

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

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

**STAFF'S REPLY BRIEF**

**COMES NOW** the Staff of the Missouri Public Service Commission, by and through counsel, and for its *Reply Brief*, states as follows:

**Introduction**

***What is the function of a Reply Brief?***

A reply brief "responds to issues and arguments raised in the brief previously filed by one's opponent."<sup>1</sup> Staff's argument will therefore follow and respond to the points raised by GMO in its initial brief.

***What is a prudence review?***

A prudence review is a proceeding in which the costs incurred by a utility over some specified period are examined to determine whether or not the company exercised reasonable care and due diligence when it incurred them. With respect to a Fuel Adjustment Clause ("FAC"), which permits variable fuel and purchased power costs to be quickly passed through to ratepayers outside of a traditional rate case, such a prudence review is required by § 386.266.4(4), RSMo,<sup>2</sup> by Commission Rule 4 CSR 240-20.090(7), and by GMO's FAC tariff,<sup>3</sup> at intervals no greater

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<sup>1</sup> *Black's Law Dictionary* 186 (7<sup>th</sup> ed., 1999).

<sup>2</sup> All references to the Revised Statutes of Missouri ("RSMo"), unless otherwise specified, are to the revision of 2000 as currently updated, amended and supplemented.

<sup>3</sup> P.S.C. MO. No. 1, 1st Revised Sheet No. 126.

than 18 months. An FAC prudence review is necessarily limited in scope to those costs and revenues that pass through the FAC.

Although § 386.266.4(4) expressly requires a prudence review, the Commission's authority to conduct such a review derives from its general obligation to ensure that all rates are just and reasonable.<sup>4</sup> For that reason, the scope of the Commission's inquiry in this and similar cases is not limited to prudence. The purpose of a prudence review of costs and revenues proposed to be passed through to ratepayers through an FAC, therefore, is to ensure that those amounts are just and reasonable.

Because this review occurs outside of a traditional general rate case, there is a danger that all of the normal safeguards will not be present. These cases may occur more frequently and proceed more quickly and involve fewer active parties.<sup>5</sup> The result is that there is a greater burden on the Commission itself to ferret out the unjust and the unreasonable.

### **Argument**

#### **I.**

***Contrary to GMO's assertion, Staff has rebutted the presumption of prudence accorded a utility under the traditional, two-step prudence analysis.***

GMO's first point is that Staff has not rebutted the presumption of prudence that is accorded a utility under the traditional, two-step prudence analysis.<sup>6</sup> Pursuant to that analysis, the utility initially enjoys a presumption that its costs were prudently incurred

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<sup>4</sup> Section 393.130.1, RSMo; see discussion at ***St. ex rel. Associated Natural Gas v. P.S.C.***, 954 S.W.2d 520, 528-530 (Mo. App., W.D. 1997).

<sup>5</sup> In the present case, no intervenors have been active. Lack of resources has also precluded the Office of the Public Counsel from taking an active role. Tr. 4:25-26.

<sup>6</sup> *GMO's Post-Hearing Brief*, pp. 15-23.

and only if a challenger successfully rebuts that presumption is the utility required to justify its expenditures in detail.<sup>7</sup> If the second phase of the analysis is reached, the conduct of the utility is judged in the context in which it actually occurred.<sup>8</sup> In this phase, the Commission employs a standard of reasonable care requiring due diligence for evaluating the prudence of a utility's conduct.<sup>9</sup> The Commission has described this standard as follows:<sup>10</sup>

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?"

As the quotation above makes clear, one important feature of the traditional two-step prudence test is that, in the second step of the analysis, the utility's conduct is not judged in hindsight. In its initial brief, GMO repeatedly asserts that Staff has improperly used hindsight to criticize GMO's actions and decisions.<sup>11</sup> These assertions are incorrect and are intended to mislead the Commission. Hindsight is off-limits *only* in the second step of the prudence analysis, not in the first. The end result of the utility's conduct and decisions is absolutely an appropriate matter for consideration in the first step of the analysis, that is, the rebuttal of the presumption of prudence.

Here is a helpful example. The unexpected disaster that befell the *R.M.S. Titanic* on its maiden voyage in April 1912 was sufficient, in and of itself, to rebut any

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<sup>7</sup> ***State ex rel. Associated Natural Gas Company v. Public Service Commission***, 954 S.W.2d 520, 528-529 (Mo. App., W.D. 1997).

<sup>8</sup> ***State ex rel. GS Technologies Operating Company, Inc. v. Public Service Commission***, 116 S.W.3d 680 (Mo. App., W.D. 2003).

<sup>9</sup> ***Union Electric***, 27 Mo.P.S.C. (N.S.) at 194.

<sup>10</sup> *Id.*

<sup>11</sup> *E.g.*, GMO's Post-Hearing Brief, at p. 43.

presumption that the ship's officers and crew had acted prudently. This Commission took the same approach in the ***Union Electric Company*** case cited in Staff's initial brief, which concerned the construction of the Callaway Nuclear Plant.<sup>12</sup> The Commission stated in that case, "the existence of \$2 billion in cost overruns raises doubts as to prudence in this case."<sup>13</sup> Like the unprecedented *Titanic* disaster, the very fact of \$2 billion in cost overruns dispelled the presumption of prudence in the ***Union Electric*** case. Hindsight is not only permissible, but may in fact be required in determining whether or not the presumption of prudence has been overcome.

Staff is confident that the presumption of prudence has been rebutted in this case. 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.<sup>14</sup> Staff suggests that \$50 million is quite an iceberg and is certainly sufficient reason for the Commission to require GMO to explain itself.

GMO also makes an issue of Staff's revision of its proposed disallowance from \$18.8 million to \$14.9 million, as though the revision is somehow indicative of careless work on Staff's part.<sup>15</sup> Again, GMO seeks to mislead the Commission. The revision occurred because GMO finally produced the detailed information showing that some \$3.9 million of the proposed disallowance was actually exempt from prudence review by

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<sup>12</sup> Op. cit., note 14, supra.

<sup>13</sup> *Id.*, p. 194.

<sup>14</sup> 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.

<sup>15</sup> *GMO's Post-Hearing Brief*, pp. 15-16.

virtue of a *Stipulation and Agreement as to Certain Issues* in a prior rate case.<sup>16</sup> Once GMO satisfied Staff that the lower number was correct, Staff revised its disallowance.<sup>17</sup> The revision is thus evidence of Staff's reasonable approach and concern with accuracy.

## II.

***Contrary to GMO's assertions, its cross-hedging activities were imprudent because they were not conducted with reasonable care or due diligence in light of the conditions existing at the time.***

GMO's next several points relate to the second-phase scrutiny of its decisions and conduct with respect to its cross-hedging activities.<sup>18</sup> The most important point to keep in mind here is that GMO's cross-hedging was absolutely unsuccessful and GMO knew or should have known as much at the time.

How do we know the cross-hedging was unsuccessful? Because it consistently lost money. GMO's cross-hedging is founded on the proposition that it will make money on the derivative side and use that money to mitigate the price of purchased power on the physical side.<sup>19</sup> But GMO did not make any money on the derivative side during the review period; instead, it lost \$14.9 million. The cross-hedging thus produced no profits

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<sup>16</sup> The stipulation in Case No. ER-2007-0004 provided that all hedge positions in existence on March 27, 2007, would be exempt from prudence review in exchange for GMO not seeking recovery of \$11.5 million of hedging losses incurred in 2006. Some \$3.9 million of GMO's hedging losses during the period under review in this case resulted from hedge positions in existence on March 27, 2007.

<sup>17</sup> Compare GMO's Sch. WEB-5 and its revised Sch. WEB-5. Only in the latter was the exempt portion of the hedging losses identified and segregated.

<sup>18</sup> *GMO's Post-Hearing Brief*, pp. 23-40.

<sup>19</sup> See GMO Ex. 1 HC (*Direct Testimony of W. Edward Blunk*), p. 7: "GMO is naturally "short." That is, GMO needs to purchase power and natural gas to provide energy for its customers. Therefore when GMO buys futures contracts or options it creates a hedge by offsetting that natural short position with a "long" futures position. The risk inherent in the natural position is offset with an equal and opposite risk in the purchased derivative."

whatsoever that could be used to offset purchased power prices. In fact, the net effect was to *raise* costs for GMO's customers.<sup>20</sup>

Admittedly, this is an observation made in hindsight and hindsight is off-limits in this second stage of the prudence analysis. However, it is Staff's position that GMO knew or should have known at the time that its cross-hedging program would lose money. In the words of the Commission's prudence standard, GMO failed to exercise reasonable care and failed to perform due diligence and the result was catastrophic.

How do we know that GMO was careless and not diligent? Because it engaged in these natural gas transactions when the natural gas market was collapsing due to the greater availability of natural gas resulting from the wide-spread adoption of hydraulic fracturing ("fracking").<sup>21</sup> A reasonable person would therefore not have engaged in the NYMEX futures transactions that GMO engaged in, given the conditions prevailing at the time, expecting to make a profit. And without a profit, the hedge was ineffective and resulted only in higher electric bills for ratepayers. For this reason, Staff charges that GMO failed to exercise reasonable care and failed to perform due diligence.

It is important to remember that cross-hedging is not like normal hedging. In cross-hedging, the transactions on the derivative side are always speculative and profit-seeking because they are unrelated to the physical side. GMO cannot buy or sell options and thereby "cap" the price of purchased power as it can with natural gas used as fuel. It can only speculate in natural gas futures hoping to realize a net profit that can

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<sup>20</sup> GMO witness Blunk testified that hedge costs added \$1.80 to the price of every megawatt of power that GMO purchased in 2010. Tr. 109, lines 21-25.

<sup>21</sup> Tr. 99, lines 11-20; Tr. 275, lines 14-17.

be used to offset the cost of purchased power. As GMO itself put it:<sup>22</sup>

What is important is that the natural gas futures contracts are available to produce dollars . . . to offset the changing prices of electricity over the period of the hedge. The purpose of the cross-hedging program is to mitigate the risk of spiraling electric prices during the period of the hedge.

But the cross-hedging program did not produce any dollars during the period under review in this case. Instead, it lost a lot of dollars. It is for this reason that Staff is not enchanted with cross-hedging. It is a valid risk-mitigation tool, but one that must be used carefully and thoughtfully, in the right market conditions. GMO has not used this tool correctly. When the natural gas market collapsed, there was no need to hedge. GMO should have liquidated its hedge positions to mitigate its losses and not placed any further hedges.

***Correlation:***

GMO's next point is that on-peak spot-market purchased power prices in the Southwest Power Pool ("SPP") are sufficiently correlated with Henry Hub natural gas futures traded on the New York Mercantile Exchange ("NYMEX") that the latter can be used to effectively cross-hedge against upwards volatility in the former. Staff agrees that such cross-hedging might sometimes be indicated, such as *when a rising market is expected*. However, such cross-hedging should never be implemented in a falling market as GMO did here.

GMO is wrong on the issue of correlation. Staff witness Dana Eaves calculated the correlation co-efficient for monthly NYMEX natural gas settlement prices at the Henry Hub compared to monthly SPP spot-market electricity prices over a

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<sup>22</sup> GMO's *Post-Hearing Brief*, p. 35.

multi-year period, February 2007 thru December 2011, at 0.8941.<sup>23</sup> A correlation of 0.8941 is *not* sufficient to demonstrate an effective hedge pursuant to the authority cited by GMO as GMO Exhibit 19, which states:

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.<sup>24</sup>

A correlation co-efficient of 0.8941 is not "at least 0.90" as GMO Exhibit 19 plainly requires.<sup>25</sup> Thus, even when measured against the very authority that GMO itself relies on, its hedging strategy is demonstrably ineffective.

### ***The Dollar Offset Test:***

GMO is also incorrect in its application of the Dollar Offset Test, in which the change in value of the derivative is compared to the change in value of the hedged item. Hedges that yield a ratio within the range of 80-120 percent are deemed "highly effective" under the Dollar Offset Test.<sup>26</sup> GMO contends that "the estimated physical market change of value for on-peak electricity was 109.6% of the actual change in the value of the natural gas cross hedges" and that its hedges were thus highly effective.<sup>27</sup>

GMO argues that:

this means that by hedge accounting standards, GMO's natural gas cross hedges for on-peak electricity **were in hindsight** "highly effective." That is, the hedges did what they were supposed to do. The electricity price movement was offset by a similar movement in the price of natural gas

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<sup>23</sup> Staff Ex. 1, at p. 15, line 6.

<sup>24</sup> GMO Ex. 19.

<sup>25</sup> *Id.* The R-Squared value is 0.7994.

<sup>26</sup> GMO Ex. 2, p. 12.

<sup>27</sup> *Id.*, and Sch. WEB-9.



(emphasis added).<sup>28</sup>

Note that GMO has expressly opened the door to hindsight here. And, in hindsight, GMO's hedges are revealed as utterly **ineffective** during the review period because, as Staff has already pointed out, they lost \$14.9 million over 18 months and added \$1.80 to the cost of every megawatt GMO purchased in 2010.<sup>29</sup> A hedge strategy predicated on profit-making NYMEX transactions cannot be effective when it consistently loses money. What Mr. Blunk's testimony really means is that the cross-hedges were unnecessary because purchased power prices did not spike. And, given that the natural gas market was collapsing, no reasonable person could have possibly expected SPP on-peak, spot-market purchased power prices to spike. Under those conditions, no reasonable person would have engaged in cross-hedging.<sup>30</sup>

***GMO's Criticism of Dana Eaves:***

GMO also criticized Mr. Eaves' testimony that he would only be comfortable with cross-hedging based on a perfect correlation.<sup>31</sup> According to GMO, Mr. Eaves doesn't know what he's talking about.<sup>32</sup> The fact is, Mr. Eaves spoke from the knowledge that GMO had lost \$50 million through cross-hedging over five years, of which the \$14.9 million at issue in this case is just the latest increment. Mr. Eaves testified:<sup>33</sup>

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<sup>28</sup> *GMO's Post-Hearing Brief*, p. 30.

<sup>29</sup> Tr. 109, lines 21-25; Tr. 263, lines 11-24.

<sup>30</sup> Just as Staff pointed out in its report, Staff Ex. 16, pp. 9-10.

<sup>31</sup> *GMO's Post-Hearing Brief*, pp. 32-33.

<sup>32</sup> *Id.*

<sup>33</sup> Tr. 331.

And, you know, my analysis, my very simple analysis shows that sometimes the markets are correlated, sometimes they're not correlated. What do you do when the markets aren't correlated? I don't think the company's effectively answered that.

Using the Commission's "reasonable-care-requiring-due-diligence" standard, GMO certainly knew by the start of the review period that it had already lost about \$35.1 million through cross-hedging since 2005.<sup>34</sup> That means that GMO knew, at the start of the review period, that its cross-hedging program was ineffective because it was not producing any profits on the NYMEX that could be used to off-set the cost of spot-market purchased power.

In addition to stating his preference for a perfect correlation, Mr. Eaves also repeatedly stated his need to see some sort of hedging plan based on an analysis, including contingencies for unexpected market conditions.<sup>35</sup> No such plan, analysis or contingencies were ever produced by GMO.

***Other Arguments Raised by GMO:***

GMO raised two other arguments: First, that cross-hedging is widely-known, widely-taught, and is actually used by at least six utilities in addition to itself. Second, that Staff has been aware of the practice since 2005 and has not previously criticized it. Neither of these arguments has any merit. The only issue is whether GMO can properly recover from its ratepayers the \$14.9 million it lost through cross-hedging during the review period. Staff's failure to object sooner is irrelevant, as is the fact that the theory of cross-hedging is widely-known and widely-taught.

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<sup>34</sup> \$50 million less \$14.9 million. In fact, a review of the *Stipulation and Agreement as to Certain Items* (\$11.5 million lost) and Staff's 1<sup>st</sup> (\$21.2 million lost), 2<sup>nd</sup> (\$2 million gained) and 3<sup>rd</sup> (\$18.8 million lost) FAC Prudence Review reports reveals that GMO's total losses from cross-hedging since 2005 were closer to \$50 million than \$40 million.

<sup>35</sup> Tr. 269-271; 346-348.

***Contrary to GMO's assertions, a refund to ratepayers of \$14.9 million is entirely appropriate in this case because GMO failed to use reasonable care with due diligence in conducting its cross-hedging activities during the review period.***

GMO next argues<sup>36</sup> that no refund is appropriate in this case because Staff has failed to meet the standard announced in ***Associate Natural Gas***.<sup>37</sup> GMO argues:<sup>38</sup>

in the ***Associated Natural Gas*** case, the Missouri Court of Appeals held that the Staff must provide evidence that the utility's actions caused higher costs than if prudent decisions had been made. See ***Associated Natural Gas***, 954 S.W.2d at 529. Substantive and competent evidence regarding higher costs includes evidence about the particular controversial expenditures and evidence as to the "amount that the expenditures would have been if the [utility] had acted in a prudent manner." See *id.* In other words, Staff must not only show that the Company acted imprudently (which it has not done in this case), but it must also identify what the utility should have done to act in a prudent manner. Then, according to the *Associated Natural Gas* holding, the harm to consumers would be calculated based upon a comparison of the cost of the imprudent act vis-a-viz. [*sic*] the costs of the prudent course of the action.

GMO then went on for several pages, reviewing in detail the refusal of Staff witnesses Mr. Eaves and Ms. Mantle to state what GMO should have done.<sup>39</sup>

First, GMO has misconstrued ***Associated Natural Gas***. The actual holding of the Western District Court of Appeals is as follows:<sup>40</sup>

Ultimately, the PSC's standards for the recoverability of ANG's costs arise from the statutory mandate that all charges made by a gas company be just and reasonable. Section 393.130.1. It would be beyond this statutory authority for the PSC to make a decision on the recoverability of costs, based upon a prudency analysis of gas purchasing practices, without reference to any detrimental impact of those practices

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<sup>36</sup> GMO's *Post-Hearing Brief*, at pp. 40-45.

<sup>37</sup> ***St. ex rel. Associated Natural Gas v. P.S.C.***, 954 S.W.2d 520, (Mo. App., W.D. 1997).

<sup>38</sup> GMO's *Post-Hearing Brief*, at p. 40.

<sup>39</sup> GMO's *Post-Hearing Brief*, pp. 40-42.

<sup>40</sup> 954 S.W.2d at 530.

on ANG's charges to its customers, such as evidence that the costs which ANG is seeking to pass on to its customers are unjustifiably higher than if different purchasing practices had been employed. Therefore the PSC's decision denying recovery of half the premium of the SEECO contract must be deemed unlawful.

Pursuant to the actual holding of ***Associated Natural Gas***, Staff needs only to adduce evidence that "the costs which [GMO] is seeking to pass on to its customers are unjustifiably higher than if different [hedging] practices had been employed."<sup>41</sup> Staff need not state what GMO should have done differently. GMO's own witness, Mr. Blunk, testified that cross-hedging added \$1.80 to the cost of every megawatt of power purchased in 2010, for a total in the review period of \$14.9 million.<sup>42</sup> This is ample evidence of the detrimental impact of GMO's conduct on the ratepayers and fully supports a refund herein.

***Contrary to GMO's assertions, it improperly accounted for its purchased power hedge costs by charging them to FERC Account 547, Fuel, rather than to FERC Account 555, Purchased Power. Its motive was to evade the plain language of its then-effective FAC Tariff, pursuant to which hedge costs charged to FERC Account 555 were not recoverable through the FAC.***

GMO next argues that it properly accounted for its cross-hedging costs.<sup>43</sup> GMO is incorrect. As Staff witness Charles Hyneman testified at the hearing:

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<sup>41</sup> *Id.* Such as no hedging at all.

<sup>42</sup> Tr. 109, lines 21-25; Tr. 263, lines 11-24. *And* see Dana Eaves at Tr. 133, " All it appears to be 6 doing is adding cost to an already substantial amount of purchased power that they have to buy." GMO admits, at p.15 of its *Post-Hearing Brief*, that the disallowance at issue in this case is \$14.9 million.

<sup>43</sup> GMO's *Post-Hearing Brief*, at pp. 45-51.

Purchased power is not a fuel cost. It's separate and distinct. To put hedging for purchased power in a fuel cost account would be to distort the amount that they charge to fuel. It would understate purchased power and overstate fuel. It's bad accounting.<sup>44</sup>

To refute Mr. Hyneman, GMO relies on the language of *Suggestions* filed by Staff in a prior rate case:<sup>45</sup> "Contrary to the position expressed by Mr. Hyneman in the hearings, Staff has previously recognized in the *Suggestions* that the hedging program costs should be booked consistent with "how fuel costs are developed and in compliance with generally accepted accounting principles."<sup>46</sup>

This language is unhelpful to GMO. Hedging costs incurred with respect to purchased power are not fuel costs and have nothing to do with how fuel costs are developed.<sup>47</sup> The *Suggestions* at this point are referring to the hedging costs incurred by GMO with respect to natural gas used as fuel. Generally accepted accounting principles do not authorize the commingling of unrelated expenses with the result that financial statements are inaccurate and misleading.<sup>48</sup>

GMO next asserts that it obeyed the *Nonunanimous Stipulation and Agreement* (the S&A),<sup>49</sup> the applicable orders of the PSC, and the Uniform System of Accounts ("USOA"). In fact, nothing could be further from the truth.

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<sup>44</sup> Tr. 170, lines 8-13.

<sup>45</sup> GMO Ex. 11, *Staff's Suggestions in Support of Nonunanimous Stipulation & Agreement*, Case No. ER-2005-0436.

<sup>46</sup> *GMO's Post-Hearing Brief*, p. 47.

<sup>47</sup> Tr. 170.

<sup>48</sup> *Id.*

<sup>49</sup> The *Nonunanimous Stipulation and Agreement* from Aquila's 2005 rate case, Case No. ER-2005-0436, which granted an Accounting Authority Order ("AAO") to GMO for hedge costs. GMO sought, but did not get, a Fuel Adjustment Clause in that case, but did get an Interim Energy Charge ("IEC"), another regulatory-lag-mitigating device. In the event, GMO did not successfully recover all of its fuel and purchased power costs through the IEC.

The S&A in question provides in pertinent part:

**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].

Staff has treated this issue in detail in its *Initial Brief*. GMO ignored the language of the S&A and commingled its fuel and purchased power hedge costs in its fuel account in order to evade the language of its FAC tariff, which allows recovery through the FAC of hedging costs in Account 547, *but not in Account 555*.<sup>50</sup> The tariff defines recoverable costs by an equation, “TEC = Total Energy Cost = (FC + EC + PP - OSSR),”<sup>51</sup> and goes on to define factor FC to specifically include hedging costs as follows.<sup>52</sup>

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<sup>50</sup> 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).

<sup>51</sup> GMO Ex. 6 (Rush Direct), Schedule TMR-2, P.S.C. MO. No. 1, Original Sheet 127.2.

<sup>52</sup> *Id.*; continuing on GMO Ex. 6 (Rush Direct), Schedule TMR-2, P.S.C. MO. No. 1, Original Sheet 127.3.

FC = Fuel Costs Incurred to Support Sales:

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- 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.<sup>54</sup>

Likewise, the tariff omits hedging costs in its definition of factor PP:

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.

These points render irrelevant GMO's citations to the USOA and Commission orders. Under the Filed Rate Doctrine, a tariff is the law of the land, binding on companies, customers, and the Commission itself.<sup>55</sup> The tariff language necessarily governs and that language plainly excludes from recovery hedging costs booked to FERC Account 555. It was to evade this tariff language that GMO booked its cross-hedging losses to FERC Account 547.

GMO disputes this point in its *Post-Hearing Brief*.<sup>56</sup> In particular, GMO relies on the Commission's *Order Clarifying Report and Order* in a prior rate case, in which the Commission stated:<sup>57</sup>

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<sup>53</sup> The omitted language refers to FERC Accounts 501 and 502, which are not relevant here.

<sup>54</sup> Emphasis added.

<sup>55</sup> ***Snelling v. Southwestern Bell Tel. Co.***, 996 S.W.2d 601, 604 n. 8 (Mo. App., E.D. 1999).

<sup>56</sup> pp. 49-51.

<sup>57</sup> ***In re Aquila, Inc.***, Case No. ER-2007-0004 (***Order Clarifying Report and Order***, issued on May

The treatment of hedging costs was addressed by the parties in the Stipulation and Agreement as to Certain Issues (Stipulation and Agreement). On April 12, 2007, the Commission approved the Stipulation and Agreement. Under the Stipulation and Agreement, prudently incurred hedging costs will flow through the fuel adjustment clause, but Aquila's 2006 hedge settlement losses of \$11.5 million were expressly excluded. The Stipulation and Agreement further provides that the ultimate settlement values of Aquila's hedge contracts in place on March 27, 2007, will not be subject to prudence review. Any hedge position taken after March 27, 2007, however, is subject to a prudence review and potential disallowance.

This Commission order is not helpful to GMO for two reasons. First, as noted above, the plain language of the tariff controls. The order GMO cites does not purport to examine and construe the controlling tariff language. Second, it is by no means clear just *what* hedging costs the order refers to. Under GMO's FAC tariff, as previously explained, hedge costs incurred in hedging natural gas used as fuel and booked to FERC Account 547 are properly recoverable through the FAC. Doubtless the order is referring to those costs.

***Staff takes no position with respect to GMO's requests (1) that the Commission order it to stop cross-hedging if the Commission does not like the practice and (2) that the Commission establish a hedging policy.***

GMO requests the Commission provide it with specific guidance on cross-hedging, "In the event that the Commission decides that it believes that GMO should abandon its existing practice of using natural gas futures contracts to mitigate the price risk associated with spot purchase power, then GMO will agree to do so."<sup>58</sup> Staff takes no position on this request, but does point out that its determination that GMO's cross-hedging during the review period was imprudent should provide some

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22, 2007), p. 1; cf. GMO Ex. 10.

<sup>58</sup> GMO's *Post-Hearing Brief*, at p. 51.



guidance.

GMO also requests the Commission to develop hedging guidelines.<sup>59</sup> Presumably, GMO means that the Commission should initiate a rulemaking. Staff has no position on that suggestion.

**WHEREFORE**, on account of all the foregoing, Staff prays that the Commission will find (1) that GMO was imprudent in its over-reliance on potentially volatile spot-market purchased power, (2) imprudent in its accounting practices, (3) imprudent in attempting to hedge its spot-market, purchased-power price risk with natural gas futures, and (4) imprudent in charging the costs of its hedging program to its ratepayers through its FAC in violation of its FAC tariff; and will order GMO to refund those costs, with interest at GMO's short-term borrowing rate, to its ratepayers through its FAC; and grant such other and further relief as is just in the circumstances.

Respectfully submitted,

s/ Kevin A. Thompson  
**KEVIN A. THOMPSON**  
Missouri Bar Number 36288  
Chief Staff Counsel

**MEGHAN E. McCLOWRY**  
Missouri Bar Number 63070  
Assistant Staff Counsel

Missouri Public Service Commission  
P.O. Box 360  
Jefferson City, MO 65102  
573-751-6514 (Voice)  
573-526-6969 (Fax)  
[kevin.thompson@psc.mo.gov](mailto:kevin.thompson@psc.mo.gov)

Attorneys for the Staff of the Missouri Public  
Service Commission

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<sup>59</sup> GMO's *Post-Hearing Brief*, at pp. 51-52.

### **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 **27<sup>th</sup> 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**