BEFORE THE PUBLIC SERVICE COMMISSION
STATE OF MISSOURI

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

STAFF'S INITIAL BRIEF

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

Introduction

Statement of the Case:

This case is the third prudence review of the Fuel Adjustment Clause ("FAC") of KCP&L Greater Missouri Operations Company ("GMO").[1] A prudence review, at intervals no greater than 18 months, is required by GMO's FAC tariff,[2] Commission Rule 4 CSR 240-20.090(7) and § 386.266.4(4), RSMo Supp. 2010. The Missouri Public Service Commission ("Commission") first authorized a FAC for GMO in Case No. ER-2007-0004, effective July 5, 2007.[3] Thereafter, the Commission modified GMO's FAC in Case No. ER-2009-0090, effective September 1, 2009, and again in Case No. ER-2010-0356.

Procedural History:

Staff filed its *Notice of Third Prudence Audit* on June 9, 2011, advising the Commission, GMO and all interested parties that it intended to audit the period

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

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

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

June 1, 2009, through November 30, 2010, being the fifth, sixth and seventh six-month accumulation periods since GMO's FAC first became effective.[4] Thereafter, Staff filed its *Staff Report* on November 29, 2011, setting out its conclusion that "GMO was imprudent in its use of natural gas hedges to mitigate risk associated with its future purchases in the spot power market. Staff recommends the Commission order GMO to refund" more than $18 million, "plus interest at the Company's short-term borrowing rate through the time the refund is made," to ratepayers through its FAC.[5]

GMO promptly requested a hearing on Staff's recommended disallowance[6] and the Commission established a procedural schedule that set an evidentiary hearing for May 16 and 17, 2012, and also set dates for periodic discovery conferences; the filing of prepared testimony; a list of issues and witnesses; and a joint stipulation of non-disputed facts.[7] Pursuant to a continuance sought by Staff, the hearing was eventually held on June 5 and 6, 2012.[8]

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

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

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

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

[6] On December 5, 2011.

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

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

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

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

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

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

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

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

Argument

What is this case about?

This case is about hedging. Hedging is a risk-reduction strategy. It is similar to buying insurance. The hedger, like the purchaser of insurance, accepts a small loss to avoid or mitigate the possibility of a larger one. The homeowner pays an insurance premium, accepting the loss represented by the cost of the insurance, to mitigate the possibility of a far larger loss should her house catch on fire. In this case, GMO purchased natural gas futures and options as a hedge against upwards volatility in spot-market, purchased-power prices. Staff's position is that GMO's conduct was

unreasonable and imprudent and that the costs of the hedging, which have already flowed through the FAC and onto the bills of GMO's customers, must be refunded.

GMO's Operations:

GMO is an investor-owned electric utility headquartered in Kansas City and regulated by this Commission. GMO has some 312,000 customers, including 273,500 residential customers, 38,000 commercial customers, and some 500 industrial, municipal, and other customers. To serve these customers, GMO owns 2,182 megawatts ("MW") of generating capacity, of which 1,025 MW is coal capacity, 1,094 MW is natural gas-fired combustion turbine capacity, and 63 MW is oil-fired combustion turbine capacity. In a recent year, GMO used its capacity to produce over six million megawatt hours ("MWhs") to serve its customers.[9] In addition to the energy that GMO generates itself, GMO also purchases 3.5 million to 3.9 million MWhs of power annually at a cost of $120 million to $135 million, an amount which constitutes fully 40% of GMO's energy requirements.[10] Much of this power is purchased on the spot market. Spot- market purchased power, therefore, is a big item for GMO.

GMO's FAC:

GMO's FAC provides for the recovery in rates of 95% of actual fuel and purchased power ("F&PP") costs that exceed the amount of energy costs included in base rates.[11] F&PP costs are accumulated during successive six-month-long accumulation periods and the excess is then recovered over twelve months. Because

[9] Staff Ex. 9 (HC).

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

[11] The FAC also provides for the refund of 95% of the amount by which the amount of energy cost in base rates exceeds actual F&PP costs. GMO's FAC is described in Staff Ex. 10, the *Staff Report* presenting the results of Staff's 3rd prudence audit of GMO's FAC, at pp. 2-5.

the recovered amount may not match 95% of the actual F&PP costs, there is also a true-up. Actual F&PP costs include fuel costs, purchased power costs, net emission allowance costs, and off-system sales revenue.[12]

GMO's Hedging Program:

GMO is heavily dependent on spot-market purchased power and, in view of this exposure, cross-hedges its purchased-power price risk. A cross-hedge is a risk-mitigation device in which the risk in one sort of investment is hedged by a position in another. The hedge works successfully only if a movement in the first investment is necessarily matched by a corresponding movement in the second investment.[13] In this case, GMO hedged its on-peak, spot-market purchased- power price risk by investments in natural gas futures on the NYMEX, based on the theory that upward price volatility in the purchased power spot-market would be matched by an upward price movement in the natural gas commodity market. The profit earned on the natural gas futures settlement would then mitigate the higher amount paid for purchased power on the spot-market.

Prudence:

Prudence reviews, at an interval no greater than 18 months, are required by GMO's FAC tariff, by the Commission's FAC rule, and by the statute that legalized FACs in Missouri.[14] A fuel adjustment clause is a mechanism by which changing fuel

[12] Off-system sales ("OSS") revenue is an offset to the F&PP costs that are recoverable from ratepayers through the FAC.

[13] Not necessarily a movement in the same direction. It is the predictability of the movement, not its direction, that is key.

[14] The Missouri Supreme Court held in 1979 that FACs were not lawful, ***State ex rel. Utility Consumers Council of Missouri v. Public Service Commission,*** 585 S.W.2d 41, 53 (Mo. banc 1979). GMO's FAC was the first to be approved by this Commission after the law was changed.

costs are passed on to the utility's customers quickly, outside of a general rate case. It is a way of mitigating regulatory lag, which is the period of time that passes before a change in revenue requirement is reflected in rates.

What is prudence? The dictionary tells us that it is shrewdness in the management of one's affairs and, also, caution and circumspection as to risk.[15] In this case, the Commission's duty is to scrutinize the decisions made by GMO's management in the context of what was known -- or what should have been known -- at the time the decisions were made. The Commission must determine whether GMO's management was appropriately cautious with respect to risk and shrewd in the management of its affairs. In a recent case also involving GMO, for example, this Commission determined that the company imprudently managed its affairs by over-hedging the natural gas that it used to generate steam, thereby increasing rather than reducing price volatility.[16]

Prudence cases are difficult from Staff's point of view because Staff bears the burden of making an initial showing of imprudence:

> The Federal Power Act imposes on the Company the "burden of proof to show that the increased rate or charge is just and reasonable." Edison relies on Supreme Court precedent for the proposition that a utility's cost are [sic] presumed to be prudently incurred. However, the presumption does not survive "a showing of inefficiency or improvidence." As the Commission has explained, "utilities seeking a rate increase are not required to demonstrate in their cases-in-chief that all expenditures were prudent . . . However, where some other participant in the proceeding creates a serious doubt as to the prudence of an expenditure, then the applicant has the burden of dispelling these doubts and proving the questioned expenditure to have been prudent."[17]

[15] Q.v.,Webster's Third New International Dictionary (unabridged), p. 1828 (1976).

[16] AG Processing, Inc., a Cooperative, v. KCP&L Greater Missouri Operations Company, Case No. HC-2010-0235, (Report & Order, issued on September 28, 2011).

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

Thus, in the first instance, it is the parties challenging the decisions and expenditures of a utility that have the initial burden defeating the presumption of prudence accorded the utility.[18]

> Under the prudence standard, the Commission looks at whether the utility's conduct was reasonable at the time, under all of the circumstances. In applying this standard, the Commission presumes that the utility's costs were prudently incurred.[19]

Once the presumption of prudence is dispelled, the utility has the burden of showing that the challenged items were indeed prudent.[20]

How is prudence measured? The Commission has adopted a standard of reasonable care requiring due diligence for evaluating the prudence of a utility's conduct.[21] The Commission has described this standard as follows:[22]

> 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?"

The leading Commission case in this area is ***Union Electric Company,*** which concerned the construction of the Callaway Nuclear Plant.[23] The Commission stated, "the existence of $2 billion in cost overruns raises doubts as to prudence in this case."[24] In the present case, it is Staff's position that the existence of $15 million of hedging

---

[18] State ex rel. Associated Natural Gas Company v. Public Service Commission, 954 S.W.2d 520, 528-529 (Mo. App., W.D. 1997).

[19] State ex rel. GS Technologies Operating Company, Inc. v. Public Service Commission, 116 S.W.3d 680 (Mo. App., W.D. 2003).

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

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

[22] Id.

[23] Op. cit., note 14, supra.

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

losses over an 18-month period raises doubts as to the prudence of GMO's conduct sufficient to require the Company to affirmatively show that its conduct was prudent.[25] This is particularly true when GMO's $15 million of hedging losses over an 18-month period is viewed in the context that an effective hedging program, with periodic losses and periodic gains, ought to net out approximately even over time.[26] An effective hedging program should not be "always out of the money."[27] As Staff witness Charles Hyneman testified, "a hedging program that continually results in significant hedging losses will draw more of a Staff focus than a hedging program that actually reduces costs or results in immaterial losses[.]"[28]

GMO's Imprudent Conduct:

In its testimony, Staff points to a number of areas where GMO has been imprudent. These are: (1) GMO's over-reliance on purchased power due to its lack of sufficient efficient generation capacity; (2) GMO's misleading accounting practices; (3) GMO's conduct of passing hedging costs to ratepayers through its FAC in defiance of the controlling tariff; and (4) GMO's unjustified use of cross-hedging with financial instruments based on natural gas to mitigate purchased power price risk.

GMO's Over Reliance on Purchased Power:

Staff has long taken the position that GMO is overly reliant on purchased power because it lacks sufficient efficient capacity of its own.[29] Efficient generation resources

[25] Approximately $40 million in hedging losses since the hedging program was brought above-the-line and charged to ratepayers as part of the cost of service.

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

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

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

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

are themselves a hedge against upward volatility in spot-market purchased power prices.[30] But GMO lacks sufficient efficient generation resources and is consequently extremely vulnerable to purchased power price volatility.[31] GMO's lack of efficient generation is the result of decisions made by GMO's management.[32] Because of this exposure, GMO spends large amounts of money to hedge this risk. As GMO witness W. Edward Blunk stated, "GMO has a significant exposure to movements in the market price for electricity."[33]

GMO had sufficient native capacity to serve its customers during the review period, however, some of that generation is so inefficient that it is actually cheaper for GMO to buy power on the spot market than to generate it using its own inefficient, non-base load generation assets.[34] Staff witness Lena Mantle testified, "it is less expensive for GMO to meet a large portion of its energy needs with spot market electricity instead of running its own generating units."[35] GMO witness Blunk stated, "GMO is heavily reliant on purchased power to serve its load. In 2010, GMO purchased more power than KCP&L and Union Electric combined; about twice as many MWHs as Empire District Electric Company."[36] As a matter of corporate policy, GMO did not add any capacity to its fleet between 1981 and 2005, a period of nearly twenty-five years, instead relying on "long-term, cost-plus purchased power agreements from its

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

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

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

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

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

[35] Id.

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

neighboring utilities' excess generation to provide low-cost power to its customers."[37] However, such contracts became rare when the Federal Energy Regulatory Commission ("FERC") began to restructure the national wholesale energy market in the 1990s.[38]

In 2000, GMO missed an opportunity to add the Aries combined-cycle exempt wholesale generation plant to its fleet.[39] The Aries plant is an intermediate unit and is more efficient (i.e., cheaper to operate) than combustion turbines.[40] Staff witness Mantle testified, "If GMO had acquired a combined cycle plant in 2000, its fleet would be more efficient and it now would be buying less spot market electricity. In effect, a combined cycle plant would be a "hedge" against fluctuating natural gas prices because GMO would have a highly efficient, natural gas plant to generate electricity instead of depending on the efficiency of the marginal units used to generate the electricity sold in the spot market for electricity."[41]

Because GMO is overly reliant on purchased power, GMO is particularly exposed to spot market purchased power price volatility. GMO witness Blunk noted that KCP&L, Union Electric and Empire combined supply only about 7% of their total energy requirements with purchased power, compared to 40% for GMO.[42] The result is that

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

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

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

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

[41] Id.

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

GMO is at the mercy of the market and it is that vulnerability that has led GMO to lose nearly $40 million on hedging spot-market purchased power since 2005.[43]

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

Two issues are so intertwined that Staff will discuss them together. They are the issues of (1) GMO's misleading accounting practices and (2) its violation of its FAC tariff by passing hedging costs on to ratepayers that its tariff does not permit.

First, the accounting issue. GMO has engaged in misleading and unauthorized accounting of its spot-market, purchased power hedging costs. Staff's position is that hedges intended to mitigate volatility in the cost of natural gas burned as fuel at GMO's power plants must be recorded in FERC Account 547, Fuel.[44] Hedges intended to mitigate volatility in the cost of purchased power used to serve GMO's load must be charged to Account 555, Purchased Power.[45] Fuel and purchased power are two completely separate and independent utility expenses. Costs charged to fuel accounts represent the cost of generation in the utility-owned power plants. Costs charged to purchased-power accounts represent costs incurred to acquire power from third-party sources. Mixing costs between these two accounts results in distorted financial statements that, at the very least, misrepresent the state and condition of the Company's finances and operations.

Purchased power hedge costs necessarily must be booked in Account 555, Purchased Power, in order to keep all costs and revenues related to that item together in a single account. Otherwise, purchased power costs will be misrepresented, as in

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

[44] Staff Ex. 3 (Hyneman Direct/Rebuttal), p. 24, lines 27-29.

[45] *Id*.

fact happened here. The *Nonunanimous Stipulation and Agreement* (the "*S&A*") from Aquila's 2005 rate case, Case No. ER-2005-0436,[46] governs the accounting of hedge costs and provides:

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

Contrary to the position taken in this case by GMO, the phrase "recorded in FERC Account 547 or Account 555" was not intended to grant discretion to the Company to record hedge costs in either account at its whim. Rather, it was intended to direct the Company to record each type of hedge cost in the appropriate account -- natural gas hedge costs in Account 547, Fuel, and purchased power hedge costs in Account 555, Purchased Power, as appropriate for the transaction in question. That this interpretation is correct is manifest in the fact that there is no accounting, financial or regulatory purpose that would be served by mingling these unrelated costs in a single

[46] Part of GMO Ex. 22.

account; instead, such comingling only serves to frustrate the purposes of regulatory accounting. As Staff witness Charles Hyneman testified:

> 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.[47]

Also supporting Staff's interpretation is the final sentence of Paragraph 17 of the *S&A*, "Aquila agrees to maintain separate accounting in Accounts 547 and 555 to track the hedging transaction expenditures recorded under this agreement." The undeniable inclusion of a requirement that the Company maintain *separate* accounting is fatally inconsistent with GMO's theory that it was allowed in the very same provision to commingle these two different types of transaction.[48]

There is no doubt that Paragraph 17 of the *S&A* could have been better drafted, but the time-pressed circumstances of negotiation with many parties while a major rate case is being heard is not at all conducive to the formulation of elegant and ironclad language. Nonetheless, the intent of the parties is clear from the language that they used in the context of its use. GMO's alternative interpretation cannot stand because it is nonsensical in the circumstances.

At the hearing, the Presiding Officer produced certain documents from another case at the evidentiary hearing.[49] Staff received no notice that these exhibits would be

---

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

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

[49] GMO Ex. 11, *Staff's Suggestions in Support of Nonunanimous Stipulation and Agreement,* Case No. ER-2005-0436; GMO Ex. 12, Transcript of proceedings, February 9, 2006, Case No. ER-2005-0436. 149-152

produced by the Presiding Officer and Staff's request that it be allowed to call Robert Schallenberg for clarification was not granted.[50]

Although the documents produced by the Presiding Officer are not helpful to the Commission in determining this case, Staff will address them. The first of them is *Staff's Suggestions in Support of Nonunanimous Stipulation and Agreement* filed in Case No. ER-2005-0436, which sets out in summary fashion the understanding of a Staff attorney as to the purpose of Paragraph 17 of the *S&A.* The document was drafted and filed in an effort to persuade the Commission to approve the *S&A;* its discussion of Paragraph 17 is descriptive and nothing more.[51]

The second document is the transcript of an on-the-record presentation on the *S&A* held in Case No. ER-2005-0436. At that hearing, Staff accountant Robert Schallenberg was examined under oath concerning the *S&A,* including Paragraph 17. The only point of importance is that Mr. Schallenberg was never asked, and expressed no opinion, as to whether Paragraph 17 granted discretion to the Company to deceptively record its purchased power hedge costs as fuel costs. Had Staff been permitted to call Mr. Schallenberg to clarify his opinion anent *S&A* Paragraph 17, Staff expects that his testimony would have echoed that of Mr. Hyneman, that no accountant could possibly misunderstand the language of Paragraph 17 of the *S&A* quoted above because no qualified accountant could possibly suppose that costs of different kinds ought to be commingled.[52]

---

[50] Tr. 370-371. Commission Rule 4 CSR 240-2.130(10) provides, "A party shall not be precluded from having a reasonable opportunity to address matters not previously disclosed which arise at the hearing."

[51] The specific language is, "As part of the Stipulation (paragraph 17) the Signatory Parties agree Aquila should be permitted to match its natural gas and purchased power hedging transaction settlements and associated hedging costs with the cost of fuel for accounting and ratemaking purposes[.]"

[52] Tr. 167, lines 7-25, to 168, lines 1-2.

Why is this accounting issue important? Its importance lies in the second, related issue of GMO's violation of its FAC tariff. The FAC tariff sheets applicable to the period at issue, June 1, 2009, through November 30, 2012, allow recovery through the FAC of hedging costs in Account 547, *but not in Account 555.*[53] The relevant equation is "TEC = Total Energy Cost = (FC + EC + PP - OSSR),"[54] and the tariff defines factor FC as follows:[55]

> FC = Fuel Costs Incurred to Support Sales:
>
> * * *[56]
>
> - 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.[57]

The tariff goes on to define factor PP as follows:

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

[53] 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).

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

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

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

[57] Emphasis added.

Tariffs, which are the law of the land, are construed like statutes.[58] The intent is found in the language used, understood in its plain and ordinary sense.[59] While factor FC, Fuel Costs, booked to FERC Account 547, expressly includes hedging costs, factor PP, Purchased Power, booked to FERC Accounts 555, 565 and 575, does not. Under the rules of construction, the express inclusion of hedging costs in one list and their omission from the other must be considered significant and indicative of the intent of the tariff.

In summary, the fact is that GMO has systematically booked hedging costs related to purchased power to FERC Account 547, Fuel, rather than to FERC Account 555, Purchased Power, in order to bring those costs within the scope of the FAC. Properly booked, to FERC Account 555, the hedging costs are not recoverable. GMO's conduct thus violated its FAC tariff. This Commission has previously found that the purposeful violation of its FAC tariff by a utility is imprudent.[60]

GMO's Imprudent Cross-Hedging:

Staff's final charge of imprudence against GMO is that its practice of cross-hedging spot-market, purchased-power price risk with natural gas futures is imprudent.[61] As Staff stated in its *Staff Report:*

---

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

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

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

[61] GMO hedges not only its spot-market purchased-power price risk but also the natural gas that it uses to fuel a portion of its generation fleet. Staff has not raised any question with respect to hedging costs associated with natural gas used as fuel. Staff Ex. 1 (Eaves Direct/Surrebuttal), p. 3.

> Staff concludes that purchasing natural gas futures contracts to mitigate risk associated with the purchase of spot purchase power is imprudent. The two markets (NYMEX Natural Gas and Purchase Power Markets) are not directly linked sufficiently that a prudent person would use option purchases in the natural gas futures market to prudently offset the risk of price volatility in the spot purchased power market. Under GMO's concept, GMO's actions are akin to placing a bet in the stock market in hopes of generating enough cash to pay for a future variable expense. GMO's "hedging" practice actually increases GMO's risk exposure, to the detriment of GMO's ratepayers; GMO must guess right when placing the bet, otherwise the initial risk exposure to volatile spot purchase power market remains. GMO's linking of natural gas futures contracts with purchases it makes in the spot market for purchased power is imprudent.[62]

Staff determined that GMO's hedging program was imprudent for a number of reasons. First, the effectiveness of this cross-hedging strategy is entirely dependent on the degree of correlation between natural gas prices and on-peak spot-market purchased power prices.[63] That correlation is simply not strong enough to support GMO's cross-hedging strategy. Staff witness Eaves prepared an analysis showing monthly NYMEX natural gas settlement prices at the Henry Hub compared to monthly Southwest Power Pool ("SPP") spot-market electricity prices over a multi-year period, February 2007 thru December 2011.[64] Mr. Eaves calculated the correlation co-efficient for this data set at 0.8941.[65] A correlation of 0.8941 is *not* sufficient to demonstrate an

[62] Staff Ex. 10, pp. 9-10.

[63] GMO Ex. 19, p. 3: "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. This criterion was prescribed informally (but publicly) by the staff of the Securities and Exchange Commission (SEC). *E.g.,* if there is no liquid futures contract based on jet fuel, if the correlation between jet fuel and heating oil exceeds the threshold, the evidence validates hedge effectiveness. Hedge effectiveness in the context of futures contracts is most commonly demonstrated via the correlation methodology."

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

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

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.[66]

A correlation co-efficient of 0.8941 is not "at least 0.90" as GMO Exhibit 19 plainly requires.[67] Thus, even when measured against the very authority that GMO itself relies on, its hedging strategy is found to be ineffective.

It is Staff's position that there are many factors that influence the spot-market price of electricity and that natural gas prices are only one of them.[68] These factors include weather, system congestion and unplanned outages.[69] In a prior rate case, for example, a GMO witness admitted that "purchased power prices are impacted by more than just natural gas prices."[70] In its monthly state of the market report issued in May 2009, SPP stated:

> One final noteworthy issue is fuel on the margin (Figure 10). Coal generation was setting market price 48 percent of the time in May; this is the highest since EIS Market startup. This appears to be driven by the significant base load capacity additions from Nebraska, specifically nuclear plants replacing natural gas generation resulting in more coal units on the margin.[71]

---

[66] *Supra,* note 56.

[67] Id.

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

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

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

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

The significance of this report is that if the spot-market purchased power bought by GMO is not produced by burning natural gas, then cross-hedging with natural gas futures will not be effective.

Second, there is a gross time mis-match between the hourly spot-market prices and the monthly average natural gas futures prices.[72] As Staff witness Dana Eaves explained, "The correlation of a flat set of data points (monthly gas price) against a set of data points that fluctuate (hourly on-peak prices) will show little or no correlation."[73] Mr. Eaves went on to testify, "the data shows little or no correlation when placed in context of GMO's actual practices, which involve buying power at hourly market prices cross hedged with NYMEX futures. Staff points out that when actual daily on-peak energy prices are compared to the Last Day Settlement Price ("LDSP"), the method used in valuing the monthly NYMEX natural gas futures settlement price, it reveals this relationship is not correlated. Staff's analysis . . . dramatically demonstrates this lack of correlation when analyzing GMO's actual data and practices."

Third, GMO was unable to provide to Staff any studies performed before GMO implemented its cross-hedging program that show that such a hedging program would be prudent and effective.[74] Mr. Eaves testified:

> [W]hat I was looking for was a document at the time that they started this program or when Mr. Blunk took over the program. I was hoping that there'd be some analysis, some documents, some e-mails, something that would guide me in their decision-making before they started or continued with the program.[75]

---

[72] *Id.,* p. 18.

[73] Id.

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

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

In particular, Mr. Eaves testified, such a study or studies would have included a mitigation plan describing the steps GMO should take in the event that, as actually happened, the natural gas market collapsed.[76] In fact, GMO took no steps -- other than possibly reducing its ongoing hedge volumes -- to mitigate its hedge losses when the market collapsed.[77] Mr. Eaves also testified that, in his opinion, a regulated utility such as GMO should have engaged in discussions with the Staff before initiating a hedging program of this sort.[78]

Fourth, and particularly significant, as Mr. Eaves pointed out:

> In fact, the way GMO has structured its hedging plan appears to increase the risk it incurs when the market price for natural gas is trending lower and GMO continues to hedge. In that circumstance GMO is almost assured to only realize losses in its hedging activities and the risk GMO is exposed to for on-peak electricity spot market prices remains the same. That is clearly demonstrated by GMO's actual results.[79]

GMO's hedging program actually *increased* the risk to the ratepayers because it was -- and is -- insensitive to the market. The fact is that GMO continued to hedge, despite the collapse of natural gas prices to historic lows, thereby unreasonably exposing its captive ratepayers to the certainty of increased rates due to catastrophic losses in its natural gas futures settlements.[80] What's more, this conduct is characteristic of GMO's hedging activities historically.

---

[76] Tr. 351.

[77] Id.

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

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

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

GMO -- then called Aquila -- began its hedging program in 2004.[81] At that time, the program was entirely "below the line," that is, the gains and losses, if any, were absorbed by shareholders.[82] In 2005, GMO implemented a hedging program referred to as the "one-third program." This program, too, was "below the line."[83] Staff was content that GMO's hedging program was "below the line" because Staff had some serious issues with it:

> The primary concern was related to Aquila's almost total lack of business judgment in the application of the program. For example, Aquila would systematically spend thousands of dollars buying New York Mercantile Exchange ("NYMEX") natural gas futures contracts with almost total disregard of the events that were driving wild swings in natural gas prices at that time, such as the devastating 2005 hurricanes in the U.S. Gulf region.[84]

Under the one-third program, program, one-third of GMO's expected power requirement was hedged with natural gas futures contracts to lock in a price; another third was hedged with options to cap the price; and the remaining third was not hedged at all. GMO's purchased power requirements were forecast annually and an equal portion was hedged each month. The program was purposely market insensitive -- it was implemented regardless of what the market was doing at any given time. Staff criticized the program as lacking "sound business judgment in the purchase of hedges."[85]

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

[82] Id.

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

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

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

In 2007, GMO decided to move its hedging program "above the line" so that any losses would be absorbed by ratepayers.[86] Staff opposed including any of the hedging losses in rates.[87] Eventually, a *Stipulation and Agreement as to Certain Issues* was executed in which GMO agreed to forego recovery of the $11.5 million in hedging losses in exchange for immunity from a prudence review of all the hedge positions in place as of March 27, 2007.[88] Some of those hedges were liquidated during the present review period and those amounts have been removed from consideration in this case.[89]

In 2007, GMO turned to Kase and Company to design a new hedging strategy.[90] The Kase hedging strategy was implemented in October 2007.[91] It relies upon Kase and Company's proprietary software, ezHedge and HedgeModel.[92] Again, as much as two-thirds of GMO's forecast requirements may be hedged under the two programs.[93] HedgeModel is a statistical program that places defensive hedges when prices move into the high zone; takes advantage of opportunities when prices are low; and does nothing when prices are in the neutral zone, neither high nor low.[94] ezHedge places hedges based on business cycles. ezHedge also acts to take advantage of opportunities offered by low prices.

---

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

[87] Id.

[88] Id.

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

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

[91] Id.

[92] Tr. 106.

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

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

Natural gas prices collapsed after mid-2008, from nearly $13.60 per MMBTU to $2.50 by August of 2009.[95] The hedge positions that resulted in the losses under review in this case were all taken after March 27, 2007, and were all driven by the Kase and Company hedging program.[96] That program purportedly responded to the collapse of natural gas prices by taking advantage of what appeared to be opportunities.[97] But prices did not go back up; there were no real opportunities. There were, instead, large losses when these hedges were eventually liquidated during the review period for less than GMO had paid for them. Once again, GMO's hedging program was overly-rigid and un-thoughtful. The program did not protect ratepayers from upward price volatility, but significantly increased the price paid for spot-market purchased power.[98] The program was imprudent. As Mr. Hyneman testified, "when hedging losses are passed on to the ratepayer, the ratepayer should at least be assured that the Company has tried to minimize the hedging losses to the greatest extent possible. At this point (i.e., in 2007), Aquila's ratepayers do not have this assurance."[99] Unfortunately, they continue to lack that assurance today.

Harm to Ratepayers:

In order to disallow a utility's recovery of costs from its ratepayers, a regulatory agency must find both that (1) the utility acted imprudently and (2) such imprudence

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

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

[97] Tr. 103, lines 8-18.

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

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

resulted in harm to the utility's ratepayers.[100] Harm might be found, for example, in a case involving allegedly imprudent purchasing practices, in evidence that the costs that a utility is seeking to pass on to its customers are unjustifiably higher than if different purchasing practices had been employed.[101] In the present case, the evidence is undisputed that GMO's hedging program for spot-market purchased power added nearly $15 million to the costs borne by ratepayers during the review period.[102] GMO witness Blunk testified that hedge costs added $1.80 to the price of every megawatt of power that GMO purchased in 2010.[103]

Staff contends that this additional expense is unjustified and unreasonable such that it cannot be charged to the ratepayers. It is unjustified and unreasonable because GMO should never have allowed itself to become so dependent on spot-market purchased power that it was willing to spend an exorbitant sum on hedging against the possibility of price spikes.

It is important to note that Staff is not opposed to hedging in general. A well-designed and thoughtfully-implemented hedging program is a good and prudent thing. Such a hedging program does not always result in positive gains and, indeed, cannot. However, it should not always result in exorbitant losses. In this case, GMO has lost about $14.9 million to protect $40 million. This is insurance that is too costly by far.

---

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

[101] Id.

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

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

Conclusion

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

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

Attorneys for the Staff of the Missouri Public Service Commission

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

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 **6th 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.

/s/ Kevin A. Thompson