Exhibit No.:	
Issue:	AGP Complaint
Witness:	Donald E. Johnstone
Type of Exhibit:	Rebuttal Testimony
Sponsoring Party:	AGP
Case Number:	HC-2010-0235
Date Prepared:	November 5, 2010

Kansas City Power and Light
Greater Missouri Operations
Steam Business
HC-2010-0235

Rebuttal Testimony of

Donald E. Johnstone

on behalf of the

AG PROCESSING INC A COOPERATIVE

November, 2010

Competitive Energy
DYNAMICS

HC-2010-0235

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Ag Processing, Inc., a Cooperative, Complainant,
v.
KCP&L Greater Missouri Operations Company, Respondent

HC-2010-0235

Rebuttal 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.

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.

INTRODUCTION

Q WILL YOU ADDRESS ALL ASPECTS OF THE KCP&L GREATER MISSOURI OPERATIONS COMPANY TESTIMONY?

A My rebuttal will present AGP's technical response to the testimony submitted by the KCP&L Greater Missouri Operations Company ("GMO"), to the extent that it is proper testimony. Aspects of the testimony that would go behind settlement doors to reveal privileged and confidential settlement information are being addressed by AGP's attorney.

In my direct testimony I referred to the company as "Aquila," as it was known during the timeframe of the complaint. Two of the five company testimonies were authored by current staff of KCP&L on behalf of the KCP&L Greater Missouri

Operations Company ("GMO"). These two, Mr. Rush and Mr. Blunk, were not employees of Aquila and have no first-hand knowledge of the history of the hedge program. Two are authored by current KCP&L/GMO staff that were employees of Aquila during the relevant time periods, Mr. Fangman and Mr. Gottsch. One of the GMO testimonies is authored by Mr. Clemens, a consultant that is a former employee of Aquila.

Q HOW WILL YOU REFER TO THE COMPANY?

A In this testimony my references to the steam utility will be as "GMO Steam," as "Aquila," or simply as "Company." I understand the GMO steam business and Aquila Steam (as defined herein) to be one and the same for the purposes of this complaint. Of course, both KCP&L and Aquila have had separate electric utility companies in Missouri and elsewhere and it will be my intent to specify these as "electric" to the extent they arise.

Q PLEASE PROVIDE A BRIEF OVERVIEW OF THE TOPICS RAISED IN THE GMO TESTIMONIES.

A GMO previously made a motion to dismiss the complaint as out of time. While rejected by the Commission, the argument appears again in direct testimony. GMO also contends that the time for a prudence review of a hedging program is up front, before implementation. GMO testimony asserts that there is no rate, rule, or tariff standard for hedging programs and therefore none has been violated.

One of the recurring themes of the GMO Steam testimony is that the design and implementation of the hedge program was in response to customer "demands," and that any problems in the program were the fault of customers. They suggest that the

fault lies with their customers, because these customers provided Aquila with usage projections that were not accurate in every case.

GMO Steam would have the Commission believe the Aquila hedge program was appropriate because similar programs have been approved in different places and different times and different jurisdictions for gas distribution companies and for electric utilities.

While GMO Steam makes various responses to some of my direct testimony, they did not deny that the QCA mitigated volatility. The response was silence. Another area of silence is in regard to the Aquila's forecast of its natural gas usage and the related uncertainty. There is no forecast witness, only witnesses that provided input or accepted the output. In a similar vein GMO Steam offers no one that was responsible for the analysis and design of the hedge program that was implemented for the steam system.

GMO STEAM RESPONSE TO IMPRUDENCE

Q DID GMO STEAM RESPOND TO YOUR SIX POINTS THAT SUMMARIZE THE BASIS FOR YOUR CONCLUSION OF IMPRUDENCE?

A Yes and no. The responses, to the extent that they were made, are spread among the several testimonies. I will organize this rebuttal primarily on the basis of the six-point summary and then address a few additional issues raised in the GMO Steam direct testimonies.

Q WHAT IS THE FIRST SUMMARY POINT IN YOUR DIRECT TESTIMONY?

A It is the following:

> "The QCA mechanism effectively mitigates the effects of fuel cost volatility and price spikes, by design and in practice. As such, the Aquila hedging

program was not needed. It was imprudent to ignore the QCA and to instead incur the cost of a risky financial hedge program given the effective volatility mitigation of the QCA mechanism."

Q WHAT WAS THE COMPANY RESPONSE?

A The response comes primarily from Mr. Clemens and Mr. Blunk. However, as a preliminary matter I note that the summary point is comprised of three statements addressing 1) the QCA design that inherently mitigates volatility, 2) the need for the Aquila hedging program given the QCA design benefits, and 3) the imprudent disregard of the QCA design.

Mr. Clemens argues that the QCA was not designed to be a hedging program, that Mr. Brubaker's testimony in HR-2005-0450 supported hedging, that my position is inconsistent with the AGP position in HR-2005-0450. Mr. Blunk argues that my position is inconsistent with the Commission's Natural Gas Price Volatility Mitigation Rule, and that the Williams email (Schedule 2 in my direct testimony) shows that Company and customer interests were aligned. He also provides his interpretation of the Williams email.

Q WAS THE QCA DESIGNED TO BE A HEDGING PROGRAM?

A Of course not. However, it was designed to mitigate volatility, so there is a direct impact on what is needed in a hedging program if one is implemented. This means that Aquila needed to have goals and a design suitable for the particular and relatively unique circumstances of the Aquila steam system and its customers. In this context it is easy to see why an approach used for other utilities, whether they be local natural gas distribution utilities or even an affiliated electric company, would not be expected to be *apropos*. Mr. Clemens is incorrect if he intends to deny the relevance of the QCA to the goals for and design of a hedging program.

Q DID MR. CLEMENS INTERPRET YOUR TESTIMONY TO MEAN THAT THERE SHOULD BE NO HEDGE PROGRAM OF ANY DESIGN?

A It seems so. However, it is not my testimony that no hedging program of any design whatsoever could be appropriate. Rather the point is that the hedge program designed and implemented by Aquila was not needed. Aquila's program was designed only to lower the price of the highest cost natural gas and increase the lowest cost. Volatility mitigation was the goal, although the goal was not achieved. My point is that the QCA by its design does much the same thing and that is a large part of the basis for my statement that "the hedge program," the one designed and implemented by Aquila, was unneeded.

Mr. Clemens addresses some of the history and infers that because AGP and others had knowledge of the hedge program used in the electric business and Mr. Brubaker had testified favorably in that context, the same program would be *apropos* for the steam business. I disagree. The differences are real and have been illuminated in this case. Even so it does not relieve Aquila of the responsibility to implement a program appropriate for the steam business in the context of the QCA and its uncertain forecasts. It is unfortunate that Aquila apparently did not understand these differences, but it was their responsibility and they should have done so.

Q PLEASE ADDRESS THE MATTER OF THE BRUBAKER TESTIMONY FROM HR-2005-0450 THAT IS ATTACHED TO THE TESTIMONY OF MR. BLUNK.

A Mr. Blunk and Mr. Clemens both cite the testimony. Both fail to acknowledge that the testimony predates the QCA. Aquila did not propose a fuel rider in the case. Absent clairvoyance, there is no reason for Mr. Brubaker's testimony to have anticipated any

fuel rider for the steam business, and no way to anticipate a fuel rider in the form of the QCA, with its volatility mitigating effects.

Furthermore, I think it almost goes without saying that Mr. Brubaker's support for any hedging program would be extended only to a program *prudently designed* in consideration of the goals of the hedge program and *prudently implemented*. I find no merit in taking his testimony out context in an attempt to show Aquila's design or implementation prudence before the relevant facts were known or knowable, and especially so because of the materially different circumstances. If GMO Steam wanted Mr. Brubaker's opinion of the program in the context of the QCA and its uncertain natural gas usage they should have asked him, but in any event it is not reasonable to now rely on his earlier testimony given the materially different circumstances.

Q MR. CLEMENS DISAGREES WITH YOUR OPINION THAT THE AQUILA STEAM HEDGING PROGRAM WAS UNNEEDED AND ASSERTS THAT YOUR OPINION IS INCONSISTENT WITH THE TERMS OF THE QCA. DOES HE HAVE A POINT YOU CAN AGREE WITH?

A No. Mr. Clemens cites section 8.1 of the settlement. It reads in pertinent part: "The cost of fuel will be the amounts expensed in Account 501." and "The cost of gas in Account 501 will include the cost of physical gas deliveries and financial instruments, when settled, associated with gas delivered in the quarterly period." By my reading and understanding of the plain meaning of the language it does two things. First, *if there is a hedging program*, the cost will be a part of the QCA. Second, the cost/benefit of a hedge position associated with any particular quarter will be accounted for in that particular quarter for QCA purposes. I am aware of no other ulterior motive, intent, or purpose beyond the plain meaning. The simple of fact of allowing for the existence of a hedging program does not follow logically to an

assumption that any program would be automatically acceptable, without customer or Commission review and approval, and without the prudence review provided for by the QCA.

There is an issue with the privilege afforded settlement discussions and documents. AGP Counsel has brought this matter to the Commission's attention, so pending further direction I would reserve the right to provide further rebuttal depending on the Commission's decision in the matter. I will point out that much of what Mr. Clemens chose to disclose, like the Brubaker testimony he cites, predated the creation of the QCA. Also, much was related to Aquila's electric business (where there was no QCA) and would therefore have very little bearing on a hedging program for the steam system, unless one were to imprudently ignore the volatility mitigation attributes of the QCA and other circumstances. Others address time frames after the prudence review periods at bar and again would have no bearing on the matters in this case for that reason.

Q IS THE COMMISSION'S NATURAL GAS VOLATILITY MITIGATION RULE APPLICABLE TO AQUILA/GMO STEAM?

A It is not. Mr. Blunk would nevertheless draw on it for support of the GMO Steam position. However, he overlooked some of the rule's language that would have been instructive. The rule (4 CSR 240-40.018) states:

> "(1) Natural Gas Supply Planning Efforts to Ensure Price Stability.
> (A) As part of a prudent planning effort to secure adequate natural gas supplies for their customers, natural gas utilities should structure their portfolios of contracts with various supply and pricing provisions in an effort to mitigate upward natural gas price spikes, and provide a level of stability of delivered natural gas prices.
> (B) In making this planning effort, natural gas utilities should consider the use of a broad array of pricing structures, mechanisms, and instruments, including, but limited to, those items described in (2)(A) through (2)(H), to

> balance market price risks, benefits, and price stability. **Each of these mechanisms may be desirable in certain circumstances, but each has unique risks and costs that require evaluation by the natural gas utility in each circumstance.**" [emphasis supplied]

Mr. Blunk considers the rule to be "instructive." AGP has diligently sought to obtain from Aquila information that would amount to an evaluation of the "unique risks and costs" of Aquila's hedging program. None has been provided. The recently filed testimonies of GMO steam continue this silence. The only apparent rationale is that the method was used in other circumstances.

Q PLEASE RECAP THE "WILLIAMS EMAIL" THAT WAS ADDRESSED IN YOUR DIRECT TESTIMONY, AND THEN IN THE TESTIMONIES OF MR. BLUNK AND MR. CLEMENS.

A The February 15, 2006 10:17 a.m. email authored by Mr. Williams is the third and last in a string. In its entirety the email states:

> "The sharing mechanism in the steam case provides for the flow through of hedge costs into the fuel sharing mechanism. Therefore, I believe that hedging of the anticipated gas volumes necessary to serve the steam load is prudent and that a policy similar to the one for electric volumes (1/3, 1/3, 1/3) **if stated in advance in writing would be deemed prudent**.
>
> Just one note of clarification. The steam settlement has not been filed with the Commission yet pending some last minute Staff review. However, I do not think that impacts the prudence of our decision to hedge the gas volumes. We should follow whatever procedure we would normally take whether or not there is sharing mechanism." [emphasis supplied]

Mr. Blunk and Mr. Clemens both interpret the email as being about prudence in the context of sharing. By my understanding it offers an endorsement of the (1/3, 1/3, 1/3) policy and deems it prudent based only on it being stated in advance in writing. There is no consideration of the volatility mitigation effect of the QCA. Nor is there any suggestion of the evaluation of the "**unique risks and costs that require evaluation by the natural gas utility in each circumstance"** as would be required under the Natural Gas Price Volatility Mitigation rule that was cited with approval by

Mr. Blunk. As evidenced in the two prior emails in the Williams email string that began at 9:46 a.m., within less than an hour, the question was raised and a decision was made to pursue the 1/3, 1/3, 1/3 design and to produce the written document as evidence of prudence, consistent with the Williams recommendation. Mr. Williams did not make his response contingent on any analysis to determine if the hedge program appropriate to the circumstances. It is this aspect of the email that in my opinion amounts to fundamentally bad advice to proceed.

The act of writing down a policy does not create prudence. The unique risks and costs in the circumstances that should have been analyzed would include the QCA with its volatility mitigation properties, and the uncertain natural gas volume projections. The absence of any analysis and documentation up front is undoubtedly part of what gives rise to an after-the-fact or "*ex post*" review. By all appearances there was no before-the-fact or "*ex ante*" evaluation that included these considerations and certainly no *ex ante* evaluation in which the customers or the Commission was a party. An *ex post* review is the only option in these circumstances and GMO Steam suggests a bad precedent and bad policy in attempting to squelch the only review option that exists. Another problem with GMO's argument is that any program could have a prudent design but not be prudently implemented. For example, a utility could develop a prudent plan to construct a power plant but then construct it in an imprudent manner. Only an *ex post* review could address this imprudence.

Q DOES MR. BLUNK INTERPRET THE WILLIAMS EMAIL AS AN INDICATION THAT THE 80/20 SHARING MECHANISM ALIGNS THE FINANCIAL INTEREST OF AQUILA AND ITS CUSTOMERS?

A The alignment is real and the email, while not adding to or detracting from the alignment, expresses an opinion consistent with that reality.

Q DOES THE QCA PLACE ANY LIMITATIONS ON THE RESULTS OF A PRUDENCE REVIEW?

A Yes. An imprudence adjustment is not allowed by the QCA if it would amount to less than 10% of the fuel costs in the review period. From the AGP perspective the 10% is appropriate in consideration of 80/20 sharing to align financial interests. This also provides a clear benchmark for the design of a hedge program.

Q IN WHAT SENSE DOES THE 10% THRESHOLD PROVIDE A CLEAR BENCHMARK FOR THE DESIGN OF A HEDGE PROGRAM?

A In effect it provides a budgetary guideline. A design to control hedge program costs to less than 10% of the annual fuel cost, assuming successful implementation, might have placed the effects of the hedge program beyond the reach of this prudence review. Instead, Aquila proceeded with no analysis. The circumstances of this complaint provide an example of why there must be an opportunity for a prudence review, even with the alignment of interests. When a large amount of money is put at risk with little or no significant analysis to back it up and no apparent consideration of relevant circumstances, an *ex post* prudence review ought not to be a surprise.

Q WHAT WAS YOUR SECOND SUMMARY POINT?

A It is the following:

"Aquila could have easily discussed a hedge program with all six of its

customers before implementation and should have done so. Aquila's interests in a hedge program: volatility mitigation, price protection, and price stability, all could have been subjects for discussion. Aquila's pass on the opportunity for important customer input contributes to my opinion of imprudence."

Q WHAT WAS THE COMPANY RESPONSE?

A The response comes primarily from Mr. Gottsch and Mr. Clemens. It is alleged that the hedge program was created at the request of AGP, that there was "agreement and understanding by all parties to the 2005 Steam Rate Case that Aquila's natural gas hedging program would be included in the QCA" (Clemens Direct Testimony, p.2), that AGP played an integral part in development of the QCA, that Aquila decided to implement the program that had been used for Aquila electric operations, that no party raised an objection to the hedging program in the context of Aquila electric operations, and that the Brubaker testimony in effect asks for the hedging program.

Q DID AGP REQUEST THE 1/3, 1/3, 1/3 HEDGE PROGRAM THAT AQUILA IMPLEMENTED?

A I am aware of no such request. I am advised by counsel that he is aware of no such request. Aquila provided no documentation of any such request from AGP, but instead points to the QCA settlement language and the Brubaker testimony. Earlier in this rebuttal I addressed the context of the Brubaker testimony on the subject and explained why it would not have been reasonable to interpret that as a request for or the approval of the hedge policy for steam. I have also already addressed the QCA language. It provides the accounting treatment for QCA purposes, but it is in no way an endorsement of a particular hedge policy.

Q WASN'T AGP AWARE OF THE STEAM HEDGE PROGRAM BECAUSE OF AQUILA'S HEDGE PROGRAM FOR THE ELECTRIC SYSTEM?

A AGP was certainly aware of the electric hedge program. However, in February 2006 Aquila made the unilateral decision to create a separate hedge program fashioned after the one used for the electric system. At that point, since it was a program solely for the steam business, it needed its own analysis for several reasons. The first reason is the existence of the QCA and its ability to mitigate volatility. A second reason is the different and purely industrial customer base of only six. A third reason is the uncertainty in load growth in combination with the use of gas as a swing fuel.

Q WHAT WOULD BE A REASONABLE HEDGE POLICY FOR AQUILA/GMO STEAM?

A If asked today I would begin with a statement of a goal for hedging:

> The goal I would suggest is to minimize fuel costs while avoiding exposure to upward price spikes.

To translate this goal into a hedge policy for the steam business I would suggest the following:

> Design the hedge program with the goal of limiting the exposure to upward moves in the market price while preserving participation in downward market price movements. Volumes hedged will be based primarily on historical levels and will consider the role of natural gas as a swing fuel. The cost implications to accomplish the objective under alternative approaches, including all relevant factors, shall be evaluated before proceeding.

This statement of policy is my wording based on consistent comments from AGP as to their objectives, and it comes in the context of this case in which the subject has had a lot of scrutiny. The goals of AGP, by my understanding, have been entirely consistent over these several years and if asked at any time I would have expected a substantially similar response.

Q WHAT WAS YOUR THIRD SUMMARY POINT?

A It is the following:

"Aquila adopted a hedge program design without considering the nature of its natural gas usage as a swing fuel. Part and parcel of this problem was Aquila's forecast of natural gas requirements that was very far from the mark (in many months usage forecasts were 2 and more times actual). These factors contribute to my opinion of imprudence."

Q WHAT WAS THE COMPANY RESPONSE?

A The response comes primarily from Mr. Blunk. He thinks it is presumptuous of me to believe the fact was ignored. Since he had nothing to do with Aquila at the time, perhaps in effect he is suggesting that it is hard for him to fathom that Aquila would not have considered the fact. If that is his underlying point in response I would simply point to the complete lack of any documentation that shows that the swing fuel nature of the natural gas fuel and volumes was a consideration. Certainly the results do not support that.

For the sake of discussion, assuming the swing fuel factor was considered, (although there is no indication whatsoever that it was) then it obviously was not given consideration sufficient to produce a hedge program that could accommodate large swings in usage without producing unintended effects.

Q DOES MR. BLUNK ASSERT THAT AQUILA'S PROGRAM WAS SUFFICIENT TO ACCOMMODATE THE SWING FUEL FACTOR?

A Yes. Mr. Blunk observes that it is common that swing fuel volumes are different than budget and asserts that the 1/3 program managed the risk of uncertainty. On the latter point I disagree. All evidence is to the contrary. The 1/3 program was designed to accommodate 1/3 futures, 1/3 options, and 1/3 at market. There is nothing to indicate that any aspect of the program was there to accommodate the swing nature of natural gas requirements in combination with the uncertain forecast of natural gas volumes. The program did not come close to providing 1/3 at market.

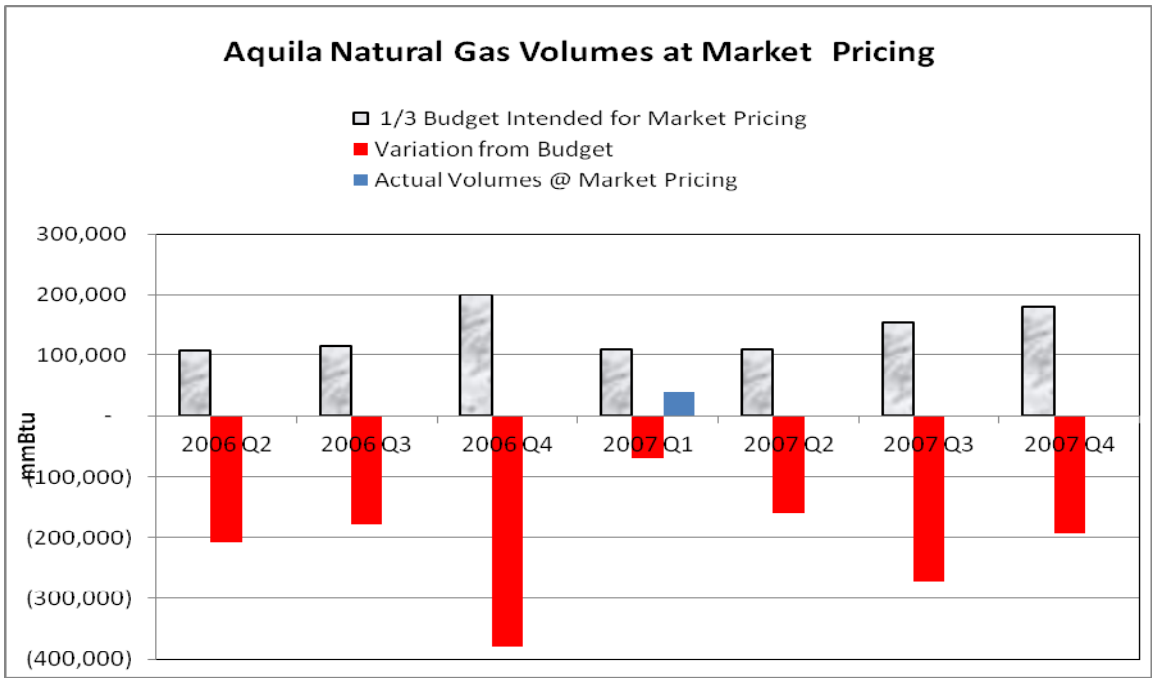
In my direct testimony I explained that limited variations from the budget volumes could be reasonably accommodated. I also explained that the large swings below the Aquila budget completely upset the intended effect of the program.

My summary point 3 is based on facts that do not depend on whether or not I was presumptuous as alleged by Mr. Blunk. The facts are that the Aquila program was woefully inadequate when it came to accommodating the usage of natural gas as a swing fuel. Moreover, Aquila never analyzed the nature of this swing load or the volumes that it would need to hedge.

Q CAN YOU COMPARE THE VOLUMES THAT REPRESENT THE 1/3 INTENDED TO FLOAT AT MARKET PRICE WITH THE VARIATIONS FROM THE FORECASTS?

A Yes. Chart Reb-1 graphically illustrates the relationship quarter by quarter.

Chart Reb-1.



This chart shows the amount of gas that would have been priced at market in each quarter, assuming Aquila's forecast natural gas volumes were accurate. The second

column in each quarter (in solid red) shows the variation between actual natural gas volumes and Aquila's forecast. In six of the 7 quarters the net effect was no gas bought at market prices. The only exception is in the first quarter of 2007.

Q WHAT DOES THIS ILLUSTRATE IN THE CONTEXT OF MR. BLUNK'S CONTENTION THAT THE 1/3 OF VOLUMES AT MARKET WOULD ACCOMMODATE THE "SWING FUEL" EFFECTS?

A The volumes were greatly affected by the fact that natural gas was a swing fuel. The 1/3 design for market did not come close to accommodating the reality of the situation.

Q WHAT WAS YOUR FOURTH SUMMARY POINT?

A It is the following:

> "Because of the design Aquila's hedge program, and because the forecast of natural gas usage requirements that was 2 or more times actual usage, the hedge program created volatility in fuel costs and price spikes. The effect of the program in some months was so extreme as to move prices up sharply in a down market. This contributes to my opinion of imprudence."

Q WHAT WAS THE COMPANY RESPONSE?

A The response comes from Mr. Rush, Mr. Blunk, Mr. Gottsch, and Mr. Fangman. Mr. Fangman weighs in about customer supplied information. Mr. Gottsch talks about revised forecasts and points to customers, Aquila's reaction thereto, and talks about a program that could have been even worse. Mr. Blunk again suggests that the 1/3 approach accommodated uncertain volumes and complains that my analysis is based on actual volumes instead of forecast. Mr. Rush suggests the fault belongs to customers that provided inaccurate information. All of this comes down to a few points, some of which are repeatedly addressed by the several witnesses.

The first point is the suggestion of the GMO Steam witnesses that it was the customers' fault that GMO Steam's forecasts of natural volumes were so far off. All four weigh in on that point. The second point is Mr. Blunk's suggestion that my analysis is somehow inappropriate because it is in part an analysis based on actual volumes. The third point is that Aquila revised its forecasts.

Q HOW DO YOU RESPOND?

A Mr. Fangman had direct contact with customers. I will begin with a review of his testimony and then proceed to the others.

Q HAVE YOU REVIEWED THE DIRECT TESTIMONY OF MR. FANGMAN THAT WAS FILED IN THIS DOCKET BY KCP&L ON OCTOBER 22, 2010?

A Yes I have.

Q WHAT WERE MR. FANGMAN'S RESPONSIBILITIES WITH AQUILA DURING THE TIME FRAME ADDRESSED IN THIS COMPLAINT?

A Mr. Fangman explains as follows: "The majority of my work at Aquila involved working with large industrial and commercial customers. I acted as a customer liaison between Aquila and its customers, managing Aquila's relationship with its customers to make sure the customers' and Aquila's needs were met." (Fangman Direct Testimony, p.2)

Q DOES MR. FANGMAN ADDRESS THE HEDGING PROGRAM OF AQUILA?

A No.

Q WHAT DOES HE ADDRESS?

A As customer liaison one of his responsibilities was to gather information from customers to be used in the Aquila's load forecast. His explanation consists of about 5

pages of testimony. He attached 17 schedules, which amount to roughly 190 pages that consist of emails between Mr. Fangman, other Aquila employees, and customers. Many of these are marked highly confidential.

Q IN MR. FANGMAN'S TESTIMONY AND ALL OF PAGES OF SCHEDULES IS THERE ANY INDICATION OF ANY DISCUSSIONS WITH CUSTOMERS THAT ADDRESSED THE HEDGE PROGRAM?

A No. In fact, based on my review the words "hedge" or "hedging" do not appear even once in the emails to or from customers.

Q ARE YOU AWARE THAT MR. FANGMAN WAS DEPOSED IN THIS DOCKET?

A Yes.

Q WHEN SPECIFICALLY ASKED OF HIS DISCUSSIONS WITH CUSTOMERS ABOUT THE HEDGE PROGRAM THAT IS AT ISSUE, IS THERE ANYTHING TO INDICATE THAT MR. FANGMAN EXPLAINED TO CUSTOMERS THAT AQUILA WAS ABOUT TO EMBARK ON A HEDGE PROGRAM FOR NATURAL GAS PURCHASES FOR THE STEAM BUSINESS?

A No.

Q WHEN SPECIFICALLY ASKED OF HIS DISCUSSIONS WITH CUSTOMERS ABOUT THE HEDGE PROGRAM THAT IS AT ISSUE, IS THERE ANYTHING TO INDICATE THAT MR. FANGMAN IN 2005 OR 2006 SOLICITED AN OPINION OF CUSTOMERS AS TO WHETHER OR NOT THERE WAS A DESIRE ON THE PART OF CUSTOMERS FOR AQUILA TO EMBARK ON A HEDGE PROGRAM FOR NATURAL GAS PURCHASES IN THE STEAM BUSINESS?

A No.

Q IS THERE ANY INDICATION THAT MR. FANGMAN AT ANY TIME EXPLAINED TO CUSTOMERS THE EFFECTIVENESS OF THE QCA IN MITIGATING FUEL COST VOLATILITY, INCLUDING NATURAL GAS PRICE VOLATILITY?

A No.

Q DOES MR. FANGMAN ADDRESS THE MANNER IN WHICH AQUILA PREPARED FORECASTS OF NATURAL GAS REQUIREMENTS?

A Yes, in a cursory fashion. He did not, however, prepare the forecasts or provide any significant detail. His role was to collect information from customers, which was in turn provided to employees of Aquila that prepared forecasts of load and natural gas requirements.

Q DOES HE CALL INTO QUESTION THE DATA THAT HE COLLECTED AND DISSEMINATED?

A Yes. In one instance he questions whether the customer data was expected steam consumption or simply connected load. The significance of this question is that the total connected load at any industrial facility will always be greater than the average load, often by a substantial margin. With new or expanded facilities it seems that connected load is commonly available.

In another instance Mr. Fangman observes that a customer provided updates pertaining to an increase in load that has not materialized - even over a period of years. He characterized the customer's information provided to him as always projecting the increase to occur "next month." In the sense of the increase in load, "next month" never came.

Q IN YOUR EXPERIENCE, IS IT UNUSUAL FOR THE SUM OF DETAILED CUSTOMER LOAD PROJECTIONS TO BE DIFFERENT THAN A CREDIBLE FORECAST OF THE AGGREGATE LOAD OF A GROUP OF INDUSTRIAL CUSTOMERS?

A It is not unusual for there to be a significant difference. Mr. Fangman's testimony provides illustrations of why this is so.

Q WOULD IT BE PRUDENT TO PREPARE A FORECAST BASED SOLELY ON CUSTOMER LOAD PROJECTIONS?

A No.

Q WOULD IT BE PRUDENT TO ENTER INTO A HEDGE PROGRAM THAT CREATES SUBSTANTIAL FINANCIAL RISKS BASED SOLELY ON THE SUM OF INDIVIDUAL CUSTOMER LOAD PROJECTIONS?

A No. And it also follows that there should be no suggestion that the results of a unilaterally designed and implemented hedging program - based on Aquila's forecasts of monthly natural gas volumes that were overstated by as much as 100% - is the responsibility of customers.

Q HOW DIRECT IS THE LINK BETWEEN THE AQUILA'S FORECAST OF INDUSTRIAL STEAM SALES AND THE VOLUMES USED IN THE HEDGE PROGRAM?

A The link was not and is not a direct link. Instead, the volumes used for the hedge program were several steps removed from the individual load projections. First, it was Aquila's responsibility to develop a credible forecast of customer load. Second, it was Aquila's responsibility to develop a credible forecast of fuel requirements. Third, it was Aquila's responsibility to develop a credible forecast of the natural gas requirements as one component of fuel. Fourth, it was Aquila's responsibility to

understand that natural gas was a swing fuel and that as such there would be volatility in volumes (as well as in price). Fifth, assuming that there was to be a hedge program, it was certainly Aquila's responsibility to develop one which would have made prudent use of its forecast of natural gas requirements and uncertain information in the context of its steam business.

Q DOES THE TESTIMONY OF MR. FANGMAN MAKE THE CASE THAT THE NATURAL GAS VOLUMES USED IN THE HEDGE PROGRAM WERE PRUDENTLY DEVELOPED?

A No. Mr. Fangman only collected customer information that was provided to others. He did not prepare the forecast of natural gas volumes. With regard to his contribution of customer information as one of the inputs to the forecast of natural gas volumes, he acknowledges questionable aspects of the customer information that would have been relevant to its use in the forecast process. While I do not doubt that the customer information was provided in good faith by customers, and was provided in good faith by Mr. Fangman to others in the Company, the fact remains that it had to be the responsibility of someone at Aquila to understand how to effectively use the information in the prudent administration of its steam utility business. Aquila apparently did not do so and has chosen to refrain from supplying a witness with responsibilities that included preparation of its erroneous forecasts of natural gas requirements.

Q WHAT IS THE TESTIMONY OF MR. GOTTSCH IN REGARD TO THE FORECAST?

A Mr. Gottsch, like Mr. Fangman, did not prepare the forecasts of either customer usage or of Aquila's natural gas needs. Nor does he provide an explanation of the various steps in the preparation of such forecasts. He can at least explain that he received an

updated forecast in February 2006 prior to the start of the hedge program and then another as part of the 2007 budget cycle. At the same time he offers the unsupported assertion that the problem with the hedge program was the customers, as though Aquila had no responsibility for its forecasts because some of the inputs had come from customers.

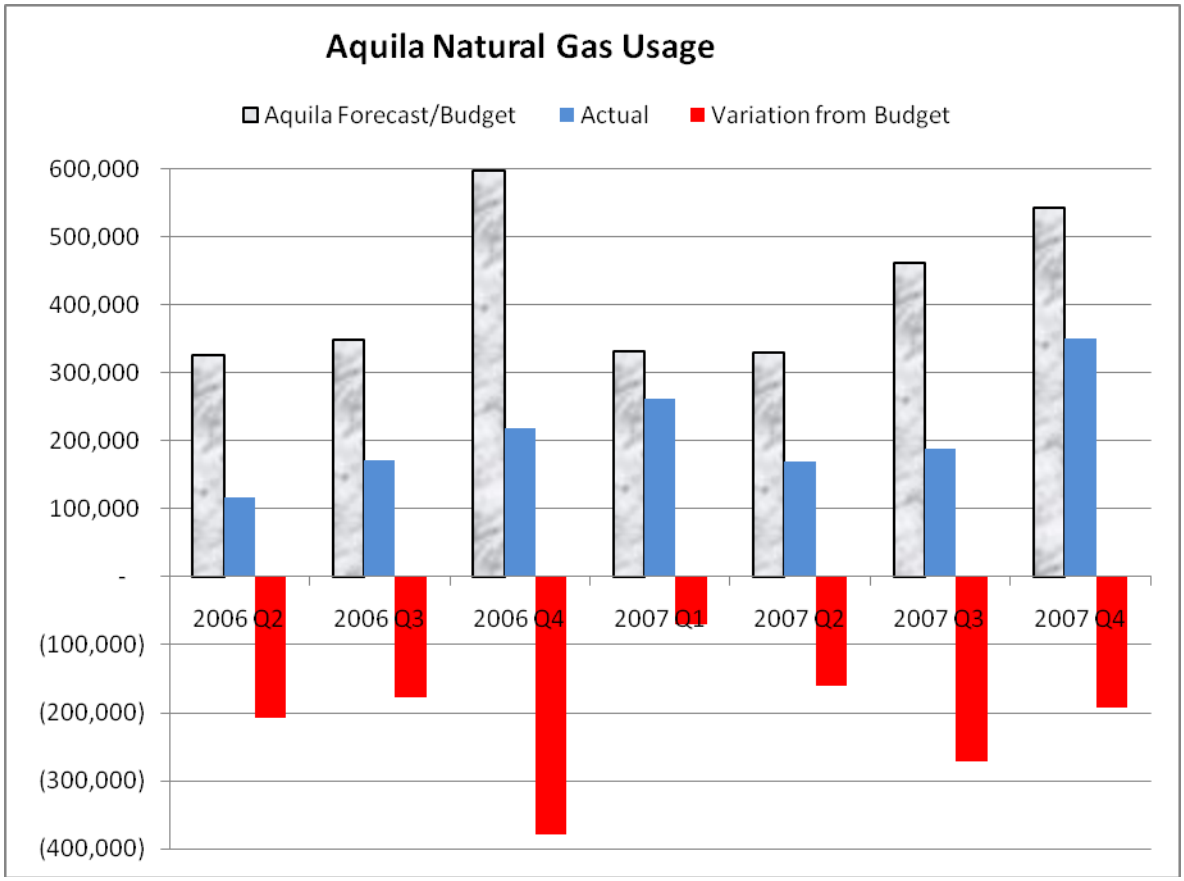
Q IN YOUR DIRECT TESTIMONY YOU MENTIONED THAT AQUILA'S FORECAST OF ITS NATURAL GAS REQUIREMENTS USED IN THE HEDGE PROGRAM WAS IMMEDIATELY IN ERROR. WHAT DID AQUILA DO IN RESPONSE?

A Mr. Gottsch, who executed purchases and sales to implement the hedge program as instructed, states that the forecast was revised and that adjustments to the hedge instruments were made based on the revised forecast. The response described, if it had been timely and accurate, certainly would have mitigated the problems created by Aquila's erroneous forecasts. Instead it is an example of too little, too late. The results of 2006 and 2007 were almost equally bad with respect to the forecasts of volumes.

Q HOW DID ACTUAL VOLUMES COMPARE TO FORECASTS?

A The following chart illustrates the variation.

Chart Reb-2.



The chart illustrates that variations larger than actual usage were not unusual.

Q WHAT DO MR. BLUNK AND MR. RUSH HAVE TO OFFER IN THEIR TESTIMONIES ON THESE TOPICS?

A Both, while even further removed from any direct knowledge, assert that it was customers that caused the erroneous Aquila natural gas volume forecast. Like Mr. Fangman and Mr. Gottsch, neither prepared the forecast and neither offers any

insights into Aquila's analytical processes that produced the forecasts nor an analysis of the inherent uncertainty in the forecast.

Q HOW DO YOU RESPOND TO MR. BLUNK'S ALLEGATION THAT YOU LOOKED AT ACTUAL VOLUMES WHEN YOU SHOULD HAVE CONSIDERED THE BUDGET VOLUMES IN ASSESSING THE HEDGING PROGRAM?

A He is simply incorrect. I would direct his attention to Chart 5 in my direct testimony. It shows the effect of the hedges for October 2006 based on both forecast and actual volumes. My workpapers contain an analogous chart for every month. Both are important. Both were considered.

Q WHAT WAS YOUR FIFTH SUMMARY POINT?

A It is the following:

> "Aquila appears to have sold puts for speculative profit and that contributed to a hedge program induced spike in the October 2006 cost of natural gas. The sale of puts was counterproductive to the volatility mitigation purpose of the hedge program. Aquila's sale of puts contributes to my opinion of imprudence"

Q WHAT WAS THE COMPANY RESPONSE?

A The response comes from Mr. Gottsch and Mr. Blunk. Both assert that Aquila did not intend to engage in speculative activity. Also, the sale of puts was a part of a collar strategy in which profits from the sale of the puts were intended to offset the cost of call options.

Q DID YOU INTEND TO SUGGEST THAT AQUILA SET OUT TO SPECULATE?

A No. I did, however, intend to suggest a result "akin" to speculation as stated in the testimony behind the summary point.

Q DOES THE COMPANY TESTIMONY ASSERTING THAT THE SALE OF PUTS WAS A PART OF A COLLAR STRATEGY DISPOSE OF THE ISSUE?

A No. First consider Mr. Blunk's characterization of options as providing insurance. As a part of the collar Aquila sold insurance with the intent to profit. The sale of the puts would produce some revenue, but, by contract terms, would raise costs whenever the market fell below the strike price.

Mr. Gottsch argues that the strike prices on the puts were well below expected market prices. In making the argument he reinforces the point that there was a chancy and speculative element. The puts offered insurance to counterparties that was underwritten by Aquila.

Mr. Blunk proceeds in his defense of the collar to discuss a "costless collar," another documented hedging strategy.

Q IN WHAT SENSE IS THE COSTLESS COLLAR, AS DESCRIBED BY MR. BLUNK, IN FACT WITHOUT COST?

A In a "costless collar" the premium cost for call options to protect the price on the high side is offset by the sale of puts that creates an exposure to an above market price result on the low side. If in the final analysis the market remains within the price range of the put strike price on the low end and the call strike price on the high end, the collar remains costless. If the market price exceeds the call strike price there is a net price benefit compared to the market. On the other hand, if the market price falls below the put strike price, there is a net cost compared to the market.

The point is that "costless" simply characterizes the effect of the premium. In the final analysis the possibilities are no cost compared to market, a benefit compared to market, or a cost compared to market.

Said in the vernacular, there is no free lunch. The sale of puts can provide profits, but the sale also creates cost exposures. The cost exposure came home to roost in the Aquila hedge program in October 2006, as explained in my direct testimony.

Q DOES ALL OF THIS AMOUNT TO SPECULATION BY AQUILA?

A I have explained the exposures that are my concern. Also, the facts are that hedge positions existed in volumes that exceeded usage. The facts are that the sales of puts, whether part of a collar or not, created an exposure to additional cost in a down market. While I do not have the opinion that Aquila initially intended to speculate in the typical sense, I continue to believe the effect was there in the program and the result.

Also consider Mr. Blunk's insurance metaphor. Suppose a homeowner wanted hazard insurance, but found the insurance pricy. Would it be logical for the homeowner to sell some related form of hazard insurance to his neighbor (whom he perceived to have a low risk of loss) in order to make a profit to offset the cost of his own hazard insurance? I believe the homeowner would not have to think much about the effect to reach his conclusion. Aquila sold "insurance" and had to pay when the market fell. The large discrepancy in its forecast of natural gas volumes amplified the effect.

Mr. Gottsch explains the Aquila judgment that the sale of insurance was a good bet because the strike prices were so low relative to market expectations. Of course the counterparty saw the other side and held the opposite opinion as to value. Call it speculation or not, the strategy created a cost exposure, and in the final analysis it

did not mitigate volatility in the Aquila hedge program. Instead it contributed to the volatility.

Q WHAT WAS YOUR SIXTH SUMMARY POINT?

A It is the following:

> "Aquila began the hedge program on February 16, 2006 by executing all of its hedge positions for the remainder of 2006 (April through December). 2007 hedge positions were executed over several months in 2006. The forecast natural gas usage requirements were immediately out of kilter with reality. These considerations contribute to my opinion of imprudence"

Q WHAT WAS THE COMPANY RESPONSE?

A The response comes from Mr. Gottsch who asserts that forecasts were revised.

Q HAVE YOU CHANGED YOUR OPINION REGARDING THIS SUMMARY POINT?

A For the remainder of the 2006 calendar year Aquila chose an "all in" approach which, by definition violated the premise of its dollar cost averaging approach. Nevertheless, Mr. Gottsch explains the reasoning for the departure so I will leave that result where it lies. On the other hand, full implementation in the context of the forecast errors meant there was an immediate need to adjust hedge positions. That did not happen. All things considered, there remains a prudence concern related to this point.

<u>OTHER ISSUES RAISED BY GMO STEAM</u>

Q WHAT ADDITIONAL ISSUES ARISE DUE TO THE TESTIMONY OF THE GMO STEAM WITNESSES?

A GMO supplies a copy of an Aquila application for a hedging program in Kansas and cites it as an exemplary *ex ante* approach. The irony of this defense is that Aquila failed to provide the Missouri Commission the same opportunity for review as was provided to

the Kansas Commission. The implication is that Missouri steam customers should have reviewed Aquila's program up front, on the record and that the Commission should have provided a prudence determination, thereby avoiding an after the fact prudence review of the design. GMO is silent as to Aquila's responsibility for the prudent administration of any hedge program. Rather, up front once and done is the standard implied. That would not be a reasonable standard in and of itself.

Another topic raised by GMO Steam is the timing of the complaint. Apparently GMO Steam now has decided it would have had the extended settlement discussions and attempted resolution of this matter cut short in favor of an earlier complaint. If true, this is either argument or admission that Aquila and GMO Steam did not deal with their customers in good faith during the protracted settlement discussion. The facts are that AGP was willing to continue to meet with Aquila over an extended period of time, including a substantial delay to accommodate the KCP&L/Aquila/GMO business combination. GMO Steam, based now on its 20/20 hindsight, would have had AGP prosecute its complaint sooner rather than later.

Q MR. RUSH QUESTIONS THE AGP MOTIVES IN THIS COMPLAINT. DO YOU HAVE ANY COMMENTS IN REPLY?

A The matter before the Commission is the instant complaint as filed. My directions are to investigate the prudence of Aquila's costs incurred and passed on to customers by operation of the QCA during the 2006 and 2007 prudence review periods, no more and no less. The QCA is explicit in making the QCA amounts collected subject to prudence review and refund. If Mr. Rush intends to be making a settlement overture, that is another matter. If so, his testimony is a dubious forum for the overture.

Q DO YOU HAVE ANY CONCLUDING COMMENTS ON THE SEVERAL CHARACTERIZATIONS OF YOUR TESTIMONY AS 20/20 HINDSIGHT?

A Yes. GMO Steam uses the phrase several times and I am not completely clear on their intent. The review of Aquila's prudence after the fact is something explicitly contemplated by the QCA tariff and I am advised by counsel that a prudence standard is indeed appropriate for determining the level of QCA costs. While I doubt it was their intent to be complimentary, it is not a trivial matter to analyze and interpret what happened. All things considered, 20/20 connotes accurate hindsight and in a proper context that is appropriate for the Commission's consideration. Among other things it has revealed imprudent judgments that led directly to unnecessary and imprudent costs.

SALIENT OMISSIONS FROM THE COMPANY TESTIMONY AND CORPORATE FAILURES

Q WERE THERE ANY SALIENT OMISSIONS FROM THE GMO TESTIMONY?

A Yes. As I reflect on the record I note the lack of a witness to support the forecast of customer usage or the natural gas portion of Aquila's fuel. Another omission is anyone responsible for the design and implementation of the hedge program. Mr. Rush and Mr. Blunk were not a part of Aquila. Neither Mr. Fangman, nor Mr. Gottsch, nor Mr. Clemens acknowledged it as their responsibility.

Q WAS THE HEDGE PROGRAM DECISION MAKER AWARE OF THE VOLATILITY MITIGATING DESIGN ATTRIBUTES OF THE QCA?

A It appears to be highly unlikely. There is nothing to indicate that Aquila understood the volatility mitigating effect of the QCA design. That was another corporate failure.

Q WAS THE HEDGE PROGRAM DECISION MAKER AWARE OF THE LEVEL OF UNCERTAINTY IN AQUILA'S FORECAST OF NATURAL GAS REQUIREMENTS?

A It appears highly unlikely. There is nothing to indicate that Aquila understood either how to effectively use the customer information they collected or the extraordinary level of uncertainly in its forecast of natural gas requirements. These were additional corporate failures.

Q DO THESE CORPORATE FAILURES CONTRIBUTE TO YOUR OPINION THAT THE HEDGE PROGRAM COSTS WERE IMPRUDENTLY INCURRED?

A Yes. My earlier opinion of imprudent hedge program costs is reinforced by the careful review of testimony submitted by GMO Steam.

Q AS A PRACTICAL MATTER, WOULD IT HAVE BEEN POSSIBLE FOR AQUILA TO HAVE BEEN AWARE OF THESE CONSIDERATIONS AND AVOID THE IMPRUDENT RESULT?

A Yes. Had they only come to their handful of customers, including AGP, these considerations would have been explained to them. They support *ex ante* review so it is not just my suggestion, but GMO Steam's as well. *Ex ante* communication with customers would have been a logical and important step.

It is fair to say that the volatility mitigating effect of the QCA is something I was well aware of and would have pointed out to them. Similarly, the volumes would have been a discussion item. Whether from my experience with forecasts of customer usage, from the knowledge of the swing fuel nature of natural gas usage, or from the practical touchstone of historical usage, there were multiple avenues that separately and collectively would have avoided the costly and imprudent result.

CONCLUSION

Q IS IT YOUR OPINION THAT THE 2006 AND 2007 COSTS OF THE HEDGE PROGRAM THAT WERE COLLECTED FROM CUSTOMERS WERE IMPRUDENTLY INCURRED AND SHOULD THEREFORE BE REFUNDED TO CUSTOMERS?

A Yes. In consideration of the Summary Points delineated in my direct testimony and reviewed again in this testimony, and in consideration of the aforementioned corporate failures, I conclude that the hedge program costs were imprudently incurred and the amounts collected from customers subject to refund should be refunded. The net cost of the hedge program was $1,164,960 in 2006 and $2,441,861 in 2007. 80% was collected from customers via the QCA so the refund amounts due are $931,968 for 2006 and $1,953,488 for 2007.

Q DOES THIS CONCLUDE YOUR TESTIMONY AT THIS TIME?

A Yes it does.

BEFORE THE

PUBLIC SERVICE COMMISSION OF MISSOURI

Ag Processing, Inc., a Cooperative, Complainant, v. KCP&L, Greater Missouri Operations Company, Respondent	)))	HC-2010-0235

Affidavit of Donald E. Johnstone

State of Missouri)
) SS
County of CAMDEN)

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

Subscribed and sworn to this 5th day of November, 2010.

CYNTHIA E. BALLIN
Notary Public - Notary Seal
State of Missouri
Commissioned for Camden County
My Commission Expires: July 18, 2012
Commission Number: 08379951

Notary Public