

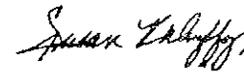
# **SCHEDULE WEB-2**

**BEFORE THE STATE CORPORATION COMMISSION  
OF THE STATE OF KANSAS**

STATE CORPORATION COMMISSION

In the Matter of the Application of Aquila, Inc., )  
d/b/a Aquila Networks-WPK, for Approval of an )  
Accounting Order to Permit Aquila, Inc., d/b/a )  
Aquila Networks-WPK, to Recover Amounts )  
Necessary to Expend in Order to Establish and )  
Maintain a Natural Gas Hedge Program for )  
Electric Generation for the 2006 Summer Season; )  
and for Approval of its "Gas Hedge Program )  
for Electric Generation". )

DEC 22 2005

 Docket Room

Docket No. 06-AQLE-494-HED

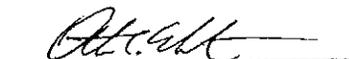
**STAFF MEMORANDUM IN SUPPORT OF STIPULATION AND AGREEMENT**

COMES NOW the Staff of the State Corporation Commission of the State of Kansas ("Staff" and "Commission", respectively) and files its Memorandum in support of the Stipulation and Agreement filed by Aquila, Inc., d/b/a Aquila Networks-WPK (Aquila), Staff and Citizens' Utility Ratepayer Board (CURB) on December 22, 2005.

1. On December 22, 2005, Aquila, Staff and CURB (Joint Movants) entered into a Stipulation and Agreement in this matter and filed their Joint Motion for an Order Approving Stipulation and Agreement.

2. In support of the Stipulation and Agreement entered into and filed by Joint Movants, Staff incorporates herein by reference the Memorandum prepared by Dr. John Cita, Chief of Economic Policy and Planning, dated December 22, 2005, which is attached hereto as Attachment 1.

Respectfully submitted,



Otto A. Newton #8760  
Assistant General Counsel  
Kansas Corporation Commission  
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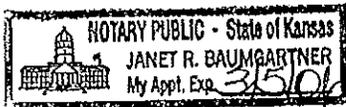
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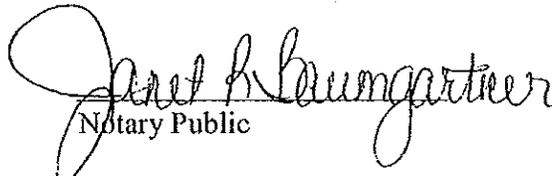
STATE OF KANSAS        )  
                                  ) ss.  
COUNTY OF SHAWNEE )

Otto A. Newton, being duly sworn upon his oath deposes and states that he is an Assistant General Counsel for the State Corporation Commission of the State of Kansas, that he has read and is familiar with the foregoing pleading and that the statements contained therein are true and correct to the best of his knowledge, information and belief.

  
\_\_\_\_\_  
Otto A. Newton

Subscribed and sworn to before me this 22<sup>nd</sup> day of December, 2005.



  
\_\_\_\_\_  
Notary Public

My appointment expires: March 5, 2006

MEMORANDUM

To: Chair Brian Moline  
Commissioner Robert Krehbiel  
Commissioner Michael Moffet

From: John Cita   
Date: December 22, 2005

RE: Staff's Discussion and Evaluation of the Summer 2006 Hedge Program  
Application of Aquila, Inc. and Support for the Joint Motion Seeking Approval of  
the Unanimous Stipulation and Agreement ("S&A"), Docket No. 06-AQLE-494-  
HED.

Background and Cumulative Performance of the Program

This Application is important because it is the first of what could be many. With this Application Aquila, Inc., d/b/a Aquila Networks-WPK ("WPK") becomes the first jurisdictional electric utility to seek approval of a Gas Hedge Program. In conjunction with approving its implementation of an ECA mechanism, the Commission has ordered Empire District Electric ("EDE") to submit a hedge program application. (Docket No. 05-EPDE-980-RTS.) In response to Westar Energy's ("WE") request to implement an ECA mechanism, Staff recommends that WE submit a Hedge Program Application. That recommendation was uncontested. (Docket No. 05-WSEE-981-RTS.) And finally, KCPL has indicated that it will soon request implementation of an ECA mechanism and, in response, Staff will recommend that KCPL submit a complementary Hedge Program Application (for the purpose of hedging on behalf of its ECA customers).<sup>1</sup>

As the Commission probably knows, if and when a utility employs an ECA mechanism, that implies its customers will be subject to monthly ECA charges/prices that change over time as the utility's fuel and purchase power expenses change. Having ECA mechanisms simply means retail customers will be faced with some degree of price volatility.

If ratepayers are risk averse, then facing price volatility can *reduce their welfare*. Moreover, risk averse ratepayers, by definition, are willing to pay extra in order to face less risk. Staff and others have gathered evidence that suggest (residential) customers of jurisdictional gas utilities *are* risk averse. Unfortunately, no such evidence has been gathered from WPK's retail customers; however, we have no reason to believe that WPK's retail customers are significantly different than the Kansas consumers that have thus far been surveyed.

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<sup>1</sup> Incidentally, WE, EDE and KCPL have for some time and currently do hedge their shareholders' exposure to natural gas price volatility. When a utility takes advantage of the Commission's ECA provisions (as stated in Order dated April 19, 1977, Docket No. 75-GIMC-009-GIG) that has the effect of shifting gas price volatility from shareholders to ratepayers.

In summary, achieving *more stable* monthly ECA prices, at a small additional cost, is the motivation for this Hedge Program Application. All parties recognize WPK's retail customers currently face some degree of price volatility given WPK's reliance on an ECA mechanism. (As the Commission may be aware, complaints about both the level and volatility of WPK's recent ECA prices are discussed and evaluated in Docket No. 05-AQLE-972-GIE.) We do assume that WPK's customers are risk averse and, therefore, we assume that WPK's customers would be willing (and able) to pay extra in order to face lower price *volatility*. As Staff has repeatedly stated, hedging serves to protect ratepayers from price *volatility*; hedging *does not* provide ratepayers with a lower price on average. And so it is in this case, hedging is not intended to provide customers with (speculation-induced) savings in the long run, rather its intent is to provide greater price *stability*.

#### Staff Evaluation of WPK's Proposed Inaugural Hedge Program

##### *On Whose Behalf Would the Hedge Program be Implemented?*

The proposed Program would be implemented on behalf of WPK's residential and commercial customers. Consequently, those two classes would be responsible for the cost of the program and would share in its benefits. The industrial class customers that are subject to the ECA would *not* participate in the program.<sup>2</sup>

##### *What is the Proposed Program Budget Amount?*

WPK proposes an annual budget of \$600,000. The method used to arrive at that amount is *consistent* with the method that has been used to set approved budget amounts for the Natural Gas LDC Hedge Programs.

##### *How Would the Approved Budget Amount be Recovered?*

It would be recovered through a distinct *volumetric charge* appearing as a line item charge on the monthly bills of residential and commercial customers. The proposed charges are: \$0.00178/kwh for residential and \$0.00140/kwh for commercial. With these charges and given the expected usage levels over the time period the charges would be collected, the economic burden on the two classes as roughly equal. Moreover, the charges are proportional to the respective usage levels over the summer months, the months whose usage would be hedged. In short, the respective charges (i.e., costs) do match the respective benefits each class is expected to receive.

##### *Which Summer Months would be Hedged?*

Only the months of June through September 2006 would be hedged. The proposed Program would terminate after September 2006.

##### *The Hedge Charges would be Assessed Over Which Months?*

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<sup>2</sup> As I understand it, WPK sought interest among its industrial class customers in having and paying for a hedge program installed on their behalf. Officials of WPK have indicated that sufficient interest was lacking.

The proposed hedge charges would apply from January through May. However, if WPK applies to renew this Program, to extend its life beyond September 2006, then it is anticipated the (new) hedge charges would apply to a longer time period, possibly October through May.

*Has WPK Specified Which Derivatives Would be Used to Establish a Price Cap?*

WPK plans to rely primarily on swaps and call options. Alternative hedging vehicles could be used. Given the size of the proposed budget, about a third of WPK's summer gas requirements would not be hedged and, therefore, would move with the market. Equivalently, about two-thirds of WPK's expected (i.e., normal)<sup>3</sup> summer gas purchases would be hedged. That proportion is *consistent* with the usual amounts hedged in Commission-approved Programs.

*Has WPK Indicated when it plans to Place its Derivatives?*

WPK submitted a detailed time schedule showing when it expects to arrange or purchase its preferred hedging instruments. The proposed schedule is *consistent* with that of a *bona fide* hedger.

*At What Level Would WPK's Gas Purchase Prices be Capped?*

As a practical matter, it is difficult to say with any degree of accuracy. The difficulty lies in not knowing where the market prices will be at the time hedges are placed. Suffice it to say, Staff has evaluated WPK's forecast price caps and found them to be reasonable given the requested hedging budget and expected hedge coverage.

*Will WPK Submit Monthly Reports to Staff and CURB Showing the Progression of Implementation and Subsequent Program Performance?*

Yes. As the Commission knows, Staff monitors both the implementation and resultant performance of approved programs. This monitoring is facilitated by the monthly reports.

~~Summary and Recommendation~~

This program is designed to reduce, but not eliminate the volatility of WPK's monthly ECA prices.<sup>4</sup> It is Staff's opinion the proposed program would work as designed.

Aquila-WPK submitted a well developed Application and the presentation of its "preferred hedge plan" is the best Staff has ever seen. Aquila should be commended.

The Hedge Program described through the proposed S&A is nearly identical to any of the Hedge Programs this Commission has approved over the years. Those programs have

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<sup>3</sup> As a provider of electricity to retail customers, WPK purchases all of the various fuels used to generate the required electricity. In a normal year WPK purchases approximately 25 MMBtu of natural gas on behalf of its average residential customer. This hedge program is designed to hedge those natural gas purchases. This program would not hedge any other fuels nor would it hedge WPK's purchased power. If and when a competitive wholesale electric market is developed, it is likely that derivatives for directly hedging the price of electricity – such as an electricity futures contract – will be widely available and economical to use. When those instruments are available it may be possible to design hedge programs that would largely eliminate ECA price volatility.

worked to reduce the volatility of monthly bills at a very low cost.<sup>5</sup> Accordingly, such programs have worked to enhance the well being of risk averse retail customers.

For reasons stated and evidence presented in this Memorandum, Staff believes the Commission could find implementation of the proposed Hedge Program to be consistent with the public interest. It follows that Staff believes Commission approval of the unanimous S&A would be reasonable.

Cc: Don Low

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<sup>5</sup> Incidentally, at this moment in time, the cumulative net cost of the Commission approved Hedge Programs is negative. That is, thus far, the Hedge Programs have delivered both less volatile bills and positive net savings on those bills.

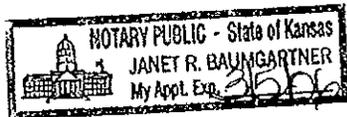
VERIFICATION  
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STATE OF KANSAS        )  
                                  ) ss.  
COUNTY OF SHAWNEE )

John Cita, being duly sworn upon his oath deposes and states that he is Chief of Economic Policy and Planning for the State Corporation Commission of the State of Kansas, that he prepared the foregoing Memorandum and is familiar with the content thereof and that the statements contained therein are true and correct to the best of his knowledge, information and belief.

  
\_\_\_\_\_  
John Cita

Subscribed and sworn to before me this 22<sup>nd</sup> day of December, 2005.



  
\_\_\_\_\_  
Notary Public

My Appointment expires:  
March 5, 2006

**CERTIFICATE OF SERVICE**  
06-AQLE-494-HED

I hereby certify that a true and correct copy of the foregoing Staff Memorandum in Support of Stipulation and Agreement was placed in the United States Mail, postage prepaid, on this 22<sup>nd</sup> day of December, 2005, properly addressed to:

James G. Flaherty  
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Ottawa, KS 66067

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