Staff question and Empire's response thereto, Empire notes that hedging programs are not one-size-fits-all and that hedging policies and procedures and individual hedging decisions must be based upon the particular facts and circumstances then known to the utility, certain market realities, and the utility's unique structure and history.

Staff Question 1: What market conditions support hedging fuel and purchased power?

Empire's Response: Markets are subject to a variety of conditions which can be unpredictable and outside a market participant's control, thereby introducing market risk and

price volatility and fluctuations. Market prices for fuel and power costs, and their related transportations costs, are subject to these conditions. Future prices reflect supply expectations compared with demand, given the factors known to the market. Factors such as extreme weather events, unexpected economic changes, and technological advances all impact market prices, sometimes to a significant degree. Hedging is an integral part of any commodity market where prices are volatile, as it allows for proper planning and scheduling of supply, budgeting associated with maintenance of equipment, and investment. Defining the risk exposure is a key to designing an effective strategy or program.

Staff Question 2: What market conditions support *not* hedging fuel and purchased power?

Empire's Response: Hedging is an integral part of any commodity market where prices are volatile. If there is no market risk, then there is no need to hedge to mitigate risk.

Staff Question 3: Do electric utility customers place a value on less volatile fuel and purchased power prices? How should electric utilities determine that value?

Empire's Response: Empire believes customers should, and likely do, place a value on less volatility. Through the Fuel Adjustment Clause ("FAC"), customers see a realistic and more transparent fuel/energy price signal and realize more stable fuel/energy prices, and Empire believes its customers place a value on this. A survey of customers would be a possible method of determining the value customers place on stable fuel/energy prices.

Staff Question 4: How should utilities develop and use fuel and purchased power price forecasts in determining a hedging strategy?

Empire's Response: Historically, Empire has implemented a somewhat prescriptive form of hedging that results in the dollar cost averaging of natural gas purchases to mitigate future price variations and to avoid undue reliance on the use of speculative future price forecasts. This

approach has leveled out the natural gas price volatility over time. Empire does not believe speculation should be part of a utility's hedging strategy.

Staff Question 5: What impact does a fuel adjustment clause have on mitigating fuel and purchased power price volatility for customers, and on a company's cash flow?

Empire's Response: As currently configured, Empire's FAC contributes to energy price stability by spreading energy price changes over six-month recovery periods. This creates changes in cash flow for Empire, but Empire's current FAC includes a carrying cost component that is designed to compensate the customer or Empire for fluctuations in cash flow.

Staff Question 6: What are the different hedging tools available to electric utilities, and what are the costs and benefits of each tool? For each tool identified, what fuel and purchased power market conditions support its use?

Empire's Response: A hedging strategy can be as simple as a long-term fixed contract or as complicated as setting up a fully-staffed trading desk. Hedging should offset exposures created by the market, but should not be used as a profit center. Empire's Risk Management Policy, implemented by Empire's Risk Management Oversight Committee in 2001 to establish and describe Empire's policy in assuming, assessing, and controlling the level of natural gas commodity risk exposure involved in the normal course of serving Empire's native load energy requirements, outlines certain hedging tools which may be used to mitigate energy price volatility and limit fluctuations in the cost of supplying energy to retail customers. Any time risk results from market conditions, these tools may be used to mitigate or manage that risk.

- **Physical Forward Contracts:** These contracts can be priced as a fixed price contract or indexed to an appropriate published index. Almost all gas is priced using forward index price curves as the basis. There can be both situations where there is a premium or a discount to the forward index prices depending on the needs of the counterparties. Producers may provide a discount when they want to lock in delivery of volumes for longer terms and not rely on the spot market demand. These contracts

commit to deliver a volume of physical gas to a defined point and therefore allow for planning by the counterparties. This tool is good for establishing a firm source of physical gas that is deliverable to defined points where transportation contracts are established and delivery is more assured.

- **Futures Contracts:** These contracts are financial instruments that allow the utility to establish forward prices for volumes of gas without committing to the physical delivery at the time of contract. This provides a more liquid market for establishing a forward price commitment than dealing only with the entities who have known physical positions at the firm receipt points on the pipeline. This market provides the index price that will ultimately be used to price the physical product in most cases and the contract settlement covers any difference between the price at the time the contract was entered into versus the price set on the physical contract.
- **Put Option / Call Option:** Put Options give you the right to set a floor price on NG contracts. They are typically used by producers to ensure a minimum price for gas but allow them to gain the benefit of higher prices than the option in the event the market index increases. Conversely, call options give you the right to set a cap price that you will have to pay for gas but allow you to get a lower price if the market index price drops. These two instruments both involve paying a premium to cover the risk that the counterparty is exposed to on the commodity price. They are utilized together to form a collar. This is done in part to allow some flexibility in the settle price to let both parties share in the benefit/cost of the market index price changing. It is also done by an entity to cover the cost of the option premiums. By selling a put option with a somewhat lower strike price, an entity can use the premium received to buy a call option at a higher price and avoid paying a net premium for the option while gaining the benefit of avoiding larger changes in index prices.
- **OTC Instruments:** Any of the previously described instruments can be utilized by counterparties using contracts that are not traded on the public exchanges. This allows parties to define terms different than the established contracts if desired.
- **Physical Storage:** Storage allows real time flexibility to deal with differences between physical gas commitments and actual use by the end use customer. To the extent forecast commitments are not exactly what is needed, then injection/withdrawal from storage can be used to balance.

Staff Question 7: How should electric utilities and state utility regulators measure the effectiveness of a hedging strategy?

Empire's Response: Effectiveness should be measured in terms of risk mitigation and thus reduced price volatility. Regulators must recognize that hedging resulting in higher prices to customers may still be regarded as successful and prudent. If after-the-fact prudence reviews are conducted, regulators should determine if the utility's conduct was reasonable at the time, under

all of the circumstances, considering that the utility had to solve its problem prospectively rather than in reliance on hindsight.

Staff Question 8: Should utilities use generally accepted accounting principles (GAAP) in measuring the results of their hedging strategies (from both an operational perspective and a financial reporting perspective)? Why or why not?

Empire's Response: Yes. GAAP is required for an Investor Owned Utility (IOU) from a financial perspective. This ensures accuracy and transparency of Empire's financial results from hedging, as well as its overall financial statements. GAAP rules should be considered in measuring the operational results of hedging strategies, as the use of GAAP rules would provide a consistent method across similar companies.

Staff Question 9: What measured/measurable benefits should customers receive from a utility's hedging strategy?

Empire's Response: The customers should receive the gains/losses associated with the hedging program through the FAC so that the price volatility of energy prices is mitigated.

Staff Question 10: Should utilities have a budget for their hedging programs? Why, or why not?

Empire's Response: It would depend upon the structure of the hedging program. For example, Empire's historical hedging program has involved the dollar cost averaging of a predetermined percentage of its future natural gas requirements (as forecasted by our fuel and purchased power and customer demand budgeting processes) over multiple years. This type of program does not involve the use of specific annual budgets for hedging.

Staff Question 11: How active should electric utilities be in changing hedging positions or strategy based on new market conditions and new information?

Empire's Response: Market conditions and new information should be monitored by the electric utilities, but the hedging program should be designed to avoid wholesale changes in positions or strategy based on speculative forecasts of prices or future events.

Staff Question 12: 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's Response: As the natural gas prices have declined, both Empire and its customers have benefitted from the price declines – the customers through lower electric bills, and Empire through a lower overall revenue requirement. In addition to the lower fuel costs for Empire and its customers, the decline in natural gas prices has resulted in lower spot power prices, which have also been flowed through the FAC to the benefit of Empire's customers. To a certain degree, these lower natural gas prices have also been locked in through Empire's hedging policy for the future benefit of its customers.

Respectfully submitted,

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ATTORNEYS FOR THE EMPIRE
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CERTIFICATE OF SERVICE

The undersigned certifies that, on the 3rd day of July, 2013, the foregoing document was submitted into EFIS and sent by electronic transmission to all counsel of record.

_____/s/ Diana C. Carter