Exhibit No.:	
Issue:	Imprudence
Witness:	Donald E. Johnstone
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Sponsoring Party:	AGP
Case Number:	HC-2012-0259
Date Prepared:	September 18, 2012

Kansas City Power and Light
Greater Missouri Operations
Steam Business
HC-2012-0259

Surrebuttal Testimony of

Donald E. Johnstone

on behalf of the

AG PROCESSING INC, A COOPERATIVE

September 2012

Competitive Energy
DYNAMICS

NP

BEFORE THE

PUBLIC SERVICE COMMISSION OF MISSOURI

Ag Processing, Inc., a Cooperative, Complainant,	)	
v. KCP&L,	)	HC-2012-0259
Greater Operations Company, Respondent	)	

Affidavit of Donald E. Johnstone

State of Missouri	)	
	)	SS
County of Jackson	)	

Donald E. Johnstone, being first duly sworn, on his oath states:

1. My name is Donald E. Johnstone. I am a consultant and President of Competitive Energy Dynamics, L. L. C. I reside at 384 Black Hawk Drive, Lake Ozark, MO 65049. I have been retained by AG PROCESSING INC, A COOPERATIVE.

2. Attached hereto and made a part hereof for all purposes are my testimony and schedules in written form for introduction into evidence in the above captioned proceeding.

3. I hereby swear and affirm that my testimony is true and correct and show the matters and things they purport to show.

Donald E. Johnstone

Donald E. Johnstone

Subscribed and sworn to this 18th day of September, 2012

Angela C. Hedges

Notary Public

ANGELA C. HEDGES
Notary Public - Notary Seal
State of Missouri
Commissioned for Jackson County
My Commission Expires: September 22, 2013
Commission Number: 09402477

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Surrebuttal Testimony of Donald E. Johnstone

Q PLEASE STATE YOUR NAME AND ADDRESS.

A Donald E. Johnstone. My address is 384 Black Hawk Drive, Lake Ozark, MO 65049. My qualifications and experience are attached to my direct testimony in this matter.

Q ON WHOSE BEHALF ARE YOU APPEARING?

A I am appearing on behalf of AG PROCESSING INC A COOPERATIVE ("AGP"). AGP is a steam customer of KCP&L, Greater Missouri Operations Company (GMO) in the St. Joseph District.

Q WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A My testimony will respond to the rebuttal testimony of KCPL and the Report of the Staff of the Commission.

KCPL submitted over 550 pages of rebuttal testimony that covers a wide range of issues, but nevertheless, in my opinion, the testimony is woefully short on any details that might be used to prove prudence in the administration of the Hedge

Program. Moreover, given the imprudence finding in HC-2010-0235, I would have expected KCPL to come forth with details of its administration of the Hedge Program in an effort to demonstrate prudence in its administration. In spite of the volume of testimony such details are largely absent.

At issue are the hedging costs that were booked during 2009, and subsequently collected from customers in the amount of $1,244,510. There is no dispute about the magnitude of the costs in the accounting sense, but rather the dispute has arisen about whether or not the costs were prudently incurred. The relevant activities leading to the costs under investigation occurred during 2006 through 2009.

Staff has provided testimony that supports imprudence.

My direct testimony in this docket reiterated much of my testimony from HC-2010-0235, an earlier docket in which the Commission found imprudence. The same Hedge Program is at issue and that information relates to the 2009 costs. GMO filed over 550 pages of response in which I searched for proof of prudence. There are, however, important admissions.

In this docket GMO, takes a different path. Allegedly Aquila/GMO did what they were directed to do by me when there was the opportunity to close out the Hedge Program at a profit instead of a loss. This will be addressed further in due course. However, it is important to note at the outset that GMO proffers no documentation of the alleged $2,000,000 “offer.” I have conferred with counsel and my client and also inquired of Mr. Featherstone. I can find nothing written and no recollection of such an offer. On the other hand, given the expressed concerns with the cost of the program it is very difficult to understand how such an offer could have occurred and not been noted, by myself, Mr. Conrad, AGP, or Mr. Featherstone. The alleged discussions that were had, if any, whether intended to be privileged or not, simply left no documentation that I can find of the alleged offer. Moreover, given the concerns expressed with the cost of the program and given the documented request to terminate the program, it is very difficult to understand why GMO, being aware that the program was "in the money", failed to close out the program.

On top of the concerns noted in my direct testimony, I will present in rebuttal to GMO additional information provided by GMO in response to Staff's data requests. The additional information casts more doubt on the program itself.

SUMMARY OF SURREBUTTAL TESTIMONY

Q WILL YOU ADDRESS ALL OF THE REBUTTAL TESTIMONY OF GMO?

A GMO submitted over 550 pages of rebuttal. Much of it describes the history and operation of the steam business and does not relate specifically to the prudence matter before the Commission. Due to sheer volume I have made an effort to identify and address the more important issues. Silence does not imply agreement or disagreement. AGP may assert additional positions in due course.

Q WILL YOU ADDRESS THE STAFF TESTIMONY AND REPORT

A I make reference to Staff's work, but I do not find need to rebut it.

Q DO YOU DISAGREE WITH THE GMO CONTENTIONS THAT WOULD TEND TO SUGGEST THAT THE CUSTOMERS CULPABLE FOR IMPRUDENTLY INCURRED COSTS?

A I do not find support for the GMO contention. Rather, GMO's attempt to assign blame generally supports AGP's allegation of imprudent Hedge Program costs. Absent imprudent costs GMO would not seek a scapegoat.

Q DID AGP BRING ITS CONCERNS TO AQUILA/GMO AT AN EARLY DATE?

A Yes. As a result of AGP vigilance even before a formal prudence review, the program was terminated.

Q WAS AGP IN A POSITION TO MANAGE THE WIND DOWN OF THE PROGRAM?

A No. Given that the program was cancelled due to concerns and objections to the continued operation of the Hedge Program, I believe Aquila/GMO should have been alert to opportunities to close out the remaining positions at a minimum cost. Instead, GMO passed on the opportunity to close out the positions at a profit.

Q WAS THE LOST OPPORTUNITY TO CLOSE OUT AT A PROFIT THE FAULT OF STAFF, CUSTOMERS, OR AGP?

A No. GMO could have made Staff and customers fully aware and sought advice in writing. Perhaps it should have done so, but in any event it did not.

I find no support for the GMO suggestions that the decision to forego was made by AGP such that GMO merely acted on the advice and consent of AGP. There was no suggestion that the responsibility for the wind down had become the responsibility of AGP. Nor was I ever under the impression that GMO's management control of the Hedge Program had somehow been ceded to AGP.

Q HAS THERE BEEN REBUTTAL TO THE NINE CONSIDERATIONS THAT LED TO YOUR CONCLUSION OF IMPRUDENCE?

A I find no convincing rebuttal. GMO speaks in generalities, and seeks to lay blame for imprudent costs on customers. Customers did not design, implement or administer the program. GMO has not, in my opinion proven prudence.

On the other hand, based on the weight of the many considerations addressed in my testimonies, I believe a finding of imprudent Hedge Program costs is appropriate.

Q WHAT WAS THE AMOUNT OF HEDGE PROGRAM COSTS PRUDENTLY INCURRED DURING THE REVIEW PERIOD?

A Zero. The imprudent costs collected from customers is the entire amount charged, $1,244,510.

Q IS THERE ANY OTHER AMOUNT THAT COULD BE APPROPRIATE?

A I cannot prejudge the Commission's decision. While I believe a refund of the entire amount is in order, it is conceivable that the Commission could follow a line of reasoning that would result in a partial refund. If so, I would respectfully recommend that the Commission, to the extent it needs additional information, direct the parties to respond accordingly.

CHRONOLOGY AND ALLEGED CUSTOMER RESPONSIBILITY

Q DID AGP SUPPORT TESTIMONY THAT SPOKE FOR FOR A HEDGE PROGRAM?

A Yes. GMO cites the testimony of Mr. Brubaker.

Q DID AGP SUPPORT A HEDGE PROGRAM REGARDLESS OF WHETHER OR NOT IT WAS IMPRUDENT IN DESIGN OR IN IMPLEMENTATION?

A No. Of course not.

Q DID THE TESTIMONY OF MR. BRUBAKER PREDATE THE DESIGN OF THE QCA?

A Yes. Due to the timing it was impossible for that testimony to consider the circumstances that existed when the Hedge Program was implemented. As I have previously explained, Aquila proceeded unilaterally with its design and implementation.

Q HAS MR. FEATHERSTONE EXPLAINED SOME OF THE HISTORY OF HEDGE PROGRAM INCLUDING CONCERNS THAT WERE BROUGHT FORWARD BY AGP.

A Yes. AGP first became aware of a problem as a result of the impact of the Hedge Program on QCA costs and rates. Even before a prudence review, AGP brought its concerns to Aquila/GMO.

Q WAS IT THE RESPONSIBILITY OF AGP TO DESIGN ANY HEDGE PROGRAM THAT MIGHT HAVE BEEN IMPLEMENTED?

A No. It was the responsibility of Aquila/GMO. While GMO now attempts to lay blame on AGP and customers, it was Aquila/GMO that had the responsibility to design, implement and administer any hedge program prudently. For its part, AGP brought its concerns to Aquila/GMO and wisely sought an early end to the imprudently incurred costs of the Hedge Program. But for AGP's request to stop the program, the imprudently incurred costs would have been larger.

Q DOES THE QCA PROVIDE FOR THE PRUDENCE REVIEW TO TAKE PLACE AFTER THE FACT?

A Yes. In my experience the review of costs incurred and recovered pursuant to a fuel rider such as the QCA are subject to a review for prudence after the fact. My point is that such reviews are not practical before the fact. There was no procedural vehicle for AGP to assert review or management of the design, implementation, or administration of the Hedge Program before the prudence review.

AGP brought its concerns to Aquila/GMO and beyond that the next steps were the prudence reviews, including this one.

Q DID STAFF EXPRESS AN OPINION OF HOW TO PROCEED WITH THE REVIEW?

A Mr. Featherstone opined that he viewed the QCA as a rate designed by Aquila and its largest customer, AGP. As such, I understand that he felt AGP should shoulder some of the burden of the prudence review. Staff proceeded to audit the costs incurred under the QCA. However, as a practical matter, prior to the report in this case, opinions as to the prudence of the Hedge Program were left to GMO and customers, including of course, AGP.

Staff performed its audits of the costs and facilitated meetings that included AGP. The audits, reviews, and meetings were after the fact. This is consistent with the QCA and also the typical approach in other fuel cost recovery mechanisms. In other words, there was no before the fact opportunity for Staff, AGP, or any other customer to ensure that the Hedge Program was prudently designed, implemented, and administered.

AGP finds no fault with how Staff handled this matter. AGP appreciates the Staff's audit work and Staff's active work to facilitate discussions in an attempt to resolve the matter of the prudence of the costs of Hedge Program without the need for formal prudence reviews. Mr. Featherstone's testimony documents his long history and deep experience with the steam business.

Q DOES GMO ASSERT THAT YOU AND MR. CONRAD INSTRUCTED GMO TO FORGO A $2,000,000 CASH OUT OPPORTUNITY?

A Mr. Blunk states that GMO could have cashed out of the troubled program in the spring of 2008 with roughly a $2,000,000 surplus. He further states that Mr. Conrad and I instructed him not to do so.

My memory is not the same. I can find no record of an instruction having been provided. Assuming the message was sent, I can report that to the best of my knowledge and belief it was not received by me. I remember that there was discussion of what to do about the existing hedge contracts and again, to the best of my recollection, I did not disagree with allowing them to run their course.

As a part of my long employment as a consultant, it has been my consistent practice, and my responsibility, to convey settlement offers timely and accurately. I did not convey any such offer to AGP and that reinforces my recollection that I never received such an offer.

GMO also asserts that the offer was conveyed to Mr. Conrad. If it was, I have no doubt that I would have been consulted and that the client would have been advised. That did not occur.

If the client would have received any such offer from any source I have no doubt that I would have been consulted. I was not.

Q DO YOU BELIEVE GMO HAD A RESPONSIBILITY TO CONVEY ANY SUCH OFFER?

A If GMO intended to rely on advice from AGP on a $2,000,000 matter such as to whether it should cash out or not, it should have made AGP aware in writing and/or asked for confirmation in writing. For example when the Hedge Program was discontinued GMO sought such confirmation and it was provided. On matters of substance this is standard business practice.

Assuming arguendo that GMO intended to provide notice of the cashout opportunity and to rely on an AGP decision regarding a possible cashout, the failure to provide written notice and to obtain written confirmation of the decision was imprudent.

HEDGE PROGRAM – COMPARISON TO THE GMO RISK CONTROLS POLICY

Q PLEASE BRIEFLY REVIEW THE DEFINITION OF A "HEDGE" IN THE CONTEXT OF NATURAL GAS USED IN STEAM PRODUCTION?

A The essence of a hedge program is an intent to provide protection, to build a wall of protection, a "hedge" that protects from undesirable cost outcomes. In constructing a hedge there are risks that must be managed.

Q DOES GMO HAVE A RISK MANAGEMENT POLICY?

A Yes. It has a "Risk Controls Policy." A copy is attached as Schedule 1.

Q

**

Q DOES THE GMO OCTOBER 2009 RESPONSE TO THE QUESTIONS OF MR. FEATHERSTONE SHED ANY OTHER LIGHT ON ACTIVITY RELEVANT TO THE HEDGE PROGRAM?

A Yes. The procedure for the physical purchases of natural gas is described as follows:

> "Physical natural gas for steam production is typically purchased either as a monthly product with daily pro rata deliveries or as a daily product. Typically about one-third (20-40%) of the expected usage based on historical usage patterns is purchased as a monthly or "base load" product. The remainder is purchased as a daily product. The daily purchased volumes are based on day ahead or that day usage estimates." [emphasis in original]

One of the questions that has been addressed in this prudence review is the extent to which natural gas is a swing fuel. When it came to physical purchases GMO recognized 20 to 40% as base usage, based on historical usage patterns. That left 60 to 80% to be purchased as a daily product.

Another important point is made in the response. The 20 to 40% purchased as "base load" was based not on forecast usage, but rather it was based on "historic usage patterns." Thus the physical purchases accommodated the use of natural gas as a swing fuel. The majority of natural gas usage, roughly 2/3, on a monthly basis was described as swing fuel usage that was purchased on a daily basis subject to need. This is the physical reality.

The GMO response to the questions of Mr. Featherstone reveals another unfortunate reality. The review and monitoring of the Hedge Program were too little and too late. Mr. Blunk, in his October 2009 response makes the following admission:

> "By the time it was apparent that actual steam load was significantly less than budgeted volumes it was too late to affect Aquila's natural gas hedge program for the steam system. The hedges would have already been purchased."

Q WHY IS THE INFORMATION REVEALED IN THE OCTOBER 2009 RESPONSE TO THE QUESTIONS OF MR. FEATHERSTONE IMPORTANT IN THE CONTEXT OF THIS PRUDENCE REVIEW.

A The response is particularly important when considered in the context of the Risk Controls Policy. The design of the Hedge Program was inconsistent with the Risk Controls Policy as to products, as to strategies employed, and as to reporting and monitoring, was inconsistent with the role of natural gas as a swing fuel, and was inconsistent with the reality of physical gas purchases where base load usage was necessarily understood and differentiated from swing usage.

What is also important is that these documents, requirements, descriptions, and admissions come directly from GMO in their own words. I reached similar conclusions that were described in my direct testimony and GMO responded with many pages of rebuttal. While I continue to support my earlier testimony, this surrebuttal comes from GMO's Risk Controls Policy and GMO's description of what occurred.

SURREBUTTAL ADDRESSING IMPRUDENCE CONSIDERATIONS FROM DIRECT TESTIMONY

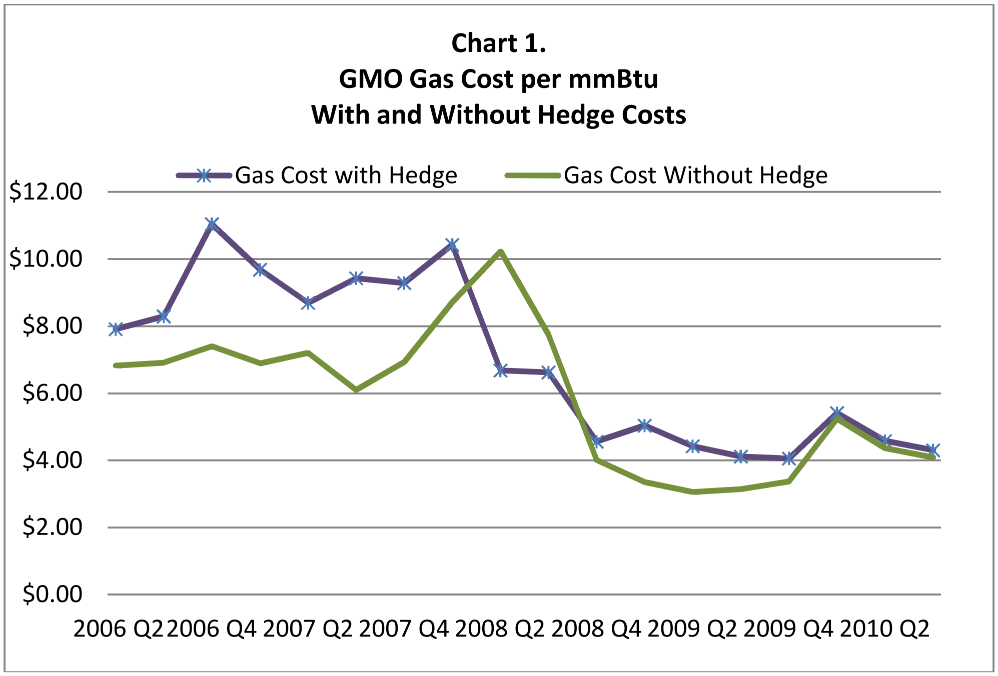
Q HOW WILL YOU ORGANIZE THIS PORTION OF YOUR SURREBUTTAL?

A I will restate the summary findings and conclusions from my direct testimony to provide context. Each of the summary findings and conclusions, 1 through 9, will be followed with a short surrebuttal.

Summary Findings and Conclusions:

1. The QCA mechanism effectively mitigates the effects of fuel cost volatility and price spikes by design. This is confirmed by several years of experience. In fact the QCA actually mitigated the effects of the price spikes created by the GMO Hedge Program. As such, the GMO Hedging Program as implemented was counterproductive and not needed. GMO ignored the beneficial effects of the QCA design and instead incurred the cost of a risky financial hedge program.

    - RESPONSE: GMO incorrectly asserts that I have not considered the cost of the physical gas supplies as well as the Hedge Program costs. That was a part of the analysis. Yet the combination of the two is addressed in this first contributing factor. Chart 1 below illustrates the quarterly natural gas cost with and without hedges. The Hedge Program results varied substantially from quarter to quarter. On an annual basis there were costs every year. The chart also illustrates the substantial increases created immediately after implementation. Of particular concern in this prudence review are the high costs of 2009.



2. GMO could have easily discussed a hedge program with all six of its customers before implementation and it would have been prudent to do so. GMO's purported interests in a hedge program - volatility mitigation, price protection, and price stability - all would have been good subjects for discussion. However, GMO's management did not avail itself of the opportunity for important customer input.

- RESPONSE: GMO witnesses conflates information provided regarding its electric hedging program and the natural gas Hedge Program for steam. GMO also points to statements made before the QCA was proposed, developed and implemented. While there is no doubt that AGP had an interest in stabilizing costs, the fact remains that when the time came to act, Aquila did so unilaterally and with not apparent regard of the stabilizing effect of the design of the QCA. Given that the stated goal was not to reduce costs, but to stabilize costs and avoid price spikes (retail price spikes from the customer perspective), the benefits of the QCA should have recognized, but were not.

GMO refers to an on the record presentation of the stipulation in HR-2005-0450 that addressed in part the initial QCA mechanism and the Hedge Program. It is pointed out that AGP did not object or assert imprudence. Of course not. AGP reasonably assumed Aquila would proceed prudently. AGP also reasonably assumed that the program would be implemented as described. It was not implemented as described and did not produce the result described. See Schedule 3, page 4 for an excerpt from the transcript cited by GMO.

3. GMO adopted a hedge program design without adequate consideration of the uncertain nature of its natural gas usage as a swing fuel in its steam operations. As a swing fuel, variations in steam load would have a disproportionate impact on gas usage. GMO's forecast of natural gas requirements was very far from the mark (in several months usage forecasts were 2 and more times actual). The uncertain nature of GMO's swing fuel requirements should have been a consideration when designing the hedge program, but was not.

- RESPONSE: The GMO witness Nelson suggests the effect of variations in load had a 1 to 1 relationship to gas usage. In fact, gas usage went up by well over 100% in some months and down by over 50% in other months. The changes in sales never remotely approached that level of volatility.

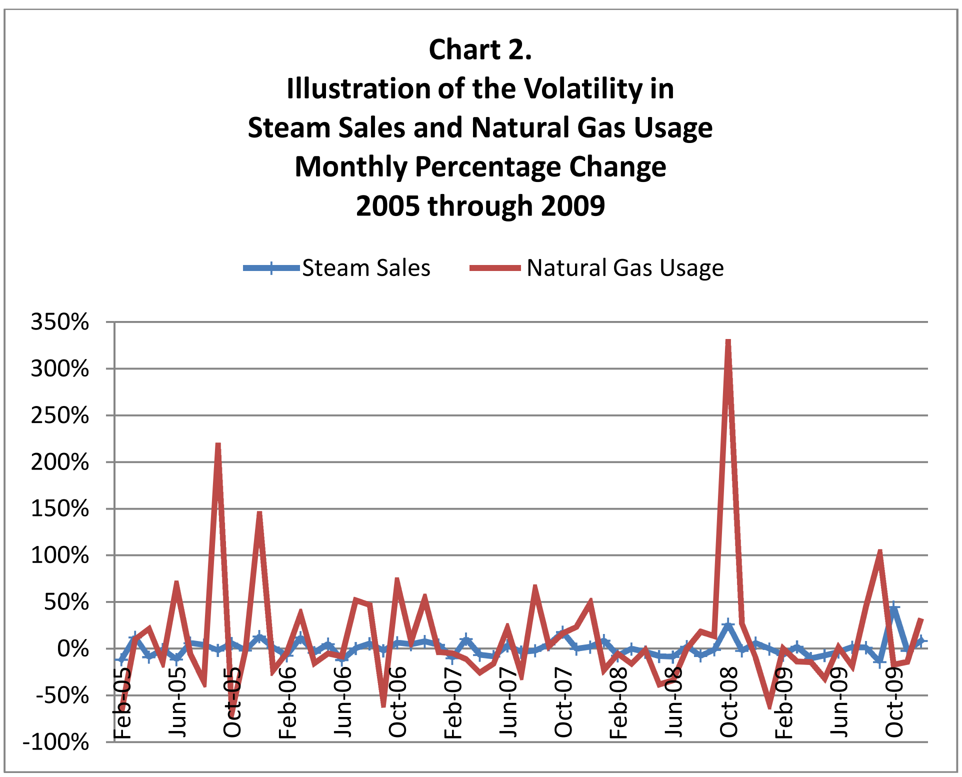


Chart 2.
Illustration of the Volatility in
Steam Sales and Natural Gas Usage
Monthly Percentage Change
2005 through 2009

-

Chart 2 is a graphical illustration of the extreme volatility in natural gas usage. It plots the percent change in gas usage each month. It also shows the percentage change in steam sales (customer usage). There is a sharp contrast between the volatility of gas usage and steam sales. Chart 2 illustrates what I characterized as disproportionate changes in gas usage relative to changes in steam sales. GMO has had much to say about the variation in customer usage, but there is an extreme difference between steam sales to customers and natural gas usage. Chart 2 illustrates how the variability in customer usage pales in comparison to the variability in gas usage. This occurs because of the role gas as a swing fuel.

Instead of explaining how the matter was accommodated – or why it was ignored and not accommodated, GMO merely obfuscates. The underlying problem was the variability in natural gas usage that was apparently unrecognized by Aquila/GMO.

4. GMO in previous presentations has conflated the cooperation of customers in their provision of estimated steam usage with its own forecasts of steam load and natural gas requirements. As admitted by Mr. Rush in questioning from the bench during the HC-2010-0235 case, customer forecasts of their own load, in spite of good faith, suffer from known problems. For one reason or another, new or expanded loads are difficult to predict. Nevertheless, when forecasts of customer steam load, system steam load, and natural gas requirements were made by GMO (Aquila) the limitations of the customer-provided information were apparently ignored. GMO's forecasts of customer steam load necessarily and unavoidably had a large uncertainty. With the role of natural gas usage as a swing fuel, the uncertainty in gas usage was necessarily and unavoidably magnified. Nevertheless, the GMO hedge program apparently proceeded based on forecast volumes that were treated as though they were a base load requirement. They were not.

- RESPONSE: Item 4 remains unrebutted. GMO would have us believe that the customers' forecasts of steam were the problem, but it was natural gas that was hedged, not customer steam volumes. Even now GMO feigns a lack of understanding of the large uncertainty in their natural gas requirements. Customers had no opportunity to review and comment before the fact on Aquila/GMO natural gas requirements. Even Mr. Fangman, the GMO customer representative and no knowledge of the monthly natural gas usage forecast.

Under the terms of the QCA rate schedule this proceeding provides the first opportunity for AGP to review the circumstances of the 2009 natural gas Hedge Program and the costs.

5. Because of the design of GMO's Hedge Program, and because of a forecast of natural gas usage requirements that in some months was 2 or more times actual usage, the Hedge Program created volatility in fuel costs – the opposite of the intended effect. GMO's program did not reasonably accommodate the uncertainly of its natural gas requirements.

- RESPONSE: This is an unrebutted fact. GMO asserts that total gas costs, both physical and financial/hedge costs, were not considered by me. GMO must have overlooked my direct testimony including the Chart 1 at page 11 of my direct testimony. Also see Chart 1 hereinabove.

6. Besides creating volatility the Hedge Program as implemented created price spikes – the opposite of what a reasonably designed and reasonably implemented program should have done. The effect of the program in some months was so extreme as to **<u>move prices up sharply</u> -- <u>in a down market</u>** – contrary to GMO's descriptions of the Hedge Program. The purported intent was mitigation of natural gas volatility, and mitigation of price spikes, both while providing for participation in down markets. The Hedge Program manufactured price spikes inapposite to the falling prices.

- RESPONSE: Again, GMO overlooks Chart 1 in my direct testimony when asserting that I did not consider the combined cost of physical gas cost and hedge program costs. Indeed, the combined effect was adverse.

  GMO does not explain why it chose to deviate from a program that would have provided the promised protection in all down markets. Instead, GMO explains that Collars are an "accepted" hedge mechanism in some circumstances, but as implemented by Aquila and GMO the Collars detracted from the explicitly extolled effect of participation in a down markets. See Schedule 3, page 4.

7. GMO appears to have sold puts for profit, allegedly intended to function as part of a collar mechanism. The effect was to limit participation in a falling market. In effect, instead of simply purchasing protection from high gas prices for one third of the volumes, GMO also sold protection against falling prices to others. Combined with the deficiencies in its treatment of

uncertain natural gas requirement, the deleterious effect in some months was so extreme as to eradicate all intended participation in a falling market and to instead increase prices. This contributed to a Hedge Program induced spike in the October 2006 cost of natural gas. This illustrates the flaws of the GMO Hedge Program that among other adverse effects was counterproductive to the volatility mitigation purpose of the Hedge Program.

- RESPONSE: GMO admits that it sold puts for an upfront profit to offset the costs of Hedge Program.

  GMO states that its sale of puts was part of a collar and not speculation.

  GMO describes the Hedge Program as one in which 2/3 of the gas would be supplied at market prices in a down market. (GMO cites the transcript in HR-2005-450, a relevant excerpt is attached as Schedule 3.)

  The program described on the record to the Commission and the one implemented simply do not jibe. The operations in down markets did not have the effect of providing 2/3 of the supply at the lower market prices.

8. GMO began the Hedge Program on February 16, 2006. Its forecast natural gas usage requirements were immediately out of kilter with reality. It failed to review, recognize problems, on a quarterly basis.

- RESPONSE: The lack of timely review is admitted. GMO describes an annual review process that was only occasionally supplemented.

9. GMO, at the request of AGP, discontinued new purchases under the Hedge Program in 2007. In spite of being aware of the customer dissatisfaction and the high costs and in spite of its drastically wrong forecasts of natural gas requirements, GMO allowed the then existing hedge positions to simply run their course.

- RESPONSE: The Staff report asserts that GMO was imprudent in not terminating the program at a profit instead of loss when the opportunity presented. I concur. GMO was not prudent.

Q DOES THIS CONCLUDE YOUR TESTIMONY AT THIS TIME?

A Yes it does.

SCHEDULE 1

HAS BEEN DESIGNATED AS

HIGHLY CONFIDENTIAL

IN ITS ENTIRETY

Questions from Cary Featherstone regarding Aquila Steam Fuel:

How were the purchases of natural gas and hedging made-- by the use of the forecast/budget expected volumes/ amounts by month or on annual basis?

Were the purchases and hedging instruments made on some type of adjusted budget levels, i.e., as the budget levels didn't materialize were the forecasts adjusted to ensure that quantities of natural gas were not over-purchased?

Cary is trying to gain an understanding of the purchasing policies of the natural gas amounts in volumes and how the expected steam loads impacted, if any, the procurement process of the natural gas commodity both in terms of actual procurement and how much to hedge.

REPLY:

Under Aquila's 1/3, 1/3, 1/3 hedge strategy 1/3 of budgeted volumes were fixed by purchasing NYMEX futures contracts, 1/3 of budgeted volumes were protected by purchasing either vanilla or synthetic NYMEX call options. The remaining 1/3 of budgeted volumes were not hedged. The budgets used to develop those volumetric forecasts were typically developed prior to mid-July of the year preceding the first year of the budget horizon.

By the time it was apparent that actual steam load was significantly less than budgeted volumes it was too late to affect Aquila's natural gas hedge program for the steam system. The hedges would have already been purchased.

Physical natural gas for steam production is typically purchased either as a monthly product with daily pro rata deliveries or as a daily product. Typically about one-third (20-40%) of the expected usage based on historical usage patterns is purchased as a monthly or "base load" product. The remainder is purchased as a daily product. The daily purchased volumes are based on day ahead or that day usage estimates.

10/02/2009
Ed Blunk

fuel run. And the 2.6 million MM Btu takes into account Triumph that was coming in and the Albaugh (phonetic spelling) Chemical who was adding a second shift.

So we took into account the low growth. But that's -- that's basically how we came up with the $3 price per MM Btu.

MR. CONRAD: I should caution we're not HC here so...

CHAIRMAN DAVIS: Okay. All right. Well, I'll try not to tax Mr. Clemmons with anything that's HC. And I'm not asking for any specific number, Mr. Clemmons, but how far are you hedged out on your coal contracts?

MR. CLEMMONS: We don't hedge our coal contracts.

CHAIRMAN DAVIS: You don't hedge your coal contracts?

MR. CLEMMONS: Coal, no. That -- those are contracts. I mean, those are just --

CHAIRMAN DAVIS: Well --

MR. CLEMMONS: We don't -- there's no hedging.

CHAIRMAN DAVIS: Okay. So you've got a contract to purchase coal, right? And when did -- so

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without asking you what those numbers are, how long are your coal -- how long are your coal costs known and measurable within a reasonable degree of certainty?

MR. CLEMMONS: About five years on the coal contract. I'd say around five years.

CHAIRMAN DAVIS: About five years. And we've already heard some testimony from you that you're about, was it two-thirds hedged for natural gas for '06; is that correct?

MR. CLEMMONS: That's correct. That's the current plan.

CHAIRMAN DAVIS: Okay. So is there any way -- way feasible that you can beat this $3 per million Btu amount?

MR. CLEMMONS: Well, the other third gas that we have not hedged, we are in the process of buying that at a lower rate just through efficiencies. And if we can burn more coal at the plant, that would lower the ratio. If we can burn higher than the 2.1 that's built into the rate, that would give an opportunity for us. It gives us incentive to try to be efficient on the --

CHAIRMAN DAVIS: On the coal side.

MR. CLEMMONS: -- on the coal side,

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yeah.

CHAIRMAN DAVIS: Okay. So you're telling me that -- that it is feasible then, that you could potentially beat this number and Aquila could actually make some money on this?

MR. CLEMMONS: It's feasible.

CHAIRMAN DAVIS: But not likely?

MR. CLEMMONS: With current prices, possibly not, but I don't know. See how the market goes in the future.

MR. CONRAD: Judge, one way to look at this is, springing from what Mr. Clemmons has said, the predominant quantity of the MM Btu's are raised from coal. The predominant dollars come from the gas cost. So if -- if in that scenario, if the gas costs were to drop, and praise the Lord if they would do that --

COMMISSIONER CLAYTON: They've dropped significantly today, Mr. Conrad. I don't know how much further they'll drop, but they've dropped significantly today.

MR. CONRAD: -- then there would be some potential for both of the utility and for the customer to have some benefit from that. Certainly as compared with locking in a hard number.

MR. CLEMMONS: I might add on our two-thirds hedge, half of that are call options which we would just pay the premium, so I mean, we would have an advantage to buy the cheaper gas.

If they weren't -- weren't in the money, we would just pay the costs of that premium and then buy gas at the market rate. So we'd still have some opportunities to lower that gas price.

CHAIRMAN DAVIS: And then you feel like this arrangement sufficiently protects you in the event that, you know, coal can't be delivered from the Powder River basin and the price of natural gas shoots up to $10 or more again, that 80 percent of that is sufficient to help you get through until you can file a rate case and adjudicate it in the 11-month process after that.

MR. CLEMMONS: Yes, sir.

CHAIRMAN DAVIS: Mr. Mills, you're awful silent there.

MR. MILLS: Yes, sir.

CHAIRMAN DAVIS: You've not -- you've not signed on to this stip and agreement, correct?

MR. MILLS: That's correct. And, in fact, we did not really participate very actively in this case. The steam customers are not people that