BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

In the Matter of the Sixth Prudence Review	)	
of Costs Subject to the Commission-Approved	)	**File No. EO-2017-0065**
Fuel Adjustment Clause of The Empire District	)	
Electric Company	)	

AMENDED REPORT AND ORDER

Issue Date: February 28, 2018

Effective Date: March 10, 2018

BEFORE THE PUBLIC SERVICE COMMISSION OF THE STATE OF MISSOURI

In the Matter of the Sixth Prudence Review of Costs Subject to the Commission-Approved Fuel Adjustment Clause of The Empire District Electric Company	))))	**File No. EO-2017-0065**

APPEARANCES

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For the Office of the Public Counsel and the Public.

Chief Regulatory Law Judge: **Morris L. Woodruff**

REPORT AND ORDER

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The Missouri Public Service issued its report and order resolving this case on January 3, 2018, and gave it an effective date of February 2, 2018. The Office of the Public Counsel filed a timely application for rehearing. In response to that application, the Commission will withdraw its January 3 report and order and replace it with this amended report and order. The amended report and order will be given a ten-day effective date to allow an opportunity for the filing of a new application for rehearing if any party wishes to do so.

The Missouri Public Service Commission, having considered all the competent and substantial evidence upon the whole record, makes the following findings of fact and conclusions of law. The positions and arguments of all of the parties have been considered by the Commission in making this decision. Failure to specifically address a piece of evidence, position, or argument of any party does not indicate that the Commission has failed to consider relevant evidence, but indicates rather that the omitted material was not dispositive of this decision.

Procedural History

On February 28, 2017, the Commission's Staff filed its report regarding its sixth prudence audit of The Empire District Electric Company's costs subject to the company's fuel adjustment clause (FAC). Staff's report set forth the results of its prudence audit and concluded that Staff "identified no instances of imprudence on the part of Empire during the period of review." On March 10, the Office of the Public Counsel timely requested an evidentiary hearing. The Commission adopted the procedural schedule proposed by the parties and written direct, rebuttal, and surrebuttal testimony was filed by Empire, Staff, and Public Counsel. An evidentiary hearing was held on August 24. Thereafter, the parties filed initial and reply briefs.

Public Counsel's Motion to Strike a Portion of Empire's Reply Brief

On October 27, Public Counsel filed a motion asking the Commission to strike a portion of Empire's reply brief. Public Counsel challenges a chart entitled Gas Market Review Prices, which appears on page 12 of that brief, alleging that the chart is not in evidence and has not been subject to cross-examination. Empire replied to Public Counsel's motion on November 6, explaining that the chart is based on data that is in evidence and is offered to illustrate that evidence.

The Commission agrees with Public Counsel that the brief of any party is not evidence and that the challenged chart is not evidence. As such, the Commission has not relied on the chart in reaching its decision. But the chart is intended to illustrate data that is in evidence. Public Counsel counters by asserting that the chart does not accurately illustrate the record evidence.

The chart is not direct evidence, but it is an illustration of record evidence. As such it is properly included in Empire's brief.[1] It is up to the Commission to determine whether it accurately illustrates the record evidence just as the Commission must weigh the accuracy of all the other arguments presented by the parties in their briefs. Public Counsel's motion to strike will be denied.

Findings of Fact

1. Empire is a Missouri certificated electrical corporation as defined by Section 386.020(15), RSMo 2016, and is authorized to provide electric service to portions of Missouri.

2. The Commission first authorized Empire to utilize a fuel adjustment clause -

[1] *Berlin v. Pickett*, 221 S.W.3d 406, fn. 4, (Mo. App. W.D. 2006).

an FAC – to recover certain costs from its ratepayers in a 2008 general rate case.[2] Subsequently, the Commission approved Empire's continued use of an FAC in its 2010, 2011, 2012, 2015, and 2016 general rate cases.[3]

3. In this, Empire's sixth prudence review since it was authorized to utilize an FAC, the Commission's Staff:

> reviewed, analyzed and documented items affecting Empire's fuel and purchased power costs, net emission allowance costs, and items affecting Empire's fuel and purchased power costs, net emission allowance costs, and off-system sales and renewable energy credit ("REC") revenues for its FAC's fourteenth, fifteenth, and sixteenth six-month accumulation period ….[4]

That eighteen-month period, beginning March 1, 2015 and ending August 31, 2016, is the period at issue in this prudence review case.[5]

4. Staff filed its Sixth Prudence Audit Report on February 28, 2017, and generally concluded that it found no evidence of imprudence by Empire for the items it examined during the period of review.[6] In particular, Staff "did not find Empire acted imprudently in the administration of its risk management strategies during the review period."[7]

5. Further, Staff found that during the review period Empire experienced a hedging net loss on natural gas derivatives of $10,712,168. However, Staff found "no indication of imprudence associated with Empire's purchases of natural gas including the

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[2] *In the Matter of The Empire District Electric Company's Tariffs to Increase Rates for Electric Service Provided to Customers in the Missouri Service Area of the Company,* Case No. ER-2008-0093, 17 Mo. P.S.C. 3d 631 (July 30, 2008).

[3] Staff's Sixth Prudence Audit Report, Ex. 200, Page 1.

[4] Staff's Sixth Prudence Audit Report, Ex. 200, Page 1.

[5] Staff's Sixth Prudence Audit Report, Ex. 200, Page 1.

[6] Staff's Sixth Prudence Audit Report, Ex. 200, Page 1.

[7] Staff's Sixth Prudence Audit Report, Ex. 200, Page 14.

hedging loss on natural gas derivatives for the prudence review period."[8]

6. Staff made the same finding of no indication of imprudence in each of Empire's five previous prudence audit reports.[9]

7. Public Counsel challenged Staff's finding of no-indication-of-imprudence and requested an evidentiary hearing, arguing that Empire's inflexible natural gas hedging policies resulted in significant additional costs to ratepayers.[10]

8. Empire purchases natural gas as a fuel source for the generation of electricity to sell to its customers. Generation from natural gas accounts for approximately 40 percent of Empire's total electric generation.[11]

9. In making hedging decisions, Empire utilizes a formal Risk Management Policy and has done so since 2001. The Risk Management Policy:

> defines the goals of Empire's hedging strategy as the provision of predictable fuel and purchased power costs over a multi-year period and the framework to allow for management of its risk positions. The framework includes a comprehensive set of tools to mitigate the adverse impacts associated with changing natural gas or wholesale electricity prices. In effect, the strategies set out to determine the reasonable amount of market risk to balance costs and volatility while still providing the electric customers with reasonable fuel costs.[12]

10. One of the stated objectives of the Risk Management Policy is to "[a]llow utilization of physical and financial tools to provide a predictably priced reasonable cost gas-supply."[13]

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[8] Staff's Sixth Prudence Audit Report, Ex. 200, Page 16.

[9] Doll Direct, Ex. 100, Page 2, Lines 11-19. .

[10] Motion for Evidentiary Hearing, Filed March 10, 2017.

[11] Mertens Surrebuttal, Ex. 105, Page 7, Lines 21-23.

[12] Sager Rebuttal, Ex. 106, Page 3, Lines 7-15.

[13] Energy Risk Management Policy, Ex. 18c, page 3. (Although the exhibit is marked as confidential, only appendix 12 of the RMP is confidential, see Transcript, Page 239.)

11. As to hedging, the Risk Management Policy provides that Empire will begin purchasing hedges for its gas needs four years before the gas will be burned, using this structure:

- Hedge a minimum of 10% of year four expected gas burn
- Hedge a minimum of 20% of year three expected gas burn
- Hedge a minimum of 40% of year two expected gas burn
- Hedge a minimum of 60% of year one expected gas burn

Current year hedging may reach up to 100% and any future year may reach up to 80%.[14] Empire's policy allows for hedging more than the minimum percentages, but not less.[15]

12. Empire's Risk Management Policy is overseen by a Risk Management Oversight Committee (RMOC). The RMOC is a committee formed of Empire's management team. Robert Sager, Empire's Vice President of Finance and Administration,[16] who testified for Empire, is the chair of that committee.[17]

13. The RMOC meets at least quarterly and monitors Empire's aggregate risks and ensures they are managed in accordance with the Risk Management Policy. As part of its oversight, the RMOC approves Empire's hedging strategies.[18]

14. If Empire's gas procurement managers were to conclude that market conditions were such that it would not be appropriate to hedge the minimum volumes of gas in a particular year, the managers would need to seek approval from the RMOC to change those minimum hedging requirement. The managers have never sought such a modification to the

[14] Sager Rebuttal, Ex. 106, Page 5, Lines 16-24.
[15] Transcript, Page 170, Lines 9-20.
[16] Sager Rebuttal, Ex. 106, Page 1, Lines 3-4.
[17] Sager Rebuttal, Ex. 106, Page 2, Lines 14-19.
[18] Sager Rebuttal, Ex. 106, Pages 2-3, Lines 21-24, 1-6.

policy.[19]

15. Empire has always hedged at least the minimum amounts required by its policy, although in recent years it has moved closer to the minimum hedging bands established in its policy.[20]

16. There is nothing in the Commission's rules or in Missouri's statutes that requires Empire to hedge its natural gas supply. The decision to do so is a management decision for the company.[21]

17. The hedging practices of other utilities may vary. Different situations call for different responses. For example, Empire relies heavily on natural gas to generate electricity so it is more sensitive to the price of natural gas than would be another electric utility more reliant on coal-fired generation.[22]

18. Hedging costs are defined by Empire's FAC tariff as "realized losses and costs … minus realized gains associated with mitigating volatility in the Company's cost of fuel, …."[23]

19. Empire has engaged in natural gas price hedging since 2002. The net annual gains and losses it has realized from its financial hedging activities since that time are shown in this table:[24]

Year	Gains	Losses
2002	$ 1,017,390	
2003	$10,245,457	
2004	$12,177,140	

[19] Transcript, Pages 176-177, Lines 19-25, 1-4.

[20] Transcript, Page 186, Lines 9-15.

[21] Transcript, Page 295, Lines 11-21.

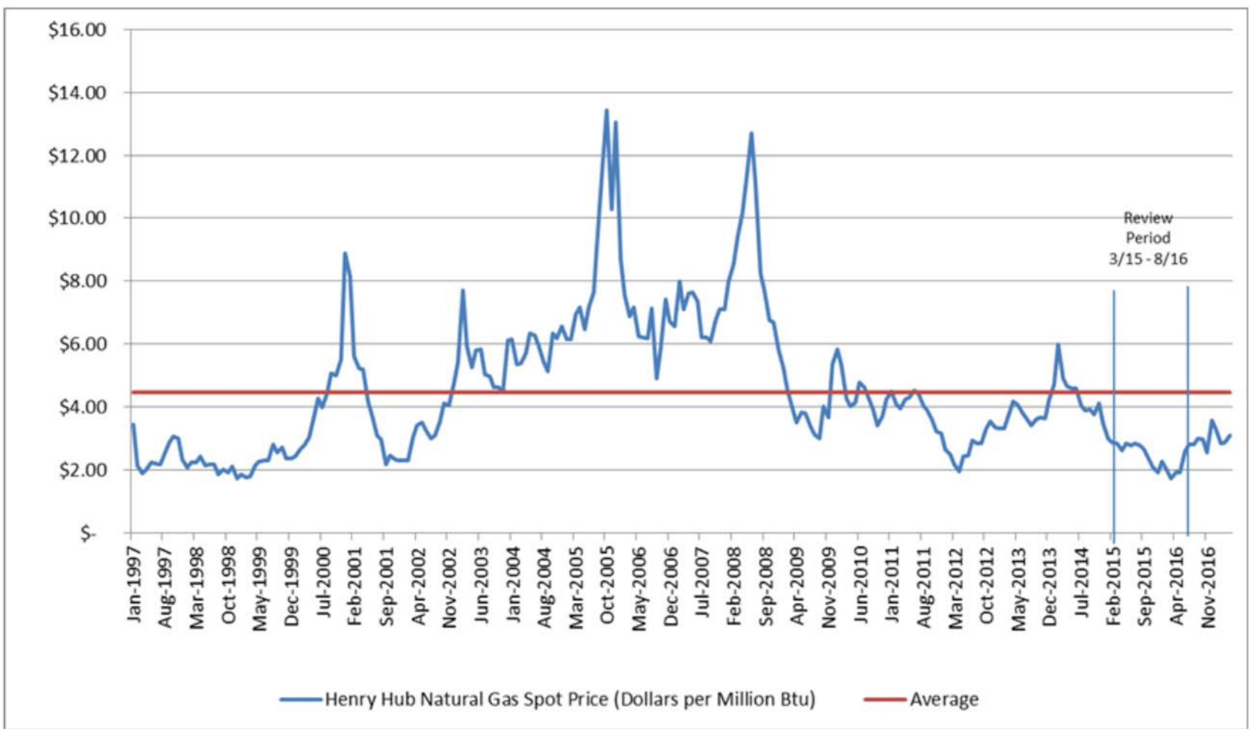
[22] Transcript, Page 296, Lines 12-19.

[23] The Empire District Electric Company Tariff, P.S.C. Mo. No. 5, Sec. 4 Sheet No. 17.

[24] The numbers are drawn from Doll Rebuttal, Ex. 101, Appendix AD-2 as corrected, and made public, at Transcript, Page 166, Lines 14-23.

2005	$ 8,369,693	
2006	$1,286,382	
2007	$ 1,921,630	
2008	$ 6,043,016	
2009		$16,103,732
2010		$ 5,984,150
2011		$ 904,230
2012		$ 5,374,710
2013		$ 3,114,847
2014		$ 1,233,467
2015		$ 7,993,467
2016		$ 3,803,464
2017	$ 763,428	
Cumulative Total		$2,259,949

20. The following chart shows monthly natural gas spot prices from January 1997 to April 2017, measured at the Henry Hub, a location in Louisiana used as a the standard delivery location for futures contracts on the NYMEX:[25]



The chart shows that the period of 2000 through 2008 was a period of high natural gas spot prices with frequent price spikes and general price volatility in the natural gas market. Since

[25] The chart is taken from Eaves Rebuttal, Ex. 202, Page 6.

2009, the natural gas market has been less volatile with a downward price trend. During the 18-month period covered by this prudence review, natural gas commodity price levels were lower than any 18-month period since 2000.[26]

21. The market change since 2009 is usually attributed to the emergence of shale gas production, improved transportation pipeline infrastructure, and reduced demand for natural gas.[27]

22. While the natural gas market has been less volatile in recent years compared to what it was between 2000 and 2008, there is no guarantee that those markets will not become increasingly volatile in the future. Indeed, current low natural gas prices may increase future demand, leading to higher prices and possible price spikes.[28] The fact that prices are currently low means the upside risk that prices will increase is greater than the possibility that prices will decrease from their current levels.[29] If utilities abstain from hedging until market volatility increases and market prices rise, the cost of hedging would also increase.[30]

23. For the period of March 2015 through August 2016, the audit period for this prudence review, Empire purchased hedges at various times between 2010 and 2015.[31]

24. In 2010 and 2011, when Empire was purchasing many of the higher priced hedges during the audit period, the NYMEX Henry Hub futures prices were showing market projections for 2015 of $5.00 to $7.00 rather than the $2.00 monthly spot gas prices

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[26] Eaves Rebuttal, Ex. 202, Page 7, Lines 4-5.

[27] Hyneman Direct, Ex. 5, Pages 13-14, Lines 18-32, 1-8.

[28] Doll Surrebuttal, Ex. 102, Page 6, Lines 6-23.

[29] Transcript, Page 213, Lines 13-25.

[30] Sager Rebuttal, Ex. 106, Page 8, Lines 9-12, citing a Public Utilities Fortnightly article attached to Mertens Rebuttal, Ex. 104, Schedule BAM-1.

[31] Doll Rebuttal, Ex. 101, Page 2, Lines 9-10.

actually experienced during that period.[32] A further explanation of the Empire's hedging decisions leading into the audit period, an explanation that the Commission finds to be reasonable, is shown in the testimony of Empire's witness, Aaron Doll.[33]

25. For example, in responding to an assertion in the direct testimony of Public Counsel's witness, John Riley, that in December 2011 Empire hedged over a million dekatherm (Dth) of natural gas at $5.44/MMBtu when the December 2011 price of natural gas was $3.17, Doll explained that as of December 31, 2011, Empire's 2015 hedged position was comprised of five transactions, none of which were procured in December 2011. Rather, those positions had been procured at various dates in 2010 and 2011. In fact, the prices paid for gas in those transactions were reasonable based on 2015 NYMEX Henry Hub futures prices existing at the time the purchases were made.[34]

26. Doll further criticizes Riley's testimony as selectively providing "forecasts which are meant to estimate natural gas prices for an entire year to critique an individual transaction in a higher priced month."[35]

27. At the time Empire purchased its hedge positions, many of those positions were negative on a mark-to-market basis. Meaning that if those positions were immediately liquidated based on the current NYMEX price; the company would realize a financial loss.[36]

28. The fact that Empire purchased hedge positions that were negative on a mark to market basis does not mean those purchases were imprudent. The purpose of a hedging program is not to "beat" the market, nor is the purpose of a hedging program to always

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[32] Mertens Rebuttal, Ex. 104, Pages 10-11, Lines 13-16 and Table BAM-2.

[33] Doll Rebuttal, Ex. 101, Pages 3-6. and Doll Surrebuttal, Ex. 102, Pages 7-9, Lines 3-24, 1—23, and 1-7, including tables AD-1 and AD-2.

[34] Doll Rebuttal, Ex. 101, Page 3 and Table AD-1.

[35] Doll Surrebuttal, Ex. 102, Page 8, Lines 16-18.

[36] Transcript, Page 182, Lines 17-25. A sampling of Empire's Gas Position Reports for the period in question may be found in Ex. 16.

attempt to obtain the lowest price for natural gas.[37] Rather, the goal of Empire's RMP is to provide predictable fuel and purchased power costs over a multi-year period by using strategies to determine the reasonable amount of market risk to balance costs and volatility while still providing its electric customers with reasonable fuel costs.[38] The hedging program still provides value to Empire and its customers by reducing risk even if the adverse outcomes hedged against do not come to pass.[39]

29. In that regard, Empire's hedging program works in the same way as property insurance. There is value in purchasing earthquake insurance even if no earthquake occurs.[40]

30. Although Public Counsel's witness expressed near certainty that there would not be a "rapid increase in fuel costs" in the future,[41] other witness were less certain of the future fluctuations in the natural gas markets. Increasing demand for natural gas to generate electricity, increased exports of liquefied natural gas and increases in extreme weather may cause prices to increase.[42] In addition, wild cards, such as hurricanes, earthquakes, pipeline breaks, and other events can affect the natural gas market price. Adverse price movements in the natural gas market, such as occurred during the polar vortex of the winter of 2014, generally are not forecasted.[43]

31. Staff's review of Empire's hedging program found that the company incurred a

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[37] Transcript, Page 188, Lines 21-24.

[38] Sager Rebuttal, Ex. 106, Page 3, Lines 7-15.

[39] Mertens Surrebuttal, Ex. 105, Page 5, Lines 12-15.

[40] Mertens Surrebuttal, Ex. 105, Page 5, Lines 4-8.

[41] Transcript, Page 116, Lines 9-21. Public Counsel's witness was Charles R. Hyneman, Chief Public Utility Accountant for the Office of the Public Counsel. Hyneman Direct, Ex. 5, Page 1, Lines 4-6.

[42] Doll Rebuttal, Ex. 101, Page 9, Lines 1-9.

[43] Doll Rebuttal, Ex. 101, Page 8, Lines 3-12. The spot price for natural gas rose to $31.27/Dth on February 6, 2014.

$10,712,168 net hedging loss on natural gas derivatives resulting from its financial hedging during the review period.[44] Public Counsel agrees with Staff's calculation of financial hedging losses,[45] but contends Empire also lost money by hedging the price of natural gas through the purchase of natural gas supplies through forward contracts.[46]

32. Public Counsel calculated the losses from physical hedging by comparing the price Empire actually paid to the spot market price for gas for the amount of gas Empire used in each month. Adding what it describes as the physical hedging losses to Staff's calculation of net hedging losses on natural gas derivatives, Public Counsel asserts a total amount of hedging losses for the 18-month prudence review period attributable to Missouri ratepayers of $13,104,811.[47]

33. Empire's hedging strategy includes physical forward purchasing of gas supplies as one of many elements of its overall hedging strategy.[48] However, for accounting purposes, physical forward contracts for the purchase of natural gas are treated as a normal purchase used in the ordinary course of business and are not included in calculations to determine hedging gains and losses.[49]

34. Empire must compete in a larger marketplace for the natural gas it uses for electric generation, as well as the pipeline space needed to transport that gas. Its first goal must be to ensure it has adequate supplies of gas to "keep the lights on."[50] Indeed, because Empire relies heavily on natural gas fueled electric generation, it is particularly

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[44] Staff's Sixth Prudence Audit Report, Ex. 200, Page 16.

[45] Riley Direct, Ex. 1, Page 18, Lines 14-19.

[46] Riley Direct, Ex. 1, Page 19, Lines 16-19.

[47] Riley Direct, Ex. 1, Pages 19-20, Lines 24-26, 1-12.

[48] Staff's Sixth Prudence Audit Report, Ex. 200, Page 15. Also, Transcript, Pages 268-269, Lines 25, 1-5.

[49] Sager Surrebuttal, Ex. 108, Page 6, Lines 1-5.

[50] Transcript, Page 308, Lines 3-23.

sensitive to the cost of its natural gas supplies.[51] For that reason, it is very unrealistic to base a calculation of hedging losses on the assumption that Empire could purchase all its gas supplies at spot market prices.

Conclusions of Law

A. Subsection 386.020(15), RSMo 2016 defines "electrical corporation" as including:

> every corporation, company, association, joint stock company or association, partnership and person, their lessees, trustees, or receivers appointed by any court whatsoever, … owning, operating, controlling or managing any electric plant except where electricity is generated or distributed by the producer solely on or through private property for railroad, light rail or street railroad purposes or for its own use or the use of its tenants and not for sale to others;

B. Section 386.266, RSMo 2016 gives the Commission authority to authorize an electrical corporation, such as Empire, to utilize a periodic rate adjustment mechanism, such as the FAC. Subsection 386.266.1 requires that such mechanisms allow the utility an opportunity to recover "prudently incurred fuel and purchased power costs, including transportation." To ensure that only "prudently incurred" costs are recovered, paragraph 386.266.4(4), RSMO 2016 requires that any authorized periodic rate adjustment mechanism provide for:

> prudence reviews of the costs subject to the adjustment mechanism no less frequently than at eighteen-month intervals, and shall require refund of any imprudently incurred costs plus interest at the utility's short-term borrowing rate.[52]

C. Commission rule 4 CSR 240-20.090(7) also requires that such prudence reviews occur no less frequently than at eighteen month intervals.

D. In determining whether a utility's conduct was prudent, the Commission will

[51] Transcript, Page 307, Lines 8-17.

[52] The statutory requirement is repeated in Empire's approved tariff, The Empire District Electric Company Tariff, P.S.C. Mo. No. 5, Sec. 4 Sheet No. 17.

judge that conduct by:

> asking whether the conduct was reasonable at the time, under all the circumstances, considering that the company had to solve its problem prospectively rather than in reliance on hindsight. In effect, our responsibility is to determine how reasonable people would have performed the tasks that confronted the company.[53]

E. The utility's management decision is judged by what the utility knew at the time it made the decision. "If the company has exercised prudence in reaching a decision, the fact that external factors outside the company's control later produce an adverse result does not make the decision extravagant or imprudent."[54]

F. By statute - subsection 393.150.2, RSMo - the requesting utility bears the burden of proving that a requested rate is just and reasonable.

G. Although Empire always bears the burden of proof, the Commission will, in the absence of adequate contrary evidence, presume that a utility's spending is prudent. This presumption of prudence affects who has the burden of proceeding, but does not change the burden of proof.[55]

H. The presumption of prudence means:

> utilities seeking a rate increase are not required to demonstrate in their case in chief that all expenditures were prudent…. However, where some other participant in the proceedings creates a serious doubt as to the prudence of the expenditure, then the applicant has the burden of dispelling those doubts and proving the questioned expenditures to have been prudent.[56]

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[53] *In the Matter of the Determination of In-Service Criteria for the Union Electric Company's Callaway Nuclear Plant and Callaway Rate Base and Related Issues* and *In the Matter of Union Electric Company of St. Louis, Missouri, for Authority to File Tariffs Increasing Rates for Electric Service Provided to Customers in the Missouri Service Area of the Company*, Report and Order, 27 Mo. P.S.C. (N.S.) 183, 194 (March 29, 1985). Quoting a decision of the New York Public Service Commission*, Re. Consolidated Edison Co. of New York, Inc. 45 P.U.R., 4th 331, 1982.* The Commission's use of this standard was cited approvingly by the Missouri Court of Appeals in *State ex rel. Associated Natural Gas Co. v. Pub. Serv. Com'n*, 954 S.W.2d 520, 529 (Mo. App. W.D. 1997).

[54] *State ex rel. Missouri Power and Light Co. v. Pub. Serv. Com'n*, 669 S.W.2d 941, 948 (Mo. App. W.D. 1984).

[55] *Office of Pub. Counsel v. Mo. Pub. Serv. Com'n*, 409 S.W.3d 371, 379 (Mo. banc 2013).

[56] *In the Matter of the Determination of In-Service Criteria for the Union Electric Company's Callaway Nuclear Plant and Callaway Rate Base and Related Issues* and *In the Matter of Union Electric Company of St. Louis,*

The Missouri Supreme Court has acknowledged the appropriateness of that presumption in matters not involving affiliate transactions.[57]

I. The Commission has, by rule, encouraged natural gas distribution utilities to engage in hedging practices to ensure price stability. Commission rule 4 CSR 240-40.018(1)(A) urges natural gas utilities to "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." Subsection (1)(B) of that rule indicates "[f]inancial gains or losses associated with price volatility mitigation efforts are flowed through the Purchased Gas Adjustment (PGA) mechanism, subject to the applicable provisions of the natural gas utility's tariff and applicable prudence review procedures." Finally, and most importantly, subsection (1)(C) of the Commission's rule recognizes that "[p]art of a natural gas utility's balanced portfolio may be higher than spot market prices at times, and this is recognized as a possible result of prudent efforts to dampen upward volatility." While Empire is an electric utility, not a natural gas distribution utility, its relatively heavy reliance on natural gas-fired electric generation increases its need to hedge to ensure price stability.

J. Empire's approved tariff provides that hedging costs, defined as "realized losses and costs … minus realized gains associated with mitigating volatility in the Company's cost of fuel …," are to be recovered under the fuel adjustment clause as a fuel cost incurred to support sales.[58]

K. Empire's approved FAC tariff allows the utility to recover 95 percent of

Missouri, for Authority to File Tariffs Increasing Rates for Electric Service Provided to Customers in the Missouri Service Area of the Company, Report and Order, 27 Mo. P.S.C. (N.S.) 183, 193 (March 29, 1985). Quoting, *Anaheim, Riverside, Etc. v. Fed. Energy Reg. Com'n*, 669 F.2d 799, 809 (D.C. Cir. 1981).

[57] *Office of Pub. Counsel v. Mo. Pub. Serv. Com'n*, 409 S.W.3d 371, 376 (Mo. banc 2013).

[58] The Empire District Electric Company Tariff, P.S.C. Mo. No. 5, Sec. 4 Sheet No. 17.

hedging costs through the FAC mechanism.[59] If those costs were not recoverable through the FAC, Empire could recover them by inclusion in its cost of service as part of a general rate proceeding.[60]

L. Section 386.266, RSMo 2016 governs the use by a utility of an interim energy charge or periodic rate adjustment mechanism, including the FAC used by Empire. Subsection 386.266.5 requires that:

> [o]nce such adjustment mechanism is approved by the commission under this section, it shall remain in effect until such time as the commission authorizes the modification, extension, or discontinuance of the mechanism in a general rate case or complaint proceeding.

This is not a general rate case or complaint proceeding, so the provisions of Empire's FAC tariff cannot be modified in this case.

Decision

Empire's $10.7 million financial hedging loss during the 18-month prudence review period draws the attention of anyone looking at the prudence of the company's hedging decisions. Public Counsel uses the fact of those losses as its basis to challenge the prudence of Empire's overall hedging program. Public Counsel contends Empire has failed to adjust its hedging program to account for important changes in the natural gas market brought about by what it terms the "shale gas revolution."

This is a prudence review. That means the Commission will review Empire's conduct to determine whether it was reasonable, at the time, without the benefit of hindsight. During the course of the hearing, Public Counsel examined several individual hedging transactions to show that Empire experienced financial losses on those transactions. Public Counsel

[59] Transcript, Page 197, Lines 12-14.

[60] Transcript, Page 302, Lines 12-15.

asserts the company should have anticipated and avoided those particular losses,[61] but Public Counsel's proposed adjustment was based on the prudence of Empire's overall hedging program, not on any particular hedging transaction. The mere fact that Empire's hedging program sustained financial losses does not mean that program was imprudent. Empire convincingly established that it operated a prudently designed and reasonable hedging program based on the information available to it at the time it made its decisions.

By pointing out the extent of the losses, Public Counsel has met the minimal requirement of demonstrating a serious doubt so as to place the burden on Empire to prove that its overall hedging policy is prudent. In the judgment of the Commission, Empire has met that burden.

Empire first implemented its risk management policy in 2001. While Empire has reviewed and modified aspects of that policy, the structure of the policy regarding the hedging of certain percentages of its anticipated natural gas needs up to four years before the gas is needed has not changed. In the first years in which that hedging policy was followed, natural gas prices trended upward, meaning purchases of hedge positions in the years before the gas was needed were profitable. In later years, natural gas prices have trended down, meaning the purchased hedge positions have lost money. However, this case is not about whether Empire has made or lost money as a result of its hedging program. Rather, the question is whether Empire acted prudently in continuing to hedge its natural gas purchases using its established risk management policy.

Empire did not undertake its hedging program in an attempt to beat the market and make a profit. Rather, consistent with the Commission's regulation of natural gas distribution companies, with which it shares some characteristics, Empire hedges to

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[61] For example, *see* Riley Direct, Ex. 1, Pages 17-18.

"structure [its] portfolios with 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."[62] The Commission's regulation recognizes that at times hedging will mean that the prices the utility will pay for gas will be higher than the spot price subject to the fluctuations of the market, but understands the value of price certainty to both the utility and its customers. It would be terribly unfair to penalize the utility for following a hedging policy just because it did not correctly anticipate the fluctuations of the natural gas markets.

It is very easy to look back at gas market spot prices with perfect 20-20 hindsight to say that Empire's decision to continue its hedging program has cost its ratepayers a definite amount of money. But the value of certainty and risk reduction gained through the use of a hedging program is less easily defined. The value of having a hedging program truly is analogous to the cost and value of buying property insurance. A homeowner may buy earthquake insurance for a lifetime at a substantial cost and never suffer damage from an earthquake. That does not mean the insurance premiums have been wasted. The risk reduction offered by insurance has a value, although that value may not be fully realized until there is an earthquake, just as the value of hedging may not be fully realized until a combination of factors results in a price spike in the natural gas market.

Public Counsel suggests Empire's hedging program is imprudent, aside from its resulting hedging losses, because it is purported to be unduly rigid. Empire does indeed continue to hedge a set percentage of the volume of its anticipated gas needs in the years leading up to the burning of that gas. Public Counsel uses this fact to conjure images of Empire heedlessly purchasing hedge positions knowing that they are certain to lose money

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[62] The quote is from Commission rule 4 CSR 240-40.018(1)(A).

for the company, knowing that those losses will simply be passed to ratepayers.[63] However, what Public Counsel decries as rigidity is really just an aspect of applying a consistent hedging strategy. No one can truly know the future and not purchasing a hedge position because of a belief that the price of natural gas will decrease in a few years is analogous to not buying earthquake insurance because of a belief that there will not be an earthquake. That decision may prove to be correct - there may not be an earthquake and there may not be a price spike - but that does not mean the decision to take the risk is the prudent decision.

Public Counsel and the other parties raise several matters that are not properly issues in this case, but that do raise the level of confusion surrounding the question of Empire's prudence. First, Public Counsel casts aspersions on Empire's FAC tariff provisions that allow for the recovery by Empire of hedging costs through operation of the FAC. Public Counsel suggests that Empire has little incentive to be prudent because it can just pass hedging losses to its ratepayers through the FAC. However, by statute, the provisions of Empire's FAC tariff can only be changed in a general rate case, not in this prudence review. Further, passing hedging losses through the FAC is not the only way Empire could recover those losses. In the same way it was allowed to recover such losses before it had an FAC, Empire could be allowed to include an amount for such losses in its cost of service established in a general rate case. Empire's hedging decisions were either prudent, or they were not; how those costs are recovered is not at issue.

Second, a good deal of time and testimony was devoted to discussion of Public Counsel's contention that Staff's review of Empire's FAC costs and revenues is not sufficient. From the other side, Empire points to Staff findings in previous prudence reviews

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[63] In adjusting its hedge purchases closer to the minimum bands established in its policy, Empire has shown appropriate consideration of current market conditions.

as support for its claim that this review should not find that it has been imprudent during this prudence review period. Neither contention is relevant to the Commission's decision in this case.

Third, Public Counsel points to decisions by other utilities and public utility commissions in other states to cease hedging activities at various times. Any such decisions certainly are not controlling on this Commission, and are not persuasive because the particular circumstances of each utility are different. What may be a prudent decision by one utility at one time may not bear any relation to the appropriate and prudent decision of another utility facing its own unique situation.

These are the issues identified by the parties and the Commission's decisions regarding those issues:

1. Was Empire's natural gas hedging policy that caused costs to be incurred for the period of March 1, 2015 through August 31, 2016 imprudent?

The Commission finds and concludes that Empire's natural gas hedging policy was prudent.

2. If the Commission finds that Empire's hedging policy was imprudent, should the Commission order a refund to Empire's customers?

Having found that Empire's policy is prudent, the Commission finds and concludes that there is no reason to order a refund.

THE COMMISSION ORDERS THAT:

1. The Report and Order issued on January 3, 2018 is withdrawn.

2. Staff's Sixth Prudence Audit Report and Recommendation regarding the costs subject to The Empire District Electric Company's fuel adjustment clause is approved.

3. Public Counsel's Objection and Motion to Strike is denied.

4. This amended report and order shall become effective on March 10, 2018.

BY THE COMMISSION

Morris L Woodruff

Morris L. Woodruff
Secretary

Hall, Chm., Kenney, and Coleman, CC., concur;
Rupp, C., dissents; and Silvey, C., abstains;
and certify compliance with the
provisions of Section 536.080, RSMo 2016

Dated at Jefferson City, Missouri,
on this 28th day of February, 2018.

STATE OF MISSOURI

OFFICE OF THE PUBLIC SERVICE COMMISSION

I have compared the preceding copy with the original on file in this office and I do hereby certify the same to be a true copy therefrom and the whole thereof.

WITNESS my hand and seal of the Public Service Commission, at Jefferson City, Missouri, this 28th day of February 2018.

Morris L. Woodruff
Secretary

MOPSC Digitally signed by MOPSC
Date: 2018.02.28
12:51:03 -06'00'

MISSOURI PUBLIC SERVICE COMMISSION

February 28, 2018

File/Case No. EO-2017-0065

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Enclosed find a certified copy of an Order or Notice issued in the above-referenced matter(s).

Sincerely,

Morris L Woodruff

Morris L. Woodruff
Secretary

Recipients listed above with a valid e-mail address will receive electronic service. Recipients without a valid e-mail address will receive paper service.