BEFORE THE PUBLIC SERVICE COMMISSION
STATE OF MISSOURI

In the Matter of the Third Prudence Review of Costs Subject to the Commission-Approved Fuel Adjustment Clause of KCP&L Greater Missouri Operations Company.	))))	**Case No. EO-2011-0390**

STAFF'S PROPOSED FINDINGS OF FACT AND CONCLUSIONS OF LAW

COMES NOW the Staff of the Missouri Public Service Commission, by and through counsel, and for its *Proposed Findings of Fact and Conclusions of Law,* states as follows:

Proposed Findings of Fact

Statement of the Case:

1. This case is the third prudence review of the Fuel Adjustment Clause ("FAC") of KCP&L Greater Missouri Operations Company ("GMO").[1]

2. The Commission first authorized a FAC for GMO in Case No. ER-2007-0004, effective July 5, 2007.[2] Thereafter, the Commission modified GMO's FAC inCase No. ER-2009-0090, effective September 1, 2009, and again in Case No. ER-2010-0356.

Procedural History:

3. Staff filed its *Notice of Third Prudence Audit* on June 9, 2011, advising the Commission, GMO and all interested parties that it intended to audit the period June 1, 2009, through November 30, 2010, being the fifth, sixth and seventh six-month

[1] Formerly known as Aquila, Inc., and, prior to that, as UtiliCorp United, Inc. For convenience, the company will be referred to as "GMO" here, regardless of its actual name at the time in question.

[2] Nine days later, on July 14, 2007, the acquisition of Aquila, Inc., by Great Plains Energy, Inc., became effective.

accumulation periods since GMO's FAC first became effective.[3]

4. Staff filed its *Staff Report* on November 29, 2011, setting out its conclusion that "GMO was imprudent in its use of natural gas hedges to mitigate risk associated with its future purchases in the spot power market. Staff recommends the Commission order GMO to refund" more than $18 million, "plus interest at the Company's short-term borrowing rate through the time the refund is made," to ratepayers through its FAC.[4]

5. GMO promptly requested a hearing on Staff's recommended disallowance[5] and the Commission established a procedural schedule that set an evidentiary hearing for May 16 and 17, 2012, and also set dates for periodic discovery conferences;

the filing of prepared testimony; a list of issues and witnesses; and a joint stipulation of non-disputed facts.[6]

6. After a continuance sought by Staff, the hearing was eventually held on June 5 and 6, 2012.[7]

7. Pursuant to the modified procedural schedule, the parties filed a pleading on May 11, 2012, stating the issues to be determined by the Commission, as follows:

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[3] The first and second accumulation periods were reviewed in Case No. EO-2009-0115 and the third and fourth accumulation periods were reviewed in Case No. EO-2010-0167. Staff did not recommend any disallowances in either of those reports.

[4] The amount in question has since been adjusted to somewhat less than $15 million. The *Staff Report* is Staff Ex. 10.

[5] On December 5, 2011.

[6] *Order Setting Procedural Schedule,* issued on December 21, 2011.

[7] Staff's *Motion to Modify Procedural Schedule and Re-Set Evidentiary Hearing,* filed on April 20, 2012; *Order Modifying Procedural Schedule,* issued on April 23, 2012.

1. Has Staff raised a serious doubt as to the prudence of GMO's use of natural gas hedges to mitigate the price risk associated with spot purchased power?

2. Was GMO imprudent in its use of natural gas cross-hedges to mitigate the price risk associated with spot purchased power during the FAC audit period?

3. If so, must GMO refund to ratepayers some amount plus interest through GMO's FAC mechanism? What is the amount that should be refunded, if any?

4. Did GMO properly account for its hedging costs under the Uniform System of Accounts, previous stipulations and orders of the Commission? If not, what is the appropriate remedy?

5. Do GMO's FAC tariffs authorize purchased power hedging costs for spot purchased power to be passed on to ratepayers through the FAC mechanism?

6. Does the Commission want GMO to stop hedging using natural gas futures contracts to mitigate the price risk associated with spot purchased power?

7. Should the Commission establish a policy which addresses the appropriateness of the use of derivative based hedges by electric utilities?

GMO's Operations:

8. GMO is a Delaware general business corporation in good standing, duly authorized to do business in Missouri. Its principal place of business is located at 1200 Main Street, Kansas City, Missouri 64105, and its registered agent is

National Registered Agents, Inc., 300 B East High Street, Jefferson City, Missouri 65101.[8]

9. GMO has been, since July 14, 2008, a wholly-owned subsidiary of Great Plains Energy, Inc. ("GPE"), a publicly-traded, unregulated, public utility holding company that also owns Kansas City Power and Light Company ("KCP&L"). Collectively, KCP&L and GMO operate and present themselves to the public under the brand and service mark "KCP&L." The workforce for GMO consists of KCP&L employees; GMO has no employees of its own. Before it was acquired by GPE, GMO was named Aquila, Inc., and before that, Utilicorp United, Inc.[9]

10. GMO is in the business of owning, controlling and operating electric plant, as defined at § 386.020(14), RSMo, used for generating, transmitting and distributing electricity for sale to the public for light, heat and power. According to GPE's Form 10-K filed with the United States Securities and Exchange Commission in February, 2010, GMO is "an integrated, regulated electric utility that primarily provides electricity to customers in the state of Missouri [and] also provides regulated steam service to certain customers in the St. Joseph, Missouri area."[10]

11. GMO has approximately 312,000 electric customers, including 273,500 residential customers, 38,000 commercial customers, and some 500 industrial,

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[8] *Joint Statement of Non-Disputed Material Facts,* ¶ 10.

[9] *Joint Statement of Non-Disputed Material Facts,* ¶ 11. For convenience, the Company will be uniformly referred to as GMO in this document, regardless of its historic name during the period under discussion.

[10] *Joint Statement of Non-Disputed Material Facts,* ¶ 12.

municipal, and other utility customers.[11]

12. GMO owns 2,182 megawatts ("MW") of generating capacity, of which 1,025 MW is coal capacity, 1,094 MW is natural gas-fired combustion turbine capacity, and 63 MW is oil-fired combustion turbine capacity. In a recent year, GMO used its capacity to produce over six million megawatt hours ("MWhs") to serve its customers.[12]

13. In addition to the energy that GMO generates itself, GMO also purchases 3.5 million to 3.9 million MWhs of power annually at a cost of $120 million to $135 million, an amount which constitutes fully 40% of GMO's energy requirements.[13]

14. Much of the total power GMO purchases from others is purchased in the spot-market. Spot-market purchased power currently constitutes 35.8% of the energy sold at retail by GMO.[14]

GMO's FAC:

15. The Commission authorized a FAC for GMO on May 27, 2007, in Case No. ER-2007-0004, finding that fuel and purchased power costs constituted approximately 46% of GMO's test year operations and maintenance expenses; that GMO's fuel and purchased power costs increased on average between 13% and 20% annually; that GMO had “heavy reliance” on both purchased power and gas-fired generation; that the purchased power and natural gas markets were characterized by “high volatility”; and that these factors were outside of GMO’s control.[15]

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[11] *Joint Statement of Non-Disputed Material Facts,* ¶ 12.

[12] Staff Ex. 9 (HC).

[13] Staff Ex. 8, p. 2.

[14] *Joint Statement of Non-Disputed Material Facts,* ¶ 14.

[15] *Joint Statement of Non-Disputed Material Facts,* ¶ 15; *see* ***In the Matter of Aquila, Inc.,*** Case No. ER-2007-0004 (***Report & Order,*** eff. May 27, 2007) at pp. 30-38.

The Commission-authorized FAC included two annual adjustments[16] and a 95% pass-through cap to encourage efficient management.[17] These features continue to characterize GMO's FAC.[18]

16. GMO's FAC allows GMO to recover from its ratepayers 95% of its prudently incurred variable fuel and purchased power costs ("F&PP") above a base amount that is set in a general rate case.[19] Likewise, 95% of any reduction of GMO's F&PP costs below the base amount is returned to ratepayers through the FAC.[20] F&PP costs include fuel costs, purchased power costs, net emission allowance costs, and off-system sales ("OSS") revenue.[21] OSS revenue is an offset to the F&PP costs that are recoverable from ratepayers through the FAC.[22]

17. GMO's fuel and purchased power costs are accumulated during six-month accumulation periods; each of which is followed by a 12-month recovery period during which the under-recovery or over-recovery is flowed through to ratepayers by an increase or decrease in the Cost Adjustment Factor ("CAF").[23] Adjustments to the CAF are designed to offset the under- or over-recovery by the end of the 12-month recovery

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[16] *Joint Statement of Non-Disputed Material Facts,* ¶ 15; *see* ***In the Matter of Aquila, Inc.,*** Case No. ER-2007-0004 (***Report & Order,*** eff. May 27, 2007) at 48. In other words, the FAC permits two price adjustments per year. Each 6-month adjustment period is referred to as an "accumulation period."

[17] *Joint Statement of Non-Disputed Material Facts,* ¶ 15; *see* ***In the Matter of Aquila, Inc.,*** Case No. ER-2007-0004 (***Report & Order,*** eff. May 27, 2007) at pp. 51-55.

[18] *Joint Statement of Non-Disputed Material Facts,* ¶ 15.

[19] *Joint Statement of Non-Disputed Material Facts,* ¶ 16.

[20] *Joint Statement of Non-Disputed Material Facts,* ¶ 16.

[21] Staff Ex. 16 HC, *Staff's Report of the Prudence Review of Costs Related to the Fuel Adjustment Clause for the Electric Operations of KCP&L Greater Missouri Operations Company, June 1, 2009, through November 30, 2010 ("3rd Staff Report"),* pp. 2-5. The *3rd Staff Report* is also in the record as Staff Ex. 10.

[22] *Id.*

[23] *Joint Statement of Non-Disputed Material Facts,* ¶ 16.

period.[24] GMO's FAC is also designed to true-up any under- or over-recoveries during recovery periods.[25] Any disallowance made by the Commission due to a prudence review is accounted for as an adjustment to the next CAF filing.[26]

GMO's Hedging Program:

18. Cross-Hedging is a method of reducing the risk of loss caused by price fluctuation. It consists of the purchase or sale of equal quantities of the same or very similar commodities, approximately simultaneously, in two different markets with the expectation that a future change in price in one market will be offset by an opposite change in the other market.[27]

19. GMO's natural gas hedging activities can be divided into two separate areas.[28] The first can be described as a traditional natural gas price hedge plan.[29] The second is best described as non-traditional hedging activities related to spot-market purchased power.[30] The objective of GMO's price-risk- management program is to reduce the price risk inherent with floating with the market without substantively degrading the Company's overall competitiveness. The program's goals are to 1) protect the Company and its customers from large upward fluctuations in the price of natural gas and 2) assure a reasonable probability that budgets are met in a cost-effective manner.

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[24] *Id.*

[25] *Id.*

[26] *Id.*

[27] *Id.,* at p. 12.

[28] Staff Ex. 16 HC, at p. 11.

[29] *Id.*

[30] *Id.*

20. In its traditional natural gas price hedge plan, through the use of financial hedges, GMO attempts to reduce the risk of operating natural gas generation plants by hedging against the fluctuations in price of natural gas used to generate electricity.[31]

21. In its non-traditional hedging activities related to spot-market purchased power, GMO utilizes the same price risk management strategies to purchase natural gas future contracts in an effort to mitigate risk associated with purchasing spot power in the market when either GMO is unable to meet its native load with its own generation or when the market price is lower than the cost of GMO's own generation.[32]

22. GMO began its hedging program in 2004.[33] At that time, the program was entirely "below the line," that is, the gains and losses, if any, were absorbed by shareholders.[34]

23. In 2005, GMO implemented a hedging program referred to as the "one-third program." This program, too, was "below the line."[35] Staff was content that GMO's hedging program was "below the line" because Staff had some serious issues with it:[36]

> The primary concern was related to Aquila's almost total lack of business judgment in the application of the program. For example, Aquila would systematically spend thousands of dollars buying New York Mercantile Exchange ("NYMEX") natural gas futures contracts with almost total disregard of the events that were driving wild swings in natural gas prices at that time, such as the devastating 2005 hurricanes in the U.S. Gulf region.

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[31] *Id.*

[32] *Id.,* p. 13.

[33] Staff Ex. 3 (Hyneman Direct/Rebuttal), p. 5.

[34] *Id.*

[35] Staff Ex. 3, p. 6.

[36] Staff Ex. 3, p. 6, lines 15-20.

24. Under the one-third program, program, one-third of GMO's expected power requirement was hedged with natural gas futures contracts to lock in a price; another third was hedged with options to cap the price; and the remaining third was not hedged at all. GMO's purchased power requirements were forecast annually and an equal portion was hedged each month. The program was purposely market insensitive -- it was implemented regardless of what the market was doing at any given time. Staff criticized the program as lacking "sound business judgment in the purchase of hedges."[37]

25. In 2007, GMO decided to move its hedging program "above the line" so that any losses would be absorbed by ratepayers.[38] Staff opposed including any of the hedging losses in rates.[39] Eventually, a *Stipulation and Agreement as to Certain Issues* was executed in which GMO agreed to forego recovery of the $11.5 million in hedging losses incurred in 2006 in exchange for immunity from a prudence review of all the hedge positions in place as of March 27, 2007.[40] Some of those hedges were liquidated during the present review period and those amounts have been removed from consideration in this case.[41]

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[37] Staff Ex. 3, p. 13, lines 4-6.

[38] Staff Ex. 3, p. 7.

[39] *Id.*

[40] *Id.*

[41] This explains the reduction of the amount at issue from $18.8 million, as described in the *3rd Staff Report,* to $14.9 million as announced by the parties at the hearing. *See* Tr. 263, lines 11-24.

26. In 2007, GMO turned to Kase and Company to design a new hedging strategy.[42] The Kase hedging strategy was implemented in October 2007.[43] It relies upon Kase and Company's proprietary software, ezHedge and HedgeModel.[44] Again, as much as two-thirds of GMO's forecast requirements may be hedged under the two programs.[45] HedgeModel is a statistical program that places defensive hedges when prices move into the high zone; takes advantage of opportunities when prices are low; and does nothing when prices are in the neutral zone, neither high nor low.[46] ezHedge places hedges based on business cycles. ezHedge also acts to take advantage of opportunities offered by low prices.

The First Prudence Review:

27. The first prudence review of GMO's FAC, Case No. EO-2009-0115, concerned accumulation periods 1 and 2, June 1, 2007, through May 31, 2008.[47] Staff did not recommend any disallowance in the first prudence review.[48] In its report, Staff noted regarding hedging that "the Company attempts to hedge against the fluctuations of natural gas, coal and diesel prices."[49] The *1st Staff Report* went on to

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[42] Tr. 94 and Staff Ex. 4.

[43] *Id.*

[44] Tr. 106.

[45] Tr. 103, lines 19-22; Tr. 104, line 25, to 105, line 4.

[46] Tr. 105, line 8, to 106, line 5.

[47] *Joint Statement of Non-Disputed Material Facts,* ¶ 19.

[48] *Id.*

[49] *Id.;* Staff Ex. 14 HC, *Staff's Report of the Prudence Review of Costs Related to the Fuel Adjustment Clause for the Electric Operations of KCP&L Greater Missouri Operations Company, June 1, 2007, through May 31, 2008 ("1st Staff Report"),* at 9.

state with respect to natural gas hedging costs:[50]

> The Company had a net loss through its natural gas hedging program of approximately $7 million for the June 1, 2007 to May 31, 2008 time period of this audit. The program had losses through the months of June 2007 through March 2008 – the first 10 months of the audit year. In the last two months of the audit year, the company's hedging program produced a gain of approximately $1.5 million.

28. The *1st Staff Report* did not expressly refer to the cross-hedging of purchased power spot market price risk with financial instruments based on natural gas futures.

The Second Prudence Review:

29. The second prudence review of GMO's FAC, Case No. EO-2010-0167, concerned accumulation periods 3 and 4, June 1, 2008, through May 31, 2009.[51] Staff did not recommend any disallowance in the second prudence review.[52] Staff's report included a section headed, "Financial Hedges of Natural Gas."[53] The *2nd Staff Report* went on to state with respect to natural gas hedging costs:[54]

> The Company had a net gain, i.e., it was able to purchase natural gas at a price lower than the market price, through its natural gas hedging program of approximately **** $2 million **** for the June 1, 2008 to May 31, 2009 time period of this audit. The program had a gain or increase of approximately **** $5 million **** through the months of June 1, 2008 through December 31, 2008 – the first seven months of the prudence review period. In the last five months of the prudence review period, the company's hedging program produced a loss or decrease of approximately **** $3 million ****. Because the company's financial hedging

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[50] *Id.*

[51] *Joint Statement of Non-Disputed Material Facts,* ¶ 20.

[52] *Id.*

[53] *Id,;* Staff Ex. 15 HC, *Staff's Report of the Prudence Review of Costs Related to the Fuel Adjustment Clause for the Electric Operations of KCP&L Greater Missouri Operations Company, June 1, 2008, through May 31, 2009 ("2nd Staff Report"),* at 6.

[54] Staff Ex. 15 HC*,* at 7.

> program is used to avoid market fluctuations in natural gas prices, there will be times that GMO benefits and times that they do not. If it was found that GMO had been imprudent in its financial hedges and natural gas fuel purchases, ratepayer harm could result from an increase in fuel costs recovered through the FAC.

30. The *2nd Staff Report* did not expressly refer to the cross-hedging of purchased power spot market price risk with financial instruments based on natural gas futures.[55]

The Third Prudence Review:

31. This case is the third prudence review of GMO's FAC and concerns accumulation periods 5, 6 and 7, June 1, 2009, through November 30, 2010.[56] Staff recommended the disallowance of ****$18,755,865**** reflecting GMO's use of natural gas hedges to mitigate risk associated with its future purchases in the spot power market.[57] Staff characterized that practice as imprudent.[58] The *3rd Staff Report* stated:[59]

> Staff concludes that purchasing natural gas futures contracts to mitigate risk associated with the purchase of spot purchase power is imprudent. The two markets (NYMEX Natural Gas and Purchase Power Markets) are not directly linked sufficiently that a prudent person would use option purchases in the natural gas futures market to prudently offset the risk of price volatility in the spot purchased power market. Under GMO's concept, GMO's actions are akin to placing a bet in the stock market in hopes of generating enough cash to pay for a future variable expense. GMO's "hedging" practice actually increases GMO's risk exposure, to the detriment of GMO's ratepayers; GMO must guess right when placing the bet, otherwise the initial risk exposure to volatile spot purchase power market remains. GMO's linking of natural gas futures contracts with purchases it makes in the spot market for purchased power is imprudent.

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[55] *Joint Statement of Non-Disputed Material Facts,* ¶ 20.

[56] *Joint Statement of Non-Disputed Material Facts,* ¶ 21.

[57] Staff Ex. 16 HC (*3rd Staff Report*), at 2.

[58] *Joint Statement of Non-Disputed Material Facts,* ¶ 21.

[59] Staff Ex. 16 HC, pp. 9-10.

32. Staff recommended that GMO be required to refund ****$18,755,865****, plus interest at the short term rate, to ratepayers through the FAC.[60] This is the first FAC prudence review in which Staff has specifically alleged that Aquila or GMO's cross-hedging activities related to the use of natural gas futures contracts to hedge spot purchased power costs were imprudent.[61]

GMO's Over-Reliance on Purchased Power:

33. Staff has long taken the position that GMO is overly reliant on purchased power because it lacks sufficient efficient capacity of its own.[62]

34. Efficient generation resources are themselves a hedge against upward volatility in spot market purchased power prices.[63]

35. GMO lacks sufficient efficient generation resources and is consequently extremely vulnerable to purchased power price volatility.[64] GMO's lack of efficient generation is the result of decisions made by GMO's management.[65] Because of this exposure, GMO spends large amounts of money to hedge this risk. GMO witness Blunk stated, "GMO has a significant exposure to movements in the market price for electricity."[66]

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[60] *Id.*

[61] *Id.*

[62] Tr. 259, lines 1-5.

[63] GMO Ex. 8 (Woo Direct), pp. 7-8; Staff Ex. 2 (Mantle Direct/Rebuttal), p. 1.

[64] Tr. 110, lines 16-19.

[65] Tr. 202, lines 3-6 (Lena Mantle): "They [i.e., GMO] could have built generation back when they needed generation. That would have been the hedge that the other utilities use."

[66] Staff Ex. 8, p. 2.

36. GMO had sufficient native capacity to serve its customers during the review period, however, some of that generation is so inefficient that it is actually cheaper for GMO to buy power on the spot market than to generate it using its own inefficient, non-base load generation assets.[67] Staff witness Lena Mantle testified, "it is less expensive for GMO to meet a large portion of its energy needs with spot market electricity instead of running its own generating units."[68]

37. GMO witness Blunk stated, "GMO is heavily reliant on purchased power to serve its load. In 2010, GMO purchased more power than KCP&L and Union Electric combined; about twice as many MWHs as Empire District Electric Company."[69]

38. As a matter of corporate policy, GMO did not add any capacity to its fleet between 1981 and 2005, a period of nearly twenty-five years, instead relying on "long-term, cost-plus purchased power agreements from its neighboring utilities' excess generation to provide low-cost power to its customers."[70] However, such contracts became rare when the Federal Energy Regulatory Commission ("FERC") began to restructure the national wholesale energy market in the 1990s.[71]

39. In 2000, GMO missed an opportunity to add the Aries combined-cycle exempt wholesale generation plant to its fleet.[72] The Aries plant is an intermediate unit

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[67] Staff Ex. 2 (Mantle Direct/Rebuttal), p. 3: "The short answer is that the cost to generate electricity with GMO's non-base load generation fleet was higher than the price of electricity on the spot market."

[68] *Id.*

[69] Staff Ex. 8, p. 2.

[70] Staff Ex. 2, p. 4.

[71] Staff Ex. 2, p. 5.

[72] The Aries plant -- now known as "Dogwood" -- was built and owned by GMO, then known as Aquila. Aquila's management made the decision to assign the plant to the unregulated, merchant side, and to sell it to a third party when Aquila experienced financial difficulties. Tr. p. 132, lines 23-25; p. 207, lines 3-7; Staff Ex. 2, pp. 5-6.

and is more efficient (i.e., cheaper to operate) than combustion turbines.[73] Staff witness Mantle testified, "If GMO had acquired a combined cycle plant in 2000, its fleet would be more efficient and it now would be buying less spot market electricity. In effect, a combined cycle plant would be a “hedge” against fluctuating natural gas prices because GMO would have a highly efficient, natural gas plant to generate electricity instead of depending on the efficiency of the marginal units used to generate the electricity sold in the spot market for electricity."[74]

40. The Aries plant -- now known as "Dogwood" -- was built and owned by GMO, then known as Aquila. Aquila's management made the decision to assign the plant to the unregulated, merchant side, and to sell it to a third party when Aquila experienced financial difficulties.[75]

41. GMO witness Blunk noted that KCP&L, Union Electric and Empire combined supply only about 7% of their total energy requirements with purchased power, compared to 40% for GMO.[76] GMO has lost nearly $40 million on hedging spot market purchased power since 2005.[77]

GMO's Misleading Accounting Practices and GMO's FAC Tariff:

42. Purchased power and fuel costs are separate and distinct costs.[78] Commingling these distinct costs in a fuel cost account would distort the amount

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[73] *Id.,* p. 6.

[74] *Id.*

[75] Tr. p. 132, lines 23-25; p. 207, lines 3-7; Staff Ex. 2, pp. 5-6.

[76] Staff Ex. 8, p. 2.

[77] Staff Ex. 3, p. 14, lines 1-2.

[78] Tr. 170, lines 8-13.

charged to fuel.[79] It would understate purchased power and overstate fuel.[80] It would not be an acceptable accounting practice.[81]

43. The *Nonunanimous Stipulation and Agreement* (the *"S&A"*) from Aquila's 2005 rate case, Case No. ER-2005-0436,[82] governs the accounting of hedge costs and provides:

> **Accounting Authority Order**
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> 17. The Signatory Parties agree, for accounting and ratemaking purposes, that hedge settlements, both positive and negative, and related costs (e.g. option premiums, interest on margin accounts, and carrying cost on option premiums) directly related to natural gas generation and on-peak purchased power transactions under a formal Aquila Networks-MPS hedging plan will be considered part of the fuel cost and purchased power costs recorded in FERC Account 547 or Account 555 when the hedge arrangement is settled. These hedging costs will continue to be recorded on a Mark-To-Market basis, as required by Financial Accounting Standard No. 133, with an offsetting regulatory asset FERC Account 182.3 or regulatory liability FERC Account 254 entry that recognizes the change in the timing of value recognition under Financial Accounting Standard No. 71. Aquila agrees there will be no rate base treatment afforded to hedging expenditures recorded on the Mark-To-Market basis. Aquila agrees to maintain separate accounting in Accounts 547 and 555 to track the hedging transaction expenditures recorded under this agreement. [emphasis added].

44. The requirement of Paragraph 17 of The *Nonunanimous Stipulation and Agreement* from Aquila's 2005 rate case, Case No. ER-2005-0436, that the Company maintain *separate* accounting in Accounts 547 and 555 to track the hedging transaction

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[79] Tr. 170, lines 8-13.

[80] Tr. 170, lines 8-13.

[81] Tr. 170, lines 8-13.

[82] Part of GMO Ex. 22.

expenditures recorded under the agreement shows that the agreement did not contemplate the commingling of fuel and purchased power hedging costs.[83]

45. The FAC tariff sheets applicable to the period at issue, June 1, 2009, through November 30, 2012, allow recovery through the FAC of hedging costs in Account 547, but not in Account 555.[84]

46. Factor FC is part of the FAC tariff equation "TEC = Total Energy Cost = (FC + EC + PP - OSSR),"[85] which defines the costs recoverable through the FAC.

47. GMO's applicable FAC tariff defined factor FC as follows:[86]

FC = Fuel Costs Incurred to Support Sales:

* * *[87]

- The following costs reflected in FERC Account Number 547: natural gas generation costs related to commodity, oil, transportation, storage, fuel losses, **hedging costs**, fuel additives, fuel used for fuel handling, and settlement proceeds, insurance recoveries, subrogation recoveries for increased fuel expenses, broker commissions and fees in Account 547.[88]

48. Factor PP is also part of the FAC tariff equation "TEC = Total Energy Cost = (FC + EC + PP - OSSR),"[89] which defines the costs recoverable through the FAC.

49. GMO's applicable FAC tariff defined factor PP as follows:

[83] Tr. 169, lines 24-25, to 170, lines 1-4.

[84] Staff Ex. 2 (Mantle Direct/Rebuttal), p. 10, lines 19-22. The actual tariff sheets may be found at Schedule TMR-2 attached to GMO Ex. 6 (Rush Direct); they are sheets P.S.C. MO. No. 1, Original Sheets 127.2 and 127.3, issued on July 8, 2009, and effective on September 1, 2009. They also appear as Schedules DEE-6-2 and DEE 6-3 attached to Staff Ex. 1 (Eaves Direct/Rebuttal).

[85] GMO Ex. 6 (Rush Direct), Schedule TMR-2, P.S,C. MO. No. 1, Original Sheet 127.2.

[86] *Id.;* continuing on GMO Ex. 6 (Rush Direct), Schedule TMR-2, P.S,C. MO. No. 1, Original Sheet 127.3.

[87] The omitted language refers to FERC Accounts 501 and 502, which are not relevant here.

[88] Emphasis added.

[89] GMO Ex. 6 (Rush Direct), Schedule TMR-2, P.S,C. MO. No. 1, Original Sheet 127.2.

PP = Purchased Power Costs:

- Purchased power costs reflected in FERC Account Numbers 555, 565, and 575: Purchased power costs, settlement proceeds, insurance recoveries, and subrogation recoveries for increased purchased power expenses in Account 555, excluding SPP and MISO administrative fees and excluding capacity charges for purchased power contracts with terms in excess of one (1) year.

GMO's Practice of Cross-Hedging:

50. The purpose of GMO's cross-hedging program is to mitigate the risk of spiraling electric prices during the period of the hedge. The natural gas futures contracts are intended to produce dollars to offset the changing prices of electricity over the period of the hedge.[90]

51. There is no formalized market that allows GMO to buy electric futures contracts in the Southwest Power Pool region.[91]

52. The effectiveness of GMO's cross-hedging strategy is dependent on the degree of correlation between natural gas prices and on-peak spot market purchased power prices.[92]

53. Application of a correlation analysis for the purpose of establishing *ex ante* effectiveness of the hedge requires that the derivatives and the hedged item exhibit a correlation coefficient of at least 0.90 (or an R-squared $\geq$ 0.80) with respect to their price fluctuations.[93]

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[90] *GMO's Post-Hearing Brief,* p. 35.

[91] *Joint Statement of Non-Disputed Material Facts,* ¶ 23.

[92] GMO Ex. 19, p. 3.

[93] *Id.*

54. Hedge effectiveness in the context of futures contracts is most commonly demonstrated via the correlation methodology.[94]

55. Staff witness Eaves prepared an analysis showing monthly NYMEX natural gas settlement prices at the Henry Hub compared to monthly Southwest Power Pool ("SPP") spot market electricity prices over a multi-year period, February 2007 thru December 2011.[95] Mr. Eaves calculated the correlation co-efficient for this data set at 0.8941.[96]

56. A correlation coefficient of 0.8941 is not equal to or greater than 0.90 and is therefore not sufficient to establish the *ex ante* effectiveness of the hedge pursuant to the authority cited by GMO as GMO Ex. 19.[97]

57. Many factors influence the spot market price of electricity and natural gas prices are only one of them.[98] These factors include weather, system congestion and unplanned outages.[99] In a prior rate case, for example, a GMO witness admitted that "purchased power prices are impacted by more than just natural gas prices."[100]

58. In its monthly state of the market report issued in May 2009, SPP stated:

> One final noteworthy issue is fuel on the margin (Figure 10). Coal generation was setting market price 48 percent of the time in May; this is the highest since EIS Market startup. This appears to be driven by the significant base load capacity additions from

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[94] *Id.*

[95] Staff Ex. 1, pp. 14-15, and Figure 1.

[96] *Id.,* at p. 15, line 6.

[97] *See* GMO Ex. 19, *supra.*

[98] Tr. 272, line 15, to 273, line 3.

[99] Staff Ex. 1, p. 20.

[100] GMO witness Davis Rooney, quoted at Staff Ex. 1, p. 20.

> Nebraska, specifically nuclear plants replacing natural gas generation resulting in more coal units on the margin.[101]

59. There is a gross time mis-match between the hourly spot market prices and the monthly average natural gas futures prices.[102] As Staff witness Dana Eaves explained, "The correlation of a flat set of data points (monthly gas price) against a set of data points that fluctuate (hourly on-peak prices) will show little or no correlation."[103] Mr. Eaves went on to testify, "the data shows little or no correlation when placed in context of GMO's actual practices, which involve buying power at hourly market prices cross hedged with NYMEX futures.[104] Staff points out that when actual daily on-peak energy prices are compared to the Last Day Settlement Price ("LDSP"), the method used in valuing the monthly NYMEX natural gas futures settlement price, it reveals this relationship is not correlated.[105] Staff's "analysis . . . dramatically demonstrates this lack of correlation when analyzing GMO's actual data and practices."[106]

60. GMO was unable to provide to Staff any studies performed before GMO implemented its cross-hedging program that show that such a hedging program would be prudent and effective.[107] Mr. Eaves testified:

> [W]hat I was looking for was a document at the time that they started this program or when Mr. Blunk took over the program. I was hoping that there'd be some analysis, some documents, some e-mails, something that

[101] Staff Ex. 11, p. 3 (*SPP Monthly State of the Market Report for May 2009,* published June 22, 2009, by SPP Market Monitoring Unit).

[102] Staff Ex. 1, p. 18.

[103] *Id.*

[104] *Id.*

[105] *Id.*

[106] *Id.*

[107] *Id.,* pp. 18-19; Tr. 269, line 13, to 271, line 25.

> would guide me in their decision-making before they started or continued with the program.[108]

61. In particular, Mr. Eaves testified, such a study or studies would have included a mitigation plan describing the steps GMO should take in the event that, as actually happened, the natural gas market collapsed.[109]

62. Natural gas prices collapsed after mid-2008, from nearly $13.60 per MMBTU to $2.50 by August of 2009.[110]

63. GMO took no steps, other than possibly reducing its ongoing hedge volumes, to mitigate its hedge losses when the market collapsed.[111]

64. Staff witness Hyneman testified, "when hedging losses are passed on to the ratepayer, the ratepayer should at least be assured that the Company has tried to minimize the hedging losses to the greatest extent possible. At this point (i.e., in 2007), Aquila's ratepayers do not have this assurance."[112]

65. Mr. Eaves also testified that, in his opinion, a regulated utility such as GMO should have engaged in discussions with the Staff before initiating a hedging program of this sort.[113]

66. Mr. Eaves pointed out:

> In fact, the way GMO has structured its hedging plan appears to increase the risk it incurs when the market price for natural gas is trending lower and GMO continues to hedge. In that circumstance GMO is almost assured to only realize losses in its hedging

[108] Tr. 350, line 22, to p. 351, line 3.

[109] Tr. 351.

[110] Tr. 99, lines 11-20.

[111] Tr. 351.

[112] Staff Ex. 3, p. 13, lines 22-25.

[113] Tr. 362, lines 12-23.

> activities and the risk GMO is exposed to for on-peak electricity spot market prices remains the same. That is clearly demonstrated by GMO's actual results.[114]

67. GMO -- then called Aquila -- began its hedging program in 2004.[115] At that time, the program was entirely "below the line," that is, the gains and losses, if any, were absorbed by shareholders.[116]

68. In 2005, GMO implemented a hedging program referred to as the "one-third program." This program, too, was "below the line."[117] Staff was content that GMO's hedging program was "below the line" because Staff had some serious issues with it:

> The primary concern was related to Aquila's almost total lack of business judgment in the application of the program. For example, Aquila would systematically spend thousands of dollars buying New York Mercantile Exchange ("NYMEX") natural gas futures contracts with almost total disregard of the events that were driving wild swings in natural gas prices at that time, such as the devastating 2005 hurricanes in the U.S. Gulf region.[118]

69. Under the one-third program, program, one-third of GMO's expected power requirement was hedged with natural gas futures contracts to lock in a price; another third was hedged with options to cap the price; and the remaining third was not hedged at all. GMO's purchased power requirements were forecast annually and an equal portion was hedged each month. The program was purposely market insensitive -- it was implemented regardless of what the market was doing at any given time.

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[114] *Id.,* at p. 21.

[115] Staff Ex. 3 (Hyneman Direct/Rebuttal), p. 5.

[116] *Id.*

[117] Staff Ex. 3, p. 6.

[118] Staff Ex. 3, p. 6, lines 15-20.

Staff criticized the program as lacking "sound business judgment in the purchase of hedges."[119]

70. In 2007, GMO decided to move its hedging program "above the line" so that any losses would be absorbed by ratepayers.[120] Staff opposed including any of the hedging losses in rates.[121] Eventually, a *Stipulation and Agreement as to Certain Issues* was executed in which GMO agreed to forego recovery of the $11.5 million in hedging losses in exchange for immunity from a prudence review of all the hedge positions in place as of March 27, 2007.[122] Some of those hedges were liquidated during the present review period and those amounts have been removed from consideration in this case.[123]

71. In 2007, GMO turned to Kase and Company to design a new hedging strategy.[124] The Kase hedging strategy was implemented in October 2007.[125] It relies upon Kase and Company's proprietary software, ezHedge and HedgeModel.[126] Again, as much as two-thirds of GMO's forecast requirements may be hedged under the two programs.[127] HedgeModel is a statistical program that places defensive hedges when prices move into the high zone; takes advantage of opportunities when prices are low;

[119] Staff Ex. 3, p. 13, lines 4-6.

[120] Staff Ex. 3, p. 7.

[121] *Id.*

[122] *Id.*

[123] This explains the reduction of the amount at issue from over $18 million, as described in the *Staff Report,* to something less than $15 million as announced by the parties at the hearing. *See* Tr. 263, lines 11-24.

[124] Tr. 94 and Staff Ex. 4.

[125] *Id.*

[126] Tr. 106.

[127] Tr. 103, lines 19-22; Tr. 104, line 25, to 105, line 4.

and does nothing when prices are in the neutral zone, neither high nor low.[128] ezHedge places hedges based on business cycles. ezHedge also acts to take advantage of opportunities offered by low prices.

72. The hedge positions that resulted in the losses under review in this case were all taken after March 27, 2007, and were all driven by the Kase and Company hedging program.[129]

Harm to Ratepayers:

73. GMO has lost nearly $50 million in its cross-hedging activities between 2005 and 2010; the $14.9 million at issue in this case is only part of the total.[130]

74. GMO's cross-hedging program did not protect ratepayers from upward price volatility, but significantly increased the price paid for spot market purchased power.[131]

Proposed Conclusions of Law

I.

By virtue of its activities described in Findings of Fact 10-14, above, GMO is an "electrical corporation" within the intendments of § 386.020(15), RSMo, and a public utility within the intendments of § 386.020(43), RSMo, and therefore "subject to the

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[128] Tr. 105, line 8, to 106, line 5.

[129] Tr. 96, lines 10-13, and Staff Ex. 5 HC.

[130] The *Stipulation and Agreement as to Certain Issues,* Case No. ER-2007-0004, revealed cross-hedging losses of $11.5 million in 2006 and immunized from prudence review all hedge positions in place as of March 27, 2007. Those positions eventually resulted in losses of $10.9 million (Staff Ex. 14, $7.0 million, and Staff Ex. 16, $3.9 million). Staff Ex. 14 documents additional cross-hedging losses of $14.2 million and Staff Ex. 16 documents additional cross-hedging losses of $14.9 million; while Staff Ex. 15 documents cross-hedging gains of $2.0 million, for a grand total of $49.5 million.

[131] Tr. 109, lines 21-25. Hedge costs added $1.80 to the price of every megawatt of power that GMO purchased in 2010.

jurisdiction, control and regulation of the commission and to the provisions of this chapter[.]"

The jurisdiction of the Missouri Public Service Commission extends to all public utilities within the state and to "the manufacture, sale or distribution of . . . electricity for light, heat and power[.]"[132] "All charges made or demanded by any . . . electrical corporation . . . [for] electricity . . . or any service rendered or to be rendered shall be just and reasonable and not more than allowed by law or by order or decision of the commission."[133] "At any hearing involving a rate sought to be increased, the burden of proof to show that the increased rate or proposed increased rate is just and reasonable shall be upon the . . . electrical corporation . . . and the commission shall give to the hearing and decision of such questions preference over all other questions pending before it and decide the same as speedily as possible."[134]

II.

A prudence review, at intervals no greater than 18 months, is required by § 386.266.4(4), RSMo Supp. 2010, Commission Rule 4 CSR 240-20.090(7) and GMO's FAC tariff.[135] Section 386.266.4, RSMo, provides:

> The commission shall have the power to approve, modify, or reject adjustment mechanisms submitted under subsections 1 to 3 of this section . . . provided that it finds that the adjustment mechanism set forth in the schedules:
>
> * * *

[132] Section 386.250, (1) and (5), RSMo.

[133] Section 393.130.1, RSMo.

[134] Section 393.150.2, RSMo.

[135] P.S.C. MO. No. 1, 1st Revised Sheet No. 126.

(4) In the case of an adjustment mechanism submitted under subsection 1 or 2 of this section, includes provisions for prudence reviews of the costs subject to the adjustment mechanism no less frequently than at eighteen-month intervals, and shall require refund of any imprudently incurred costs plus interest at the utility's short-term borrowing rate.

Commission Rule 4 CSR 240-20.090(7) provides:

(7) Prudence Reviews Respecting RAMs. A prudence review of the costs subject to the RAM shall be conducted no less frequently than at eighteen (18)-month intervals.

(A) All amounts ordered refunded by the commission shall include interest at the electric utility’s short-term borrowing rate.

(B) The staff shall submit a recommendation regarding its examination and analysis to the commission not later than one hundred eighty (180) days after the staff initiates its prudence audit. The timing and frequency of prudence audits for each RAM shall be established in the general rate proceeding in which the RAM is established. The staff shall file notice within ten (10) days of starting its prudence audit. The commission shall issue an order not later than two hundred ten (210) days after the staff commences its prudence audit if no party to the proceeding in which the prudence audit is occurring files, within one hundred ninety (190) days of the staff’s commencement of its prudence audit, a request for a hearing.

1. If the staff, OPC or other party auditing the RAM believes that insufficient information has been supplied to make a recommendation regarding the prudence of the electric utility’s RAM, it may utilize discovery to obtain the information it seeks. If the electric utility does not timely supply the information, the party asserting the failure to provide the required information must timely file a motion to compel with the commission. While the commission is considering the motion to compel the processing timeline shall be suspended. If the commission then issues an order requiring the information to be provided, the time necessary for the information to be provided shall further extend the processing timeline. For good cause shown the commission may further suspend this timeline.

2. If the timeline is extended due to an electric utility’s failure to timely provide sufficient responses to discovery and

a refund is due to the customers, the electric utility shall refund all imprudently incurred costs plus interest at the electric utility's short-term borrowing rate.

GMO's Tariff at P.S.C. Mo. No. 1, 1st Revised Sheet No. 126, Cancelling Original Sheet No. 126 (issued July 8, 2009; effective September 1, 2009) provides:

TRUE-UPS AND PRUDENCE REVIEWS

There shall be prudence reviews of costs and the true-up of revenues collected with costs intended for collection. FAC costs collected in rates will be refundable based on true-up results and findings in regard to prudence. Adjustments, if any, necessary by Commission order pursuant to any prudence review shall also be placed in the FAC for collection unless a separate refund is ordered by the Commission. True-ups occur at the end of each recovery period. Prudence reviews shall occur no less frequently than at 18 month intervals.

III.

A.

<u>The Prudence Standard</u>

The Commission conducts prudence reviews using a two-step standard in which, for the first step, the utility is accorded a presumption of prudence until a challenger makes a showing of "inefficiency or improvidence" sufficient to rebut the presumption and require the utility to justify its expenditures in detail:

> The Federal Power Act imposes on the Company the "burden of proof to show that the increased rate or charge is just and reasonable." Edison relies on Supreme Court precedent for the proposition that a utility's cost are [sic] presumed to be prudently incurred. However, the presumption does not survive "a showing of inefficiency or improvidence." As the Commission has explained, "utilities seeking a rate increase are not required to demonstrate in their cases-in-chief that all expenditures were prudent . . . However, where some other participant in the proceeding creates a serious doubt as to the prudence of an expenditure, then the applicant has the burden of dispelling these doubts and proving the questioned expenditure to have been prudent."[136]

[136] ***In the Matter of Union Electric Company,*** 27 Mo.P.S.C. (N.S.) 183, 193 (1985) (*quoting* ***Anaheim, Riverside, etc. v. Federal Energy Regulatory Commission,*** 669 F.2d 779, (D.C. Cir. 1981))

Once the presumption of prudence is dispelled, for the second step, the utility has the burden of showing that the challenged items were indeed prudent.[137] The Commission scrutinizes the utility's actions and expenditures using a standard of reasonable care requiring due diligence.[138] The Commission has described this standard as follows:[139]

> The Commission will assess management decisions at the time they are made and ask the question, "Given all the surrounding circumstances existing at the time, did management use due diligence to address all relevant factors and information known or available to it when it assessed the situation?"

B.

<u>Has Staff Rebutted the Initial Presumption of Prudence</u>?

The leading Commission case in this area is ***Union Electric Company,*** which concerned the construction of the Callaway Nuclear Plant.[140] The Commission stated, "the existence of $2 billion in cost overruns raises doubts as to prudence in this case."[141] In the present case, Staff contends that the existence of $15 million of hedging losses over an 18-month period raises doubts as to the prudence of GMO's conduct sufficient to require the Company to affirmatively show that its conduct was prudent.[142]

(*citations omitted*); *and see* ***State ex rel. Associated Natural Gas Company v. Public Service Commission,*** 954 S.W.2d 520, 528-529 (Mo. App., W.D. 1997).

[137] ***Associated Natural Gas,*** *supra,* 954 S.W.2d at 528-529.

[138] ***Union Electric,*** 27 Mo.P.S.C. (N.S.) at 194.

[139] *Id.*

[140] *Op. cit.,* note 14, *supra*.

[141] *Id.,* p. 194.

[142] Approximately $40 million in hedging losses since the hedging program was brought above-the-

This is particularly true when GMO's $15 million of hedging losses over an 18-month period is viewed in the context that an effective hedging program, with periodic losses and periodic gains, ought to net out approximately even over time.[143] An effective hedging program should not be "always out of the money."[144] As Staff witness Charles Hyneman testified, "a hedging program that continually results in significant hedging losses will draw more of a Staff focus than a hedging program that actually reduces costs or results in immaterial losses[.]"[145] In this case, the evidence shows that GMO has lost nearly $50 million in its cross-hedging activities between 2005 and 2010; the $14.9 million at issue here is only part of the total.[146]

Based on the substantial evidence of record, the Commission concludes that Staff has rebutted the presumption of prudence accorded GMO with respect to its hedging losses.

C.

<u>Was GMO's Cross-Hedging Imprudent</u>?

Staff charges GMO with imprudence in four areas. These are: (1) GMO's over-reliance on purchased power due to its lack of sufficient efficient generation capacity; (2) GMO's misleading accounting practices; (3) GMO's conduct of passing

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line and charged to ratepayers as part of the cost of service.

[143] Tr. p. 356, line 22, to p. 358, line 15.

[144] Tr. p. 358, lines 1-4.

[145] Staff Ex. 3, p. 11, lines 2-4.

[146] The *Stipulation and Agreement as to Certain Issues,* Case No. ER-2007-0004, revealed cross-hedging losses of $11.5 million in 2006 and immunized from prudence review all hedge positions in place as of March 27, 2007. Those positions eventually resulted in losses of $10.9 million (Staff Ex. 14, $7.0 million, and Staff Ex. 16, $3.9 million). Staff Ex. 14 documents additional cross-hedging losses of $14.2 million and Staff Ex. 16 documents additional cross-hedging losses of $14.9 million; while Staff Ex. 15 documents cross-hedging gains of $2.0 million, for a grand total of $49.5 million.

hedging costs to ratepayers through its FAC in defiance of the plain language of its controlling tariff; and (4) GMO's unjustified use of cross-hedging with financial instruments based on natural gas to mitigate purchased power price risk.

1.

<u>GMO's Over Reliance on Purchased Power</u>

Pursuant to management decisions, GMO did not add to its generation fleet for nearly 25 years, either by constructing new generating plants or purchasing plants like the Aries Plant that became available. Instead, GMO relied on long-term, cost-plus purchased power agreements ("PPAs"). However, due to developments on the federal level, long-term, cost-plus PPAs are no longer available. Consequently, GMO has to buy power on the spot market to meet immediate needs at whatever the market price may be. Thus, a reasonable decision based on prevailing conditions has, with the passage of time and changing conditions, left GMO in an extremely exposed position. This exposure has led GMO to spend a large amount of ratepayer money in an attempt to hedge against upward price volatility.

The Commission concludes that GMO's decision to increasingly rely on purchased power rather than adding to its own generation fleet was imprudent because it needlessly left the Company and its customers at the mercy of spot market purchased power price volatility.

2.

<u>GMO's Misleading Accounting Practices and GMO's FAC Tariff</u>

GMO has systematically booked its purchased power cross-hedging losses to a fuel account, FERC Account 547, rather than to the purchased power account, FERC Account 555. GMO has engaged in this practice because its FAC tariff provides that hedging losses booked to Account 547 are recoverable through the FAC while hedging losses booked to Account 555 are not recoverable through the FAC.

GMO relies on the *Nonunanimous Stipulation and Agreement* (the "*S&*A") from Aquila's 2005 rate case, Case No. ER-2005-0436,[147] which governs the accounting of hedge costs and provides:

> **Accounting Authority Order**
>
> 17. The Signatory Parties agree, for accounting and ratemaking purposes, that hedge settlements, both positive and negative, and related costs (e.g. option premiums, interest on margin accounts, and carrying cost on option premiums) directly related to natural gas generation and on-peak purchased power transactions under a formal Aquila Networks-MPS hedging plan will be considered part of the fuel cost and purchased power costs recorded in FERC Account 547 or Account 555 when the hedge arrangement is settled. These hedging costs will continue to be recorded on a Mark-To-Market basis, as required by Financial Accounting Standard No. 133, with an offsetting regulatory asset FERC Account 182.3 or regulatory liability FERC Account 254 entry that recognizes the change in the timing of value recognition under Financial Accounting Standard No. 71. Aquila agrees there will be no rate base treatment afforded to hedging expenditures recorded on the Mark-To-Market basis. Aquila agrees to maintain separate accounting in Accounts 547 and 555 to track the hedging transaction expenditures recorded under this agreement. [emphasis added].

The Commission agrees with Staff's contention that the phrase "recorded in FERC Account 547 or Account 555" was not intended to grant discretion to the Company to record hedge costs in either account at its whim. Rather, it was intended to direct the Company to record each type of hedge cost in the appropriate account -- natural gas hedge costs in Account 547, Fuel, and purchased power hedge costs in Account 555, Purchased Power, as appropriate for the transaction in question.

[147] Part of GMO Ex. 22.

The commingling of distinct costs is bad accounting and serves no regulatory goal. That this interpretation is correct is manifest in the final sentence of Paragraph 17 of the *S&A*, "Aquila agrees to maintain separate accounting in Accounts 547 and 555 to track the hedging transaction expenditures recorded under this agreement." The *separate* accounting requirement is fatally inconsistent with GMO's theory that it was allowed in the very same provision to commingle these two different types of transactions.[148]

GMO booked these costs to Account 547 for financial reasons. The FAC tariff sheets applicable to the period at issue, June 1, 2009, through November 30, 2012, allow recovery through the FAC of hedging costs in Account 547, *but not in Account 555.*[149] The relevant equation is "TEC = Total Energy Cost = (FC + EC + PP - OSSR),"[150] and the tariff defines factor FC as follows:[151]

> FC = Fuel Costs Incurred to Support Sales:
>
> * * *[152]
>
> - The following costs reflected in FERC Account Number 547: natural gas generation costs related to commodity, oil, transportation, storage, fuel losses, **hedging costs**, fuel additives, fuel used for fuel handling, and settlement proceeds, insurance recoveries, subrogation recoveries for increased fuel expenses, broker commissions and fees in Account 547.[153]

[148] Tr. 169, lines 24-25, to 170, lines 1-4.

[149] Staff Ex. 2 (Mantle Direct/Rebuttal), p. 10, lines 19-22. The actual tariff sheets may be found at Schedule TMR-2 attached to GMO Ex. 6 (Rush Direct); they are sheets P.S.C. MO. No. 1, Original Sheets 127.2 and 127.3, issued on July 8, 2009, and effective on September 1, 2009. They also appear as Schedules DEE-6-2 and DEE 6-3 attached to Staff Ex. 1 (Eaves Direct/Rebuttal).

[150] GMO Ex. 6 (Rush Direct), Schedule TMR-2, P.S,C. MO. No. 1, Original Sheet 127.2.

[151] *Id.;* continuing on GMO Ex. 6 (Rush Direct), Schedule TMR-2, P.S,C. MO. No. 1, Original Sheet 127.3.

[152] The omitted language refers to FERC Accounts 501 and 502, which are not relevant here.

[153] Emphasis added.

The tariff goes on to define factor PP as follows:

> PP = Purchased Power Costs:
>
> - Purchased power costs reflected in FERC Account Numbers 555, 565, and 575: Purchased power costs, settlement proceeds, insurance recoveries, and subrogation recoveries for increased purchased power expenses in Account 555, excluding SPP and MISO administrative fees and excluding capacity charges for purchased power contracts with terms in excess of one (1) year.

Tariffs, which are the law of the land, are construed like statutes.[154] The intent is found in the language used, understood in its plain and ordinary sense.[155] While factor FC, Fuel Costs, booked to FERC Account 547, expressly includes hedging costs, factor PP, Purchased Power, booked to FERC Accounts 555, 565 and 575, does not. Under the rules of construction, the express inclusion of hedging costs in one list and their omission from the other must be considered significant and indicative of the intent of the tariff.

The Commission concludes that GMO violated its FAC tariff. This Commission has previously found that the purposeful violation of its FAC tariff by a utility is imprudent.[156]

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[154] ***U.S. v. Missouri-Kansas-Texas R. Co.,*** 194 F.2d 777, 778 (5th Cir., 1952): "The construction of a printed railroad tariff presents a question of law and does not differ in character from that presented when the construction of any other document is in dispute. The four corners of the instrument must be visualized and all the pertinent provisions considered together, giving effect so far as possible to every word, clause, and sentence therein contained."

[155] ***Sermchief v. Gonzales,*** 660 S.W.2d 683, 688-89 (Mo. banc 1983).

[156] ***In the Matter of Ameren Missouri's First FAC Prudence Review,*** Case No. EO-2010-0255 (***Report & Order,*** issued April 27, 2011), p. 2 ("Ameren Missouri acted imprudently, improperly and unlawfully when it excluded revenues derived from power sales agreements with AEP and Wabash from off-system sales revenue when calculating the rates charged under its fuel adjustment clause").

3.

GMO's Imprudent Cross-Hedging

GMO attempted to cross-hedge its exposure to spot market, purchased power price volatility by purchasing an equivalent amount of natural gas futures on the NYMEX on the theory that upward price spikes for purchased power would be matched by upward spikes in the price of natural gas. In the event of a spike, GMO believed it would make a profit on its natural gas trades to mitigate the high market price of purchased power.

Staff has demonstrated that the correlation between SPP spot market purchased power prices and NYMEX Henry Hub natural gas futures was not sufficient to support GMO's cross-hedging program. Many factors influence the spot market price of electricity and natural gas prices are only one of them.[157] These factors include weather, system congestion and unplanned outages.[158] In particular, SPP spot market prices are increasingly driven by coal, not natural gas. GMO also did not perform the sort of in-depth studies and analyses necessary to support a multi-million dollar cross-hedging program. Although GMO was able, after the fact, to buy the services of an expert economist, Dr. Woo, there is no evidence that any similar analyses were done *before* GMO embarked on its cross-hedging adventure. Just as Staff cannot rely on hindsight to attack the prudence of GMO's decisions, GMO cannot rely on the hindsight embodied in Dr. Woo's calculations.

GMO's hedging program actually *increased* the risk to the ratepayers because it was insensitive to the market. GMO continued to place hedges, despite the collapse of

[157] Tr. 272, line 15, to 273, line 3.

[158] Staff Ex. 1, p. 20.

natural gas prices to historic lows, thereby unreasonably exposing its captive ratepayers to the certainty of increased rates due to catastrophic losses in its natural gas futures settlements.[159] What's more, this conduct is characteristic of GMO's hedging activities historically.

The Commission concludes that GMO's cross-hedging program was imprudent for the reasons discussed above.

D.

Harm to Ratepayers

In order to disallow a utility's recovery of costs from its ratepayers, a regulatory agency must find both that (1) the utility acted imprudently and (2) such imprudence resulted in harm to the utility's ratepayers.[160] Harm might be found, for example, in a case involving allegedly imprudent purchasing practices, in evidence that the costs that a utility is seeking to pass on to its customers are unjustifiably higher than if different purchasing practices had been employed.[161] In the present case, the evidence is undisputed that GMO's hedging program for spot market purchased power added nearly $15 million to the costs borne by ratepayers during the review period.[162] GMO witness Blunk testified that hedge costs added $1.80 to the price of every megawatt of power

[159] Tr. 275, lines 14-17: "Could have been prudent not to cross hedge at all."

[160] ***State ex rel. Associated Natural Gas Co. v. Public Service Com'n of State of Mo.,*** 954 S.W.2d 520, 529 -530 (Mo. App., W.D. 1997).

[161] *Id.*

[162] Tr. 199, lines 4-11 (Lena Mantle): " I believe a reasonable person in the position that they were in would have said what is the least expensive resource to meet our customers' need? If that was the spot market, it's the spot market. If it's generation, it's generation. I don't believe a reasonable person would have said let's add some additional loss or gain according to financial hedges in the natural gas market."

that GMO purchased in 2010.[163] GMO lost nearly $50 million on cross-hedging between 2005 and 2010.

The Commission concludes that Staff has shown that GMO's imprudence resulted in harm to its customers in the form of higher bills for service.

Conclusion

In conclusion, Staff has shown that GMO placed itself in a risky position of unusual reliance on purchased power, resulting in significant exposure to purchased power price volatility. GMO responded to that very real risk by engaging in a systematic program of hedging. However, GMO's hedging program is, and has always been, seriously flawed. The sophisticated computer models that GMO relied on did not react reasonably to the collapse of the natural gas market after 2008. GMO has attempted to cross-hedge by investing in natural gas futures, but these instruments do not create a real hedge at all. GMO cannot "fix" a purchased power price by buying natural gas futures or "cap" its risk by buying natural gas options; it can only gamble that, if power prices do go up, it will make enough profit on the natural gas hedges it placed to offset the higher cost of electricity. But, in fact, GMO has not made a profit on its natural gas transactions; it has, instead, lost a large amount of money: $14.9 million over 18 months. Most troubling of all, GMO passed these losses on to its ratepayers through its FAC by mischaracterizing the nature of the costs on its books and thereby attempting to evade the language of its tariff.

[163] Tr. 109, lines 21-25.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the foregoing was served, either electronically or by First Class United States Mail, postage prepaid, on this **27th day of July, 2012,** to the parties of record as set out on the official Service List maintained by the Data Center of the Missouri Public Service Commission for this case, a copy of which is attached hereto and incorporated herein by reference.

s/ Kevin A. Thompson