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REBUTTAL TESTIMONY

OF

CHARLES R. HYNEMAN

Submitted on Behalf of the Office of the Public Counsel

EMPIRE DISTRICT ELECTRIC COMPANY

CASE NO. EO-2017-0065

June 22, 2017


In the Matter of the Sixth Prudence
Review of Costs Subject to the
Commission-Approved Fuel Adjustment
Clause of The Empire District
Electric Company

Case No. EO-2017-0065

STATE OF MISSOURI)
COUNTY OF COLE) ss

Chas R. Hyman

A circular notary seal for the State of Missouri. The outer ring contains the text "NOTARY PUBLIC" at the top and "STATE OF MISSOURI" at the bottom, separated by small stars. The center of the seal contains the words "NOTARY" and "SEAL" stacked vertically.


Jerene A. Buckman
Notary Public

My Commission expires August 23, 2017.

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REBUTTAL TESTIMONY
OF
CHARLES R. HYNEMAN
THE EMPIRE DISTRICT ELECTRIC COMPANY
CASE NO. EO-2017-0065

INTRODUCTION

Q. Please state your name and business address.

A. Charles R. Hyneman, PO Box 2230, Jefferson City, Missouri 65102.

Q. By whom are you employed and in what capacity?

A. I am employed by the Missouri Office of the Public Counsel (“OPC”) as the Chief Public Utility Accountant.

Q. Are you the same Charles R. Hyneman who filed direct testimony in this case?

A. Yes, I am.

Q. What is the purpose of your rebuttal testimony?

A. This testimony responds to the direct testimony of Empire witness Aaron J. Doll. Mr. Doll was the only witness, other than OPC witnesses, who filed direct testimony in this case. In his direct testimony Mr. Doll makes several inaccurate and misleading statements to the Missouri Public Service Commission (“Commission”), including incorrect conclusions concerning the Commission’s Staff’s (“Staff”) findings in its February 28, 2017 *Sixth Prudence Review of Costs Related to the Fuel Adjustment Clause for the Electric Operations of The Empire District Electric Company* (“Staff’s Prudence Review of Costs Report” or “Staff’s Report”). This testimony also responds to the Staff’s Report since the Staff adopted the report as its direct testimony.

MISCHARACTERIZATION OF STAFF'S REPORT

Q. At page 5 line 12 of his direct testimony Mr. Doll states that "Empire has been found to be prudent in all five of its prior FAC audits." Is this statement false?

A. Yes, it is.

Q. Has Staff ever found Empire to be prudent?

A. No. I do not believe that Staff has ever issued an FAC Prudence Report for any utility in which the Staff found the utility to be prudent. In its prudence review reports to the Commission, Staff routinely finds that it "found no evidence" the utility was imprudent with regards to a particular review area. Finding no evidence of imprudence is a function of many factors and it in no way means or even indicates that Empire has acted prudently in its incurrence of fuel and purchased power costs.

Q. Have you reviewed Staff's Prudence Review of Costs Report filed in this case?

A. Yes, I did.

Q. Did Staff state in any section of this report that it found Empire to be prudent?

A. No, it did not.

Q. Based on your review of his credentials, does Empire witness Doll, an auditor, have any auditing experience or any auditing education?

A. No. His testimony indicates that he has no experience in auditing or any education in auditing. Mr. Doll also shows a misunderstanding regarding the difference between a prudence audit and prudence review.

1 **Q. Could Mr. Doll's statement that Staff found Empire to be prudent in this and prior**
2 **FAC reviews when it clearly did not be caused by his lack of education and experience**
3 **in the auditing profession?**

4 A. Yes.

5 **Q. Earlier you said that Staff's finding no evidence of imprudence could be based on**
6 **many factors. Please explain what you mean by this statement.**

7 A. As described in Staff's Report, Staff performed a prudence review of Empire's fuel and
8 purchased power costs. It did not perform an audit of Empire's fuel and purchased power
9 costs. As will be explained later, an audit requires a much greater effort in terms of time,
10 resources, discovery and analysis than an auditing review requires.

11 In addition to requiring more time and a commitment of greater resources, even an audit can
12 only be designed to provide "reasonable assurance" concerning the items under audit.
13 When auditing a highly complex and detailed area such as Empire's fuel and purchased
14 power costs, the absolute best conclusion auditors can reach is that they have reasonable
15 assurance concerning their findings. These types of audits can never come close producing
16 absolute assurance.

17 Given that a well-designed and well-staffed audit at best can only provide "reasonable
18 assurance," a prudence review, such as the review performed by Staff, provides substantially
19 less assurance about the items under review.

20 **Q. Are you aware of the type of review performed by Staff in its FAC prudence review of**
21 **Empire in his case?**

22 A. I am aware of the type of review performed by Staff as it relates to Empire's natural gas
23 hedging program and hedging losses in this case. I did not review Staff's procedures for
24 other areas of its prudence review of Empire.

1 **Q. Based on your understanding of Staff's review of Empire's hedging program and**
2 **hedging losses do you believe the Commission should give any consideration to the**
3 **Staff's findings in this review area?**

4 A. As will be explained below, my answer is no. Due to the nature of Staff's review in this
5 specific review area (hedging program and hedging costs), the Commission should give no
6 consideration to the Staff's findings in this area.

7 **STAFF'S REVIEW OF EMPIRE'S HEDGING PROGRAM AND COSTS**

8 **Q. How did the Staff describe the work it performed in its review of Empire's FAC?**

9 A. At page 1, Executive Summary of its "Prudence Review of Costs Report",
10 Staff stated that it conducted a "prudence review".

11 Missouri statute Section 386.266.4(4) RSMo (Supp. 2013) and
12 Commission Rule 4 CSR 240-20.090(7) **require prudence reviews**
13 of an electric utility's FAC no less frequently than at eighteen-month
14 intervals. In **this prudence review**, Staff reviewed, analyzed and
15 documented items affecting Empire's fuel and purchased power
16 costs, net emission allowance costs, and off-system sales and
17 renewable energy credit ("REC") revenues for its FAC's fourteenth,
18 fifteenth, and sixteenth six-month accumulation period which began
19 March 1, 2015, and ended August 31, 2016 ("review period").
20

21 **Q. Are the terms "audit" and "review" often used interchangeably?**

22 A. Yes, and the attribution of the same meaning to the terms "audit" and "review" creates
23 confusion where there should be none.

24 **Q. Are you critical of Staff for not performing an actual audit of Empire's hedging**
25 **program and hedging costs?**

1 A. No. Staff auditors, to my knowledge, did not state they performed an audit of Empire's
2 FAC costs. As noted above, they stated they performed only a review. My only criticism of
3 Staff auditors is that I do not believe they performed a sufficient review of Empire's hedging
4 program and hedging costs in this particular case.

5 **Q. Do you believe that Staff should be required by the Commission to perform both FAC**
6 **prudence reviews and FAC cost audits of Missouri electric utilities with FACs?**

7 A. Yes. I do not believe the current design and application of Staff's prudence reviews
8 provides adequate protection to Missouri ratepayers. I will address this topic further in my
9 rebuttal testimony.

10 **Q. Has the Commission previously required its Staff to perform both prudence and cost**
11 **audits simultaneously?**

12 A. Yes. The Commission has required construction and prudence audits of electric utility
13 construction projects. In fact, the Commission has not only required Staff to perform both
14 simultaneous prudence and cost audits, it required Staff to comply with Generally Accepted
15 Accounting Standards ("GAAS") in designing and conducting its prudence and construction
16 cost audits. See attached Schedule CRH-R-1.

17 The Commission ordered its Staff to comply with GAAS in its construction and prudence
18 audit of Kansas City Power and Light's Iatan 1 and Iatan 2 construction projects. In its
19 *Order Regarding Construction and Prudence Audits*, in File Nos. ER-2010-0355 and ER-
20 2010-0356 at page 3 paragraph 4 the Commission ordered:

21 All auditing activity shall be conducted in accordance with generally
22 accepted auditing standards issued by the American Institute of
23 Certified Public Accountants Standards. All Commission staff
24 members conducting audit activity of any type in these matters shall
25 attest by affidavit that all of their auditing activity and reports comply
26 with these standards.

1 **Q. As a member of Staff did you participate in the Iatan 1 and Iatan 2 construction and**
2 **prudence audits?**

3 A. Yes, I had significant involvement in those audits.

4 **Q. Did you design and provide training on GAAS to Staff auditors and other Staff in**
5 **response to the Commission's order requiring Staff conduct its audits in accordance**
6 **with GAAS?**

7 A. Yes. I was asked by Staff management to provide the training on GAAS to the Staff.
8 Because of the broad nature of the Commission's order, many, if not all, Staff who
9 participated in the ER-2010-0355 and ER-2010-0356 rate cases received training on GAAS.
10 I provided training on GAAS to Staff on at least two occasions during the Iatan 1 and Iatan 2
11 prudence and construction audits. Attached as Schedule CRH-R-2 to this testimony is my
12 direct testimony in File No. ER-2010-0355, which provides an overview of GAAS.

13 **Q. Do you believe the Commission should require the Staff to adopt the use of GAAS in**
14 **its FAC prudence reviews?**

15 A. Yes, I do. I have no doubt that Staff's prudence reviews of electric utility's fuel and
16 purchased power costs need to be improved. The Commission, in the past, has found it
17 necessary to require the Staff to improve their audits by the adoption of GAAS. I believe
18 the Commission should require its Staff's FAC auditors to comply with GAAS in all future
19 FAC audits. I am very confident that the adoption of GAAS by Staff's FAC auditors will
20 result in a higher quality work product and be very helpful in reaching the goal of any utility
21 audit, and that is to protect the public interest.

22 **DIFFERENCES IN COMPILATIONS, REVIEWS, AND AUDITS**

23 **Q. What are the three types of work performed by auditors?**

24 A. Auditors perform compilations, reviews, and audits.

Q. Please explain the difference between these three types of work.

A. Stephen J. Mannhaupt, CPA is a Partner with the Accounting firm Grassy & Co. He published an article on the firm's website on August 17, 2010 entitled *The Difference Between an Audit, Review and Compilation*. This article, summarized below, provides a very good description of the nature and differences between the types of services provided by auditors. This article is attached as Schedule CRH-R-3 to this testimony.

While the article's perspective is on audits and reviews of financial statements, the concepts expressed in the article apply equally to compilations, reviews and audits of a utility's cost of service in a rate case, as well as an auditor's work in single-issue rate increase cases such as an FAC and Infrastructure System Replacement Surcharge ("ISRS") cases. The article describes that there are three basic services that auditors provide: compilations, reviews and audits.

Q. Please describe a compilation service provided by an auditor.

A. The compilation is the lowest level of service an auditor can provide. A compilation involves presenting information, consistent with management's representation, in the form of financial statements or costs reports, without expressing any assurance on them.

While not strictly compilations, Staff auditors perform work very similar to compilations in utility ISRS cases. In these cases the Staff has determined that there is no need to review ISRS plant work orders and other ISRS costs in either the ISRS case itself, or later, in the utility's subsequent rate case. Utility costs included in ISRS rate increases are never subject to an audit or even a substantive review. Therefore, Staff's work in an ISRS case is much closer to a compilation service as it is mostly a verification of utility calculations of the ISRS revenue requirement.

Similar to ISRS compilations, Staff auditors also perform work that resemble the standard compilation, such as setting the purchased gas customer (PGA) rate adjustment and FAC

rate adjustments prior to the actual audit and/or review of the actual costs. This audit or review is performed by Staff auditors in the actual cost adjustment phase of the PGA case and the prudence review of the actual FAC rate charges in the FAC prudence review. In Staff's compilation services performed in PGA and FAC cases result in rates that are subject to refund based on the actual audit or review that is performed at a later date. The PGA and FAC compilations are different from an ISRS compilation as there is no follow-up audit or review with ISRS compilations.

Q. Please describe a review service provided by an auditor.

A. In his article *The Difference Between an Audit, Review and Compilation* Mr. Mannhaupt describes a 'Review' as follows:

A Review requires an accountant to perform more procedures than is required with a compilation. During a review engagement, an accountant is required by the governing standards to make inquiries of the client and perform analytical procedures related to the amounts and disclosures in the financial statement. By performing inquiry and analytics, the accountant is able to provide limited assurance that there is no material modification that should be made to the financial statement. A review typically does not require tests of accounting records or the need to obtain corroborating evidential matter. (Emphasis added).

Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data.

Mr. Mannhaupt states that the Review inquiries should include industry specific questions such as:

1. Are the financial statements prepared in conformity with generally accepted accounting principles?
2. What are the procedures to ensure that the accounting information has been recorded, classified and summarized properly?

3. Has the company performed reconciliations to determine the information is appropriate?
4. Are there any allegations or suspicions of fraud or illegal acts within the company?
5. Have there been any significant changes in the business activity?

In a Review an auditor will also typically ask questions regarding specific significant assets and liabilities to determine if the amounts are complete and accurate. An auditor will typically use analytic procedures to identifying amounts that are unusual and require additional inquiry. Based on the results of the inquiry and analytical procedures, the auditor will determine if any adjustments are necessary to the financial statements.

Q. Please describe what is meant by an “audit”?

A. In his article Mr. Mannhaupt describes key characteristics of an audit:

1. An audit provides the highest level of assurance
2. An audit requires much more work by the auditor then is required for a compilation or review.
3. The auditor is required to test of the accounting documents, physical inspection, the use of third party confirmations or other procedures deemed appropriate.
4. The auditor must also understand the company’s internal control structure and evaluate its effectiveness.
5. An audit engagement is planned and performed by an auditor with an attitude of professional skepticism

CONCERNS WITH STAFF’S FAC PRUDENCE REVIEWS

Q. Is there evidence that the current standards employed by Staff for FAC prudence reviews are not sufficient?

A. Yes. I was a Staff regulatory auditor when FAC prudence audits started in 2008 through most of 2015. The knowledge I gained as a Staff auditor led me to conclude that, for the most part, the FAC reviews conducted by FAC auditors were not performed with nearly the same rigor as Staff rate case auditors perform rate case audits. FAC audits were

1 performed at a much more superficial level. I believe this level of review of FAC costs is
2 the direct cause of Staff's FAC adjustments becoming a rare event.

3 **Q. Was it common for Staff rate case auditors to propose several fuel and purchased**
4 **power adjustments in rate cases that were based on imprudence and**
5 **unreasonableness of costs?**

6 A. Yes. Most rate case I have been associated with over my career included significant fuel
7 and purchased power prudence adjustments proposed by rate case auditors. These types
8 of adjustments have all but disappeared since fuel and purchased power costs audits were
9 removed from the rate case process and rate case audits. Removing the types of rate case
10 audits from Missouri utilities' fuel and purchased power costs has, in my opinion,
11 resulted in millions and millions of dollars in unnecessary and unreasonable costs being
12 reimbursed by Missouri ratepayers to Missouri utilities since 2008, when FAC reviews
13 essentially replaced rate case audits.

14 **Q. Did the manager of the Staff's Auditing Department, Mr. Mark Oligschlaeger,**
15 **highlight the rarity of Staff's FAC review adjustments in his March 25, 2014**
16 **Presentation "*Regulatory and Legal Framework of Audit Function*" ?**

17 A. Yes. In his presentation (see Schedule CRH-R-4) Mr. Oligschlaeger points out the fact
18 that Staff's FAC auditors only proposed two major prudence adjustments for the FAC
19 periods 2007 through 2014. Mr. Oligschlaeger's presentation, at slides 95 and 96
20 included the following information:

- 21 -FACs have only been in place for Missouri electric utilities since
- 22 2007
- 23 -Commission Staff has recommended two major prudence
- 24 adjustments since that time
- 25 -One adjustment was to properly net certain off-system sales
- 26 proceeds against increased fuel/purchased power costs for a utility

1 -The other adjustment raised concerns regarding the “hedging” or
2 risk management practices of an electric utility regarding its
3 natural gas purchases
4

5 **Q. In his presentation did Mr. Oligschlaeger address the fact that FAC reviews have a**
6 **more limited scope than Staff audits in utility rate cases and complaint cases?**

7 A. Yes. In slide 7 of his presentation he states that “[a]udits of more limited scope are
8 conducted in conjunction with single-issue rate mechanisms.”

9 **Q. Is there any rational justification why single-issue rate mechanism audits such as**
10 **FAC audits should have a more limited scope than other utility audits?**

11 A. No. Audits are designed to protect ratepayers from paying unreasonable costs.
12 Unreasonable costs are passed on to ratepayers in FAC audits just as they are in general
13 rate case audits. To the public, there is not difference and with the Staff there should be
14 no difference in the design and implementation of rate case audits and FAC audits. The
15 fact that there is a more limited scope for single-issue rate mechanisms is detrimental to
16 the public interest.

17 **Q. Is the fact that it is rare for the Staff to propose an FAC adjustment confirmed by**
18 **Mr. Doll in his direct testimony?**

19 A. Yes. At page 2 line 13 of his direct testimony Mr. Doll confirmed, at least with respect to
20 Empire, the total lack of any prudence adjustments proposed by Staff:

21 **WHAT WERE THE RESULTS OF STAFF’S AUDIT OF COSTS**
22 **SUBJECT TO EMPIRE’S FAC IN PRIOR PERIODS?**
23

24 As set forth in Staff’s Notice, there have been five previous
25 prudence reviews of Empire’s FAC. Staff identified no instances of
26 imprudence by Empire regarding the costs associated with
27 Empire’s FAC during any of these prudence reviews, and no
28 imprudence was otherwise alleged or found by the Commission.

1 There also has been no finding by the Commission of imprudence
2 on the part of Empire associated with its FAC costs outside of a
3 FAC review proceeding, such as in a general rate case or complaint
4 proceeding.
5

6 **Q. Do Staff filings in this case confirm that it reviewed Empire's fuel and purchased**
7 **power costs for the period September 1, 2008 through August 31, 2016 and never**
8 **recommended one FAC cost adjustment?**

9 A. Yes. In its filings Staff confirmed that in its 8 years of auditing Empire's fuel and
10 purchased power costs it never found any instances of imprudent management actions or
11 costs.

12 **Q. To your knowledge is the Staff the only party that has conducted FAC prudence**
13 **reviews in Missouri?**

14 A. Yes. This is the first case where OPC has performed a prudence audit of any of the
15 components of a utility's fuel and purchased power costs in a FAC prudence case. OPC's
16 prudence audit was restricted primarily to Empire's natural gas hedging policy and the
17 resultant financial detriment imposed on ratepayers in this FAC audit period. The
18 analysis performed by OPC witnesses John Robinett on generation plant heat rates and
19 Lena Mantle on purchased power and off-system sales revenue were reviews of the data
20 provided to see if there was an indication of imprudence. They did not conduct a full
21 audit in these areas.

22 **Q. Did OPC's concern with current status of FAC prudence reviews in Missouri cause**
23 **it to decide to devote audit resources to this area?**

24 A. Yes, it did. OPC began to develop its focus on FAC prudence audits, particularly with
25 natural gas hedging, in early 2016. OPC will continue to focus its audit resources in FAC
26 prudence audits until it becomes satisfied that the interests of the ratepayers are

adequately protected by Staff performing FAC prudence and cost audits guided by strong audit standards.

CONCERNS WITH STAFF'S REVIEW OF EMPIRE'S HEDGING POLICIES

Q. Did Staff conduct an audit of Empire's hedging policies and procedures in today's low cost non-volatile natural gas market?

A. No. Staff confirmed that it conducted no such audit or review. In data request No. 59 OPC asked Staff to describe its audit scope as it relates to Empire's natural gas hedging procedures, including financial hedges and physical hedges. Staff's response was that it "described the audit scope in Section 2 of the Staff Notice of Start of 6th Prudence Audit filed on September 6, 2016. The audit scope includes costs associated with Empire's fuel hedging program." Staff responses to OPC data request No. 59 are attached to this testimony as Schedule CRH-R-5.

Q. Was there anything in the Staff's stated scope to suggest it reviewed Empire's hedging policies and procedures in the current low cost and non-volatile natural gas market?

A. No. Staff's stated scope was to review only the "costs" of the hedging program and not the hedging program and its policies and procedures.

Q. Was the Staff's audit scope for an FAC prudence review sufficient?

A. No, it was not sufficient and any results reached by Staff based on this limited scope should not be considered as evidence as to the reasonableness of Empire's hedging costs let alone be considered proof of prudence as asserted by Empire witness Aaron Doll.

Q. While Staff said it included a review of Empire's hedging costs as a part of its prudence audit scope, did Staff conduct any meetings or discussions with any Empire personnel related to Empire's natural gas hedging losses incurred in this audit period?

1 A. No. In response to OPC data request 59 question 2, Staff stated that it “did not conduct any
2 meetings or discussion with any Empire personnel related to Empire’s natural gas hedging.”

3 **Q. Do you believe Staff’s decision not to have any meetings with Empire on its natural gas**
4 **hedging activities indicate that Staff intended to perform only a very high level and**
5 **very limited review of this FAC cost.**

6 A. Yes. As it relates to Staff’s review of Empire’s hedging losses in this FAC case, Staff’s
7 auditor concluded only that Staff “did not find Empire acted imprudently in the
8 administration of its risk management strategies during the review period.” This conclusion
9 apparently was based solely on Empire’s response to Staff data request No. 47, as Staff
10 admitted that it held no meetings or discussions with Empire on this issue of hedging. In
11 Staff data request No. 47 it asked for Empire’s Energy Risk Management Policy (“RMP”).

12 At page 14 of its Report, Staff made the following conclusion with respect to Empire’s
13 RMP:

- 14 3. Conclusion - Staff did not find Empire acted imprudently in the
15 administration of its risk management strategies during the review
16 period.
17 4. Documents Reviewed a) Empire’s response to Staff Data Request
18 No. 0047.
19

20 At page 16 of Staff’s Report, Staff made the following conclusion with respect to natural gas
21 hedging:

- 22 3. Conclusion - Staff found no indication of imprudence associated
23 with Empire’s purchases of natural gas including the hedging loss on
24 natural gas derivatives for the prudence review period.
25 4. Documents Reviewed a) Empire’s responses to Staff Data Request
26 Nos. 0001, 0029 and 0047; and b) Empire’s General Ledger.

1 **Q. Is there a significant flaw in the Staff's conclusion concerning Empire's hedging**
2 **policies?**

3 A. Yes. Inexplicably it appears that Staff did not evaluate the prudence of Empire's hedging
4 policies in the current natural gas market. Instead it appears Staff only evaluated Empire's
5 compliance with its own imprudent hedging policy.

6 While it is certainly acceptable to review a utility's compliance with its own policies, it is
7 not acceptable to fail to evaluate the basic policies themselves for prudence and
8 reasonableness. Ratepayers are not protected by Staff verifying compliance with an
9 imprudent hedging policy. Staff made no mention of any analysis of the appropriateness of
10 Empire's massive hedge purchases and massive hedging losses while operating a utility in a
11 natural gas market that has been low-priced and non-volatile for 9 years.

12 **Q. In comparison to Staff, what DRs did OPC ask Empire in this FAC case?**

13 A. OPC had a much wider and more comprehensive audit scope as it relates to natural gas
14 hedging in its audit of Empire's hedging policies and costs. As an example, in addition to
15 meeting with Empire personnel on its hedging policies, OPC asked the following data
16 request questions to Empire:

17 -Did Empire Electric subscribe to, consult with, or communicate
18 with any natural gas hedging consultants or entities during the period
19 January 2014 through March 2017?

20 -Please provide the names of each and every Empire employee who
21 decided to or recommended to continue with Empire's current
22 natural gas hedging policies during the period January 2014 through
23 March 2017.

24 -Please provide a copy each and every financial report, hedging
25 report, broker reconciliations, and any other report and analysis
26 produced by InstaNext for Empire in calendar year 2016 and
27 through March 31, 2017.

28 -Please provide a copy each and every financial report, hedging
29 report, broker reconciliations, and any other report and analysis

1 produced by RMI for Empire in calendar years 2015, 2016 and
2 January through March 31, 2017.

3 -Please provide a copy of each and every contract or agreement
4 between Empire and RMI Division of FC Stone, LLC that was in
5 existence from January 2010 through May 2017.

6 -Please describe the methodology used by RMI to create its natural
7 gas price projections it provides to Empire.

8 -What is the source of the RMI data Empire includes in its “market
9 detail” tab in its monthly Gas Position Reports?

10 -Are these NYMEX futures prices or are they natural gas price
11 projections similar to the natural gas price projections made by the
12 EIA in its Short- Term Energy Outlook monthly reports?

13 -Please describe how these projections are calculated and how they
14 are used by Empire.

15 -ABB provides the Company a Highly Confidential annual report
16 in Excel format, on their expectation of fuel cost, by month, for
17 2016 and several years beyond. Please provide ABB’s projections
18 from 2013 to 2016 in a similar format.

19 -Please provide a copy of Empire’s natural gas purchasing policies
20 and procedures including bid evaluation policies and procedures.

21 -Is there a bidding process for the forward contracts that are listed
22 on the FAC monthly reports? How are acceptable prices obtained?

23 -Please provide copies of the natural gas hedging reports that are
24 provided at each Board of Director meetings. For the 2014, 2015
25 and 2016 meetings as well as 2017 when they become available.

26 -From what source does the Company use to formulate the
27 projected monthly natural gas prices found on the Market Detail
28 Tab of the Natural Gas Position Report?

29 -Please list all Empire employees by name, title and salary that are
30 associated with the purchasing or hedging of natural gas for the
31 EO-2017-0065 prudence audit period.

32 -Please provide a copy of the contract between Empire and
33 InstaNext.

34 -Since the Hedging Strategy section of the current Energy Risk
35 Management Policy, effective February 1, 2017, does not appear to
36 have any material changes, how will InstaNext enhance the
37 Company’s hedging program?

38 -Does Empire Electric subscribe to any fuel forecasting services or
39 publications? If yes, please provide any and all reports from
40 January, 2015 to current.

EMPIRE'S FAILURE TO ADJUST HEDGING POLICIES TO MARKET CHANGES

Q. Mr. Doll states at page 5 of his direct testimony that “Empire’s Risk Management Policy (“RMP”) requires Empire’s Risk Management Oversight Committee (“RMOC”) to oversee execution of the Company’s risk management strategy, evaluate performance, monitor outcomes, and re-assess strategy and implement changes as appropriate.” Please comment.

A. I would say that Empire’s RMOC has been imprudent in its overseeing of Empire’s RMP for many years, at least since the major change in the natural gas market that occurred around 2009.

Mr. Doll states that Empire’s RMOC evaluates hedging performance, it monitors the outcome of its hedging policy, it re-assesses the hedging strategy and it implements hedging changes as appropriate. However, there is substantial and direct evidence that Empire’s RMOC does none of these things.

Q. Please explain how you have reached this conclusion.

A. Mr. Doll adopted the prior rate case testimony of Empire witness Blake Mertens as part of Mr. Doll’s direct testimony in this case. At page 2 lines 6-10 of his surrebuttal testimony in Case No. ER-2016-0023, Empire’s Vice President of Electric Operations, Mr. Blake Mertens, explained how Empire made no substantive changes to its hedging policy since it was created in 2001.

While slight modifications have been made throughout the years largely to update organizational or nomenclature changes, the most substantive of which was prior to the SPP IM going live to reflect changes in daily processes and reflect transmission congestion rights procurement practices, **our natural gas hedging policy and practices have remained consistent.** (emphasis added)

1 This testimony contradicts Mr. Doll's testimony that Empire's RMOC actually does
2 evaluate performance of the hedging policy, monitor outcomes of the hedging policy, re-
3 assesses hedging strategy and implement changes to the hedging strategy when appropriate.
4 It is very hard to imagine how Empire's RMOC could make no changes to Empire's
5 hedging policies despite the major restructuring and revolution in the natural gas market that
6 occurred since 2009.

7 **Q. Did Empire fail to live up to a commitment it made to the Commission in 2004 to**
8 **change its hedging policies based on changes in the natural gas market?**

9 A. Yes. In his direct testimony in Case No. ER-2004-0570, Empire's then Vice President of
10 Energy Supply, Mr. Brad Beecher, committed to the Commission that Empire revises its
11 hedging policy each year in response to changes in the natural gas market. At page 8 line 21
12 of his direct testimony Mr. Beecher, who subsequently became Empire's President and
13 Chief Executive Officer said:

14 Empire originally enacted a Risk Management Policy ("RMP") in
15 2001 that establishes the approach and internal rules that Empire will
16 use to manage specifically its power and natural gas commodity risk.
17 The policy is revised approximately annually to reflect lessons
18 learned and changes in markets and financial instruments. (emphasis
19 added).
20

21 **Q. At page 6 of his direct testimony Mr. Doll supports the proposition that a utility should**
22 **design a hedging policies specifically for the needs of that utility, as opposed to**
23 **adopting a "one size fits all" hedging strategy. Do you agree with Mr. Doll?**

24 A. Yes. A prudent natural gas hedging policy is one that was designed specifically for the
25 needs of that particular utility. Another necessary requirement for a prudent hedging policy
26 is that it must have built-in flexibility to adjustment to changes in the market conditions.

1 It is counter-intuitive in every way to believe that a natural gas hedging policy does not need
2 be flexible to changes in the natural gas market to be prudent. If an inflexible and therefore
3 imprudent hedging policy creates higher costs to ratepayers, those costs must be refunded to
4 the ratepayers and the utility must change its hedging policy. This is the essence of OPC's
5 position in this case.

6 **Q. Has Empire's hedging policy always been imprudent?**

7 A. Ignoring the lack of flexibility to changes in market conditions, Empire's implementation of
8 its hedging policy may have been prudent when it was created in 2001 under the then
9 existing natural gas market conditions. But the fact that Empire chose not to include
10 substantive hedging policy options and alternatives to respond to, not only regular changes
11 in the market, but major upheavals or revolutions in the natural gas market, Empire was
12 imprudent in the design and implementation of its hedging program.

13 **EMPIRE'S HEDGING OBJECTIVES ARE IMPRUDENT**

14 **Q. Does Mr. Doll state his understanding of the objectives of a hedging policy?**

15 A. Yes. At page 6 line 2 he states that hedging "insulates both the customers and the utility
16 from rapid price variances and allows for consistent budgeting and planning by both
17 parties."

18 **Q. Do you agree with Mr. Doll's understating of the objectives of a natural gas hedging**
19 **policy?**

20 A. I agree, in part. I agree that the purpose of a natural gas hedging policy should be to protect
21 ratepayers from rapid increases in utility rates due to rapid increases in fuel cost. That is the
22 only prudent and appropriate objective of a hedging policy for an electric utility. An electric
23 utility should purchase a natural gas hedge with the same objective it purchases fire or
24 earthquake insurance – to protect against extreme cost increases.

1 **Q. Is insurance against major price swings the reason why Empire created its hedging**
2 **program in 2001?**

3 A. No. As I noted in my direct testimony, the only reasons Empire cited as the basis for
4 creating its hedging program in 2001 was to “to lessen the impact of expense volatility and
5 establish a more predictable basis for future rate cases.”

6 **Q. Mr. Doll states that Empire uses its hedging program as a budgeting tool. Is this**
7 **appropriate?**

8 A. No. Empire’s natural gas hedging program is a program that consistently results in millions
9 and millions of dollars in ratepayer rate increases through ratepayers being forced to
10 reimburse Empire for its hedging losses.

11 It is imprudent for Empire management to use this program to budget fuel expenses. If
12 Empire wants to use its natural gas hedging program to create fuel budgets, that is fine.
13 However, all costs of this hedging-based fuel budgeting program should be allocated to
14 Empire’s shareholders.

15 Empire’s use of its natural gas hedging program as a budgeting tool may be beneficial to
16 shareholders as it may act to manage and smooth out annual earnings. However, it provides
17 no ratepayer benefit but significant ratepayer detriment considering this higher than market
18 price of natural gas Empire forces on its ratepayers. Despite the fact that ratepayers should
19 not be involved in fuel budgeting processes to manage utility earnings, Empire has placed
20 all the costs of these functions on its ratepayers where they do not belong.

21 Prior to the FAC, all hedging costs between rate cases were a part of Empire doing business
22 and the costs were subject to the competitive pressures of regulatory lag. This regulatory lag
23 provided some incentive for Empire’s management to act prudently in the management of
24 its hedging policy. The Commission first approved an FAC for Empire on September 1,
25 2008. This FAC and all FACs subsequently approved by the Commission allowed hedging

1 costs to be included in the FAC without the competitive pressures of regulatory lag and with
2 the 100 percent guarantee of rate recovery.

3 With the advent of the FAC, there apparently is no limit on the size of the hedging losses
4 Empire finds acceptable because its shareholders have zero exposure to the hedging losses.
5 The FAC transferred all risk of hedging losses from Empire's owners to Empire's
6 customers. Empire, as representatives of its shareholders, has no incentive to minimize
7 hedging losses. The hedging losses are just passed on to the ratepayer while providing no
8 ratepayer benefit at all. This is another example of imprudent management behavior on the
9 part of Empire management in the administration of its Commission authorized FAC.

10 Empire management has taken a hedging policy that should be designed to prevent major
11 and sudden increases in natural gas fuel costs and designed it to "mitigate" the minimal
12 volatility in the natural gas market and "manage" its fuel budgets. Empire's ratepayers
13 should not be paying above-market natural gas prices for these unnecessary hedging policy
14 objectives.

15 **Q. Please comment on Mr. Doll's statement that Empire's natural gas hedging program**
16 **allows for consistent budgeting and planning by Empire's ratepayers.**

17 A. That statement is truly confusing. I have audited and studied electric utility hedging
18 programs for many years and I have never heard any utility ever state that it developed a
19 hedging program so its ratepayers can budget and plan. I have no idea on what factual basis
20 this testimony is based.

21 **Q. Is the only prudent objective of an electric utility's hedging program, which is to**
22 **provide insurance against sudden major price increases, consistent with Empire's**
23 **hedging program objectives?**

24 A. No. It is clear the objective of Empire's hedging program is to mitigate natural gas price
25 volatility. Natural gas price volatility has not been significant over the past nine years. The

evidence of the lack of volatility in the natural gas fuel market is reflected in the following historical chart of natural gas fuel prices:

Henry Hub Natural Gas Spot Price (Dollars per Million Btu)													
Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Avg
1997	\$3.45	\$2.15	\$1.89	\$2.03	\$2.25	\$2.20	\$2.19	\$2.49	\$2.88	\$3.07	\$3.01	\$2.35	\$2.50
1998	\$2.09	\$2.23	\$2.24	\$2.43	\$2.14	\$2.17	\$2.17	\$1.85	\$2.02	\$1.91	\$2.12	\$1.72	\$2.09
1999	\$1.85	\$1.77	\$1.79	\$2.15	\$2.26	\$2.30	\$2.31	\$2.80	\$2.55	\$2.73	\$2.37	\$2.36	\$2.27
2000	\$2.42	\$2.66	\$2.79	\$3.04	\$3.59	\$4.29	\$3.99	\$4.43	\$5.06	\$5.02	\$5.52	\$8.90	\$4.31
2001	\$8.17	\$5.61	\$5.23	\$5.19	\$4.19	\$3.72	\$3.11	\$2.97	\$2.19	\$2.46	\$2.34	\$2.30	\$3.96
2002	\$2.32	\$2.32	\$3.03	\$3.43	\$3.50	\$3.26	\$2.99	\$3.09	\$3.55	\$4.13	\$4.04	\$4.74	\$3.37
2003	\$5.43	\$7.71	\$5.93	\$5.26	\$5.81	\$5.82	\$5.03	\$4.99	\$4.62	\$4.63	\$4.47	\$6.13	\$5.49
2004	\$6.14	\$5.37	\$5.39	\$5.71	\$6.33	\$6.27	\$5.93	\$5.41	\$5.15	\$6.35	\$6.17	\$6.58	\$5.90
2005	\$6.15	\$6.14	\$6.96	\$7.16	\$6.47	\$7.18	\$7.63	\$9.53	\$11.75	\$13.42	\$10.30	\$13.05	\$8.81
2006	\$8.69	\$7.54	\$6.89	\$7.16	\$6.25	\$6.21	\$6.17	\$7.14	\$4.90	\$5.85	\$7.41	\$6.73	\$6.75
2007	\$6.55	\$8.00	\$7.11	\$7.60	\$7.64	\$7.35	\$6.22	\$6.22	\$6.08	\$6.74	\$7.10	\$7.11	\$6.98
2008	\$7.99	\$8.54	\$9.41	\$10.18	\$11.27	\$12.69	\$11.09	\$8.26	\$7.67	\$6.74	\$6.68	\$5.82	\$8.86
2009	\$5.24	\$4.52	\$3.96	\$3.50	\$3.83	\$3.80	\$3.38	\$3.14	\$2.99	\$4.01	\$3.66	\$5.35	\$3.95
2010	\$5.83	\$5.32	\$4.29	\$4.03	\$4.14	\$4.80	\$4.63	\$4.32	\$3.89	\$3.43	\$3.71	\$4.25	\$4.39
2011	\$4.49	\$4.09	\$3.97	\$4.24	\$4.31	\$4.54	\$4.42	\$4.06	\$3.90	\$3.57	\$3.24	\$3.17	\$4.00
2012	\$2.67	\$2.51	\$2.17	\$1.95	\$2.43	\$2.46	\$2.95	\$2.84	\$2.85	\$3.32	\$3.54	\$3.34	\$2.75
2013	\$3.33	\$3.33	\$3.81	\$4.17	\$4.04	\$3.83	\$3.62	\$3.43	\$3.62	\$3.68	\$3.64	\$4.24	\$3.73
2014	\$4.71	\$6.00	\$4.90	\$4.66	\$4.58	\$4.59	\$4.05	\$3.91	\$3.92	\$3.78	\$4.12	\$3.48	\$4.39
2015	\$2.99	\$2.87	\$2.83	\$2.61	\$2.85	\$2.78	\$2.84	\$2.77	\$2.66	\$2.34	\$2.09	\$1.93	\$2.63
2016	\$2.28	\$1.99	\$1.73	\$1.92	\$1.92	\$2.59	\$2.82	\$2.82	\$2.99	\$2.98	\$2.55	\$3.59	\$2.52
2017	\$3.30	\$2.85	\$2.88	\$3.10									\$3.03

Source: <https://www.eia.gov/dnav/ng/hist/rngw hhdh.htm>

NECESSITY FOR REVIEW OF DECISIONS MADE BEFORE THE PERIOD

Q. The Staff's Report states throughout that the Staff relied upon Empire's answers to the Staff's data requests to develop the Staff's findings. Do you have any concerns with the data reviewed by the Staff?

A. Yes. All of the data requests Staff sent Empire in this case start with the phrase "[f]or the period March 1, 2015 through August 31, 2016", which is the period under review.

1 Limiting the Staff's review to documents from the review period neglects data and decisions
2 from before the review period that resulted in fuel costs incurred during the review period.

3 **Q. OPC's data requests to Empire sought information from before the period under**
4 **review to help OPC understand what Empire knew or should have known at the time**
5 **fuel cost decisions were being made for the review period. Was Empire responsive to**
6 **OPC's request for information related to its natural gas hedging policies and**
7 **procedures from prior to the review period?**

8 A. No. Empire objected to a significant number of OPC data requests in this case. What is of
9 particular concern is that Empire objected to providing basic audit data including any data,
10 reports, analysis, projections, that occurred before the FAC audit period in this case. This
11 refusal to provide relevant information to the OPC reflects a significant and fundamental
12 lack of understanding on the part of Empire about the appropriate nature and design of a
13 FAC prudence audit.

14 By objecting to OPC's discovery efforts in this case Empire demonstrated that it does not
15 believe the prudence of its management's actions during the period when it purchased its
16 natural gas hedges (2012 to 2016) should be reviewed. Through its objections and its April
17 21, 2017 response to OPC's motion to compel, Empire attempted to significantly limit the
18 scope of OPC's audit of Empire's hedging activities.

19 For example, OPC sought information from the time period when the natural gas hedge
20 purchases were made. This is information that Empire management knew at the time it
21 engaged in the hedge transactions that caused the hedging losses in this audit period.
22 Without this data, OPC could not perform a basic prudence audit review of the information
23 that was known by management at the time it engaged in the actions that resulted in the
24 costs under review in this review period. Empire's actions indicate that it believes OPC
25 should be forced to rely solely on the information that was produced by Empire during the
26 FAC audit period and data that is related only to the audit period. This is in direct contrast

1 to the Commission's policy that imprudence should be based on the information known by
2 management at the time decisions were made, not when costs were actually incurred.

3 **EMPIRE'S PARENT COMPANY STOPS HEDGING DUE TO CHANGES IN NATURAL**
4 **GAS MARKET**

5 **Q. At page 5 line 17 of his direct testimony Mr. Doll states Empire's hedging strategy**
6 **continue to provide Empire's customers a balanced approach to managing the various**
7 **risks of price volatility, price mitigation, and credit exposure, and also provide**
8 **protection against upward price trends." Is he correct?**

9 A. No. In its direct testimony OPC filed substantial evidence demonstrating that this statement
10 is not correct and that Empire's imprudent hedging policy resulted in millions of dollars in
11 unnecessary costs passed on to its ratepayers.

12 Empire's hedging policies attempt to hedge against something that does not exist – a highly
13 volatile natural gas market. This is not an opinion, but a fact that is generally accepted and
14 has been generally accepted for a long time.

15 **Q. Was this fact recognized recently by Liberty Utilities Co, Empire's parent company?**

16 A. Yes. Empire is a subsidiary of Liberty Utilities Co. ("Liberty Utilities") which is owned by
17 Algonquin Power & Utilities Corp. Liberty Utilities has utility operations in several states,
18 including New Hampshire.

19 In May 2014, Liberty Utilities sought to change its Commission-approved hedging policy in
20 New Hampshire. The case was docketed as State of New Hampshire Public Utilities
21 Commission (NHPUC) Docket No. DG-13-133, Liberty Utilities (EnergyNorth Natural Gas
22 Corp) D/B/A Liberty Utilities, Petition to Change Hedging and Fixed Price Option
23 Programs.

1 In his direct testimony before NHPUC (attached as Schedule CRH-R-6), Liberty Utilities
2 witness Francisco C. DaFonte supported the utility's proposal to stop hedging natural gas
3 prices due to the lack of price volatility in the natural gas market. Mr. DaFonte was Liberty
4 Utilities Senior Director, Energy Procurement.

5 **Q. Please summarize Mr. DaFonte's direct testimony in Docket No. DG-13-133.**

6 A. In his May 2014 direct testimony Mr. DaFonte made the following points to the New
7 Hampshire Public Utilities Commission:

8 -Overall, it is my opinion that the hedging program as currently
9 constituted does not provide customers with meaningful benefits.

10 -Currently, customers are paying for the option premiums
11 (insurance against escalating prices) used to hedge future firm
12 purchases at the NYMEX/Henry Hub index price and since there
13 has been very little volatility, the options typically expire "out of
14 the money" and customers do not see any offsetting benefit to the
15 premiums they are paying.

16 -In addition, any hedges entered into using OTC swaps, which do
17 not have a specifically identified premium, have been settling
18 above the market causing a net payout at settlement to the swap
19 counterparty.

20 -In effect, customers are paying for a hedging program that was
21 developed to manage natural gas price volatility at a time when
22 natural gas supplies were tight and gas prices fluctuated
23 considerably.

24 -More recently, the market dynamics have changed with the
25 increase of Shale gas production and the volatility in the NYMEX/
26 Henry Hub futures has been muted and shows continued signs of
27 stability through 2020.

28 -The Company proposes to eliminate the current hedging program
29 which focuses exclusively on the hedging of the NYMEX/Henry
30 Hub futures contracts.

31 -In its place, the Company would propose to begin hedging the
32 New England basis via the very straightforward purchase of
33 physical fixed basis supply contracts commencing with the winter
34 of 2014-2015.

Q. Did the NHPUC Staff make a recommendation to the NHPUC in this docket?

A. Yes. The following is a summary of the New Hampshire Staff's recommendation to the New Hampshire Commission

-Liberty stated in its filing that the current policy was developed at a time when there was significant volatility in the New York Mercantile Exchange (NYMEX) price of gas, and thus was intended to minimize price volatility with regard to supply area purchases.

-Since 2008, with the emergence of shale gas, the Henry Hub price and correlating NYMEX price have been relatively stable and the price volatility has been occurring in purchases made in the market area.

-After reviewing the testimony and Liberty responses to Staff data requests, Staff believes that the proposed changes of the hedging program are consistent with the changing market conditions, particularly changes related to pricing risk and volatility.

-Staff also believes that the proposed changes to the FPO program are reasonable. Based on its review of the filing, Staff recommends that the Commission approves Liberty's request to change the hedging program.

Q. Did the NHPUC accept Liberty's and the Staff's recommendations?

A. Yes. In its Order Granting Petition, Order No. 25,691 issued on July 10, 2014, attached as Schedule CRH-R-7, the NHPUC ruled as follows:

COMMISSION ANALYSIS

The Commission finds Liberty's proposed change to its hedging program to be reasonable. The Commission accepts Liberty's testimony that the NYMEX natural gas prices are relatively stable and that the recent volatility rests in the basis differential. Liberty's proposal to obtain fixed-price contracts for the basis differential for certain base load supplies is a simple and reasonable way to manage that risk

1 **Q. Does this conclude your rebuttal testimony?**

2 **A. Yes, it does.**

**STATE OF MISSOURI
PUBLIC SERVICE COMMISSION**

At a session of the Public Service Commission held at its office in Jefferson City on the 7th day of July, 2010.

In the Matter of the Application of Kansas City
Power & Light Company for Approval to Make
Certain Changes in its Charges for Electric
Service to Continue the Implementation of Its
Regulatory Plan)
)
) **File No. ER-2010-0355**
) **Tariff No. JE-2010-0692**
)

In the Matter of the Application of KCP&L)
Greater Missouri Operations Company) **File No. ER-2010-0356**
for Approval to Make Certain Changes in its) **Tariff No. JE-2010-0693**
Charges for Electric Service)

ORDER REGARDING CONSTRUCTION AND PRUDENCE AUDITS

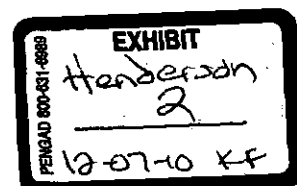
Issue Date: July 7, 2010

Effective Date: July 7, 2010

On June 4, 2010, Kansas City Power & Light Company ("KCPL") and KCP&L Greater Missouri Operations Company ("GMO") submitted to the Commission proposed tariff sheets intended to implement general rate increases for electrical service provided in their Missouri service areas. The proposed tariff sheets bear effective dates of May 4, 2011. On June 11, 2010, the Commission issued notice of both actions, set intervention deadlines and set tentative dates for evidentiary hearings.

Because the newly-filed rate cases involve the Iatan plant additions to KCPL and GMO,¹ and because the Commission will require completed construction and prudence audits of the Iatan I and II facilities and common plant, the Commission will direct its

¹ The in-service date for the Iatan 1 environmental upgrades was June 19, 2009. The projected in-service date for the Iatan 2 generating facility is December 31, 2010.



Staff to complete all auditing of the environmental upgrades to latan I and common plant and commence, if not already started, all audits associated with latan II immediately, subject to the specific direction of the Commission.

The Commission's Staff shall submit to the Commission the complete list of specific personnel it proposes to be involved with any portion of auditing or audit activity of any type, in relation to the proposed rate increases, the environmental upgrades to latan I, the latan II generating facility and any common plant. This list will include the names, and specific planned assignments for each individual involved with the auditing activity. The list provided will delineate and distinguish between all individuals assigned to auditing activity, of any type, for the primary rate case actions and all individuals assigned to auditing activity, of any type, associated with the latan I and II construction projects and common plant.

The Commission's Staff shall identify each project coordinator for any phase of any type of auditing activity and which individual staff members are under their direction. Staff will file complete audit scopes and a proposed schedule for completion of the audits in relation to the latan II generating facility and any common plant that conforms to the final deadlines set in this order. The Commission will set final deadlines for the audit activity in association with the requested rate increases, the environmental upgrades to latan I, the latan II generating facility and any common plant. The Commission shall also assign primary audit oversight and completion to its Executive Director, Wess Henderson.

By separate order, the Commission will set a schedule for monthly status hearings. Additionally, all parties will be directed to identify the individual or individuals

that have settlement authority and at least one of those individuals will be required to attend the monthly status hearings. The status conferences will be set by separate order and attendance may be made by phone.

THE COMMISSION ORDERS THAT:

1. The Staff of the Missouri Public Service Commission shall file the list of proposed audit personnel, as described in the body of this order, no later than July 17, 2010.

2. The Staff of the Missouri Public Service Commission shall file the audit scopes, as described in the body of this order, no later than July 17, 2010.

3. Any auditing activity in relation to these matters not already begun by the Commission's Staff shall begin immediately. The Commission's Staff shall not delay, in any manner, any audit activity in association with these cases pending the Commission's approval of the personnel assignments described herein.

4. All auditing activity shall be conducted in accordance with generally accepted auditing standards issued by the American Institute of Certified Public Accountants Standards. All Commission staff members conducting audit activity of any type in these matters shall attest by affidavit that all of their auditing activity and reports comply with these standards.

5. Monthly status hearings will be set by separate order. At the status hearings the Commission's Staff shall update the Commission on the status of all audit activity of any type involved with these actions. Any discovery disputes shall be taken up immediately at these hearings. Any discovery dispute not timely raised at the status hearings shall be deemed waived.

6. All parties shall identify the individual or individuals that have settlement authority. All parties shall have at least one individual with settlement authority present at each monthly status conference. Status conference may be attended by phone.

7. Copies of all data requests, interrogatories, requests for production of documents, notices of depositions, depositions by written questions, or any other discovery device already issued by the parties in these matters shall be filed immediately in these files. Copies of any data requests, interrogatories, requests for production of documents, notices of depositions, depositions by written questions, or any other discovery device employed by any party after issuance of this order shall be filed on the same date it is issued.

8. All audit activity, of any type, associated with the environmental upgrades to Iatan I, if not already filed, shall be completed and filed no later than August 6, 2010.

9. The deadline for final completion for all audit activity, of any type, involved with the Iatan II generating facility, including any common plant shared between Iatan I and II is January 30, 2011.

10. The deadline for final completion for all audit activity, of any type, associated specifically with the rate increase request shall be no later than the date set for Staff to file its direct True-Up testimony. If no True-Up is required the final completion date is the deadline set for Staff to file its surrebuttal testimony in Staff's case-in-chief.

11. The Commission's Executive Director, Wess Henderson, is assigned primary audit oversight and completion. Mr. Henderson shall file monthly status reports with the Commission.

12. Any party wishing clarification of this order shall file a motion for qualification, stating with particularity the clarification sought, no later than July 14, 2010.

13. Non-compliance with the Commission's order may result in sanctions, including the striking of pleadings and testimony.

14. This order shall become effective immediately upon issuance.

BY THE COMMISSION

(S E A L)



**Steven C. Reed
Secretary**

Davis, Jarrett, Gunn, and Kenney, CC., concur;
Clayton, Chm., dissents.

Dippell, Deputy Chief Regulatory Law Judge

STATE OF MISSOURI
PUBLIC SERVICE COMMISSION

At a session of the Public Service
Commission held at its office
in Jefferson City on the 7th
day of July, 2010.

In the Matter of the Application of Kansas City Power & Light Company for Approval to Make Certain Changes in its Charges for Electric Service to Continue the Implementation of Its Regulatory Plan)))))	File No. ER-2010-0355 Tariff No. JE-2010-0692
 In the Matter of the Application of KCP&L Greater Missouri Operations Company for Approval to Make Certain Changes in its Charges for Electric Service)))))	 File No. ER-2010-0356 Tariff No. JE-2010-0693

ORDER REGARDING CONSTRUCTION AND PRUDENCE AUDITS

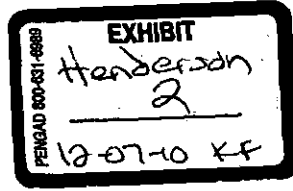
Issue Date: July 7, 2010

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Because the newly-filed rate cases involve the Iatan plant additions to KCPL and GMO,¹ and because the Commission will require completed construction and prudence audits of the Iatan I and II facilities and common plant, the Commission will direct its

¹ The in-service date for the Iatan I environmental upgrades was June 19, 2009. The projected in-service date for the Iatan 2 generating facility is December 31, 2010.



Staff to complete all auditing of the environmental upgrades to latan I and common plant and commence, if not already started, all audits associated with latan II immediately, subject to the specific direction of the Commission.

The Commission's Staff shall submit to the Commission the complete list of specific personnel it proposes to be involved with any portion of auditing or audit activity of any type, in relation to the proposed rate increases, the environmental upgrades to latan I, the latan II generating facility and any common plant. This list will include the names, and specific planned assignments for each individual involved with the auditing activity. The list provided will delineate and distinguish between all individuals assigned to auditing activity, of any type, for the primary rate case actions and all individuals assigned to auditing activity, of any type, associated with the latan I and II construction projects and common plant.

The Commission's Staff shall identify each project coordinator for any phase of any type of auditing activity and which individual staff members are under their direction. Staff will file complete audit scopes and a proposed schedule for completion of the audits in relation to the latan II generating facility and any common plant that conforms to the final deadlines set in this order. The Commission will set final deadlines for the audit activity in association with the requested rate increases, the environmental upgrades to latan I, the latan II generating facility and any common plant. The Commission shall also assign primary audit oversight and completion to its Executive Director, Wess Henderson.

By separate order, the Commission will set a schedule for monthly status hearings. Additionally, all parties will be directed to identify the individual or individuals

that have settlement authority and at least one of those individuals will be required to attend the monthly status hearings. The status conferences will be set by separate order and attendance may be made by phone.

THE COMMISSION ORDERS THAT:

1. The Staff of the Missouri Public Service Commission shall file the list of proposed audit personnel, as described in the body of this order, no later than July 17, 2010.

2. The Staff of the Missouri Public Service Commission shall file the audit scopes, as described in the body of this order, no later than July 17, 2010.

3. Any auditing activity in relation to these matters not already begun by the Commission's Staff shall begin immediately. The Commission's Staff shall not delay, in any manner, any audit activity in association with these cases pending the Commission's approval of the personnel assignments described herein.

4. All auditing activity shall be conducted in accordance with generally accepted auditing standards issued by the American Institute of Certified Public Accountants Standards. All Commission staff members conducting audit activity of any type in these matters shall attest by affidavit that all of their auditing activity and reports comply with these standards.

5. Monthly status hearings will be set by separate order. At the status hearings the Commission's Staff shall update the Commission on the status of all audit activity of any type involved with these actions. Any discovery disputes shall be taken up immediately at these hearings. Any discovery dispute not timely raised at the status hearings shall be deemed waived.

6. All parties shall identify the individual or individuals that have settlement authority. All parties shall have at least one individual with settlement authority present at each monthly status conference. Status conference may be attended by phone.

7. Copies of all data requests, interrogatories, requests for production of documents, notices of depositions, depositions by written questions, or any other discovery device already issued by the parties in these matters shall be filed immediately in these files. Copies of any data requests, interrogatories, requests for production of documents, notices of depositions, depositions by written questions, or any other discovery device employed by any party after issuance of this order shall be filed on the same date it is issued.

8. All audit activity, of any type, associated with the environmental upgrades to Iatan I, if not already filed, shall be completed and filed no later than August 6, 2010.

9. The deadline for final completion for all audit activity, of any type, involved with the Iatan II generating facility, including any common plant shared between Iatan I and II is January 30, 2011.

10. The deadline for final completion for all audit activity, of any type, associated specifically with the rate increase request shall be no later than the date set for Staff to file its direct True-Up testimony. If no True-Up is required the final completion date is the deadline set for Staff to file its surrebuttal testimony in Staff's case-in-chief.

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BY THE COMMISSION

(S E A L)



**Steven C. Reed
Secretary**

Davis, Jarrett, Gunn, and Kenney, CC., concur;
Clayton, Chm., dissents.

Dippell, Deputy Chief Regulatory Law Judge

The Difference Between an Audit, Review and Compilation

by Grassi & Co. | Aug 17, 2010 | General | 0 comments

By: Stephen J. Mannhaupt, CPA, Partner

With the tightening of the credit market, banks and other credit grantors are scrutinizing financial statements more than in the past. In some instances, non-public companies are being required to provide financial information with a higher level of assurance than was required in the past. If a company was only required to provide internal statements or tax returns to their banks in prior years, they may now be required to provide financial statements that have been compiled or reviewed by an independent accountant. Where compilations or reviewed financials were acceptable in the past, reviews and audits are now being required. Additionally, when companies are looking to increase their lines of credit or obtain additional financing, these increased requirements may be necessary.

Since the landscape is changing, it is important to understand the significant differences between these levels of services—Compilation, Review and Audit. This article summarizes the different requirements for each level of service.

The Compilation is the lowest level of service that a CPA can provide for a client's financial statement. A compilation basically involves presenting information, consistent with management's representation, in the form of financial statements, ***without expressing any assurance on them.*** During a compilation engagement, the CPA is not required to verify or corroborate the amounts included in the financial statement that is presented by the client. If the accountant becomes aware that the information that is supplied by the client is incorrect or misleading, the information must be revised or additional information must be obtained.

A Review requires an accountant to perform more procedures than is required with a compilation. During a review engagement, an accountant is required by the governing standards to make inquiries of the client and perform analytical procedures related to the amounts and disclosures in the financial statement. By performing inquiry and analytics, the accountant is able to provide limited assurance that there is no material modification that should be made to the

financial statement. A review typically does not require tests of accounting records or the need to obtain corroborating evidential matter.

Accountants must have knowledge of the client and their industry to formulate the necessary inquiries. Credit grantors are increasingly assessing the CPA's specific industry knowledge in determining the level of assurance they require. The importance of this assessment cannot be overemphasized. Is your CPA a specialist in the industry or a general practitioner? The inquiries should include industry specific questions. Are the financial statements prepared in conformity with generally accepted accounting principles?

What are the procedures to ensure that the accounting information has been recorded, classified and summarized properly? Has the company performed reconciliations to determine the information is appropriate? The accountant will inquire if there are any allegations or suspicions of fraud or illegal acts within the company. Have there been any significant changes in the business activity? The accountant will inquire regarding specific significant assets and liabilities to determine if the amounts are complete and accurate.

Analytic procedures will assist the accountant in identifying amounts that are unusual and will require additional inquiry. Based on the results of the inquiry and analytical procedures, the accountant will determine if any adjustments are necessary to the financial statements.

An audit provides the highest level of assurance and, as such, requires much more work by the CPA than is required for a compilation or review. The most significant difference between an audit engagement and other financial statements is that the auditor is required to corroborate the amounts and disclosures included in the financial statements through test of the accounting documents, physical inspection, the use of third party confirmations or other procedures deemed appropriate. The auditor must also understand the company's internal control structure and evaluate its effectiveness. The auditor's report provides an opinion that the financial statements present fairly in all material respects, the financial position of the company and the results of operations in conformity with generally accepted accounting principles. An audit engagement is planned and performed by an auditor with an attitude of professional skepticism and obtains various types of evidence to reduce the risk that the financial statements are materially misstated.

As indicated above, depending on the level of service, additional time may be required to complete the necessary engagement if the credit grantor is requiring a higher level of service. Companies that are in these situations need to plan ahead. Increasing the service requires more planning and effort than is needed with a lower level of service.

Companies that have provided financial information to credit grantors in the past should have a conversation with these individuals prior to their year-end to allow for sufficient time to make the necessary changes. It may not be easy to just change from one service to another without the proper planning. Certain procedures need to be performed at or near the year-end, while reconciliations or schedules may need to be produced that were not prepared in the past.

The best approach is to make sure that companies have a discussion with their CPA firm early in the process. This will go a long way to ensure the proper engagement is completed timely and efficiently.



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**National
Association of
Regulatory
Utility
Commissioners**

Regulatory and Legal Framework of Audit Function

Schedule CRH-R-4
1/8

Mark Oligschlaeger
Missouri Public Service Commission
March 25, 2014

Definition of “Audit”

- An audit is usually performed to provide some type of “assurance” to a user of the financial information being reviewed
- “Assurance” is not the same thing as a guarantee

Definition of “Audit”

- However, the primary reason the Missouri Commission conducts audits of utilities under its jurisdiction is to assess in detail the need for a utility to change its customer rate levels
- Most frequently, audits are conducted when a utility seeks a general rate increase

Definition of “Audit”

- Audits are also conducted when Commission Staff or another entity files an “earnings complaint against a utility;” i.e., an allegation that the utility is excessively earning and should have its general rates reduced
- Audits of more limited scope are conducted in conjunction with single-issue rate mechanisms

Initiation of Audits

- In Missouri, utilities have the burden of justifying that any proposed change in their customer rates is reasonable
- As part of that burden, the Commission routinely requires that its Staff conduct a thorough review of a utility's existing cost structure to determine whether the utility's prudent and reasonable cost of service exceeds the level reflected in its current rates
- "Thorough review" – Rate Audit

Missouri Commission Audits

- Fuel Adjustment Clause Audits
 - These single-issue rate mechanisms were authorized by the Missouri Legislature around ten years ago
 - At the time, electric utilities faced rapidly increasing and volatile levels of fuel expense, mostly associated with natural gas prices

Missouri Commission Audits

- Fuel Adjustment Clause Audits
 - Within the prudence audit process, auditors have six-month period to file report with their findings and any proposed prudence adjustments
 - FACs have only been in place for Missouri electric utilities since 2007
 - Commission Staff has recommended two major prudence adjustments since that time

Missouri Commission Audits

- Fuel Adjustment Clause Audits
 - One adjustment was to properly net certain off-system sales proceeds against increased fuel/purchased power costs for a utility
 - The other adjustment raised concerns regarding the “hedging” or risk management practices of an electric utility regarding its natural gas purchases

1. Please describe Staff's audit scope as it relates to its audit of Empire's natural gas hedging procedures, including financial hedges and physical hedges.

Staff described the audit scope in Section 2 of the Staff Notice of Start of 6th Prudence Audit filed on September 6, 2016. The audit scope includes costs associated with Empire's fuel hedging program.

2. Did Staff conduct any meetings or discussions with any Empire personnel related to Empire's natural gas hedging losses incurred in this audit period?

No, Staff did not conduct any meetings or discussion with any Empire personnel related to Empire's natural gas hedging.

3. What criteria did Staff rely on to determine that Empire's incurrence of natural gas hedging losses in this audit period was 1) reasonable and 2) prudent?

Based on its review, Staff found no evidence of imprudence by Empire for the items it examined for the period of March 1, 2015 through August 31, 2016.

In *State ex rel. Associated Natural Gas Co. v. Public Service Commission of State of Missouri*,¹ the Western District Court of Appeals summarized the Commission's prudence standard by quoting the Commission as follows:

[A] utility's costs are presumed to be prudently incurred... However, the presumption does not survive "a showing of inefficiency or improvidence."...[W]here 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... .

...[T]he company's conduct should be judged 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. (Citations omitted).

The Court did not criticize the Commission's definition of prudence. However, it added that, to disallow a utility's recovery of costs from its ratepayers based on imprudence, the Commission must determine the detrimental impact of that imprudence on the utility's ratepayers.²

Several Data Requests were answered by Empire. Staff reviewed and compared the natural gas hedging costs to past periods.

As stated in the Sixth Prudence Review of Costs Related to the Fuel Adjustment Clause for the Electric Operations of The Empire District Electric Company on page 1, "In evaluating prudence, Staff reviewed whether a reasonable person would find both the information the decision-maker relied on and the process the decision-maker employed when making the decision under review was reasonable based on the circumstances at the time the decision was made, i.e., without the benefit of hindsight. The decision

¹ 954 S.W.2d 520, 528-29 (Mo. App. W.D. 1997).

² *Ibid* at 529-30.

actually made is disregarded, and the review is an evaluation of the reasonableness of the information the decision-maker relied on and the decision-making process the decision-maker employed. If either the information relied upon or the decision-making process employed was imprudent, then Staff examines whether the imprudent decision caused any harm to ratepayers. Only if an imprudent decision resulted in harm to ratepayers will Staff recommend a refund.”

4. What specific criteria did Staff rely upon to determine that Empire’s continuation of its natural gas hedging program was 1) reasonable and 2) prudent?

According to Empire’s last rate case “In the Matter of The Empire District Electric Company’s Request for Authority to Implement a General Rate Increase for Electric Service” case no. ER-2016-0023, Stipulation and Agreement filed on June 20, 2016, the parties (including The Empire District Electric Company, Staff of the Commission, Office of the Public Counsel, City of Joplin, Missouri, Division of Energy, and Midwest Energy Consumers Group) did not change the approach to hedging except for reporting. Staff also compared the costs of hedging to past costs.

Staff also reviewed the Energy Risk Management Policy, April 29, 2016, which describes Empire’s natural gas hedging strategy. Staff determined that Empire adhered to its approved Energy Risk Management Policy as it relates to fuel hedging activities.

5. Is the specific criteria that Staff relied upon to determine that Empire’s continuation of its natural gas hedging program was reasonable and prudent consistent with the criteria used by Staff in the previous GMO and KCPL rate cases? If not, why not?

Yes.

6. If Staff recommended the Missouri electric utility KCPL – Greater Missouri Operations (GMO) should no longer engage in natural gas financial hedges, why is it taking a different approach with Empire and supporting Empire’s continuation of its natural gas financial hedging program?

Staff did not take a different approach for GMO and Empire. Staff did not recommend GMO to stop hedging. Staff moved from its stated position in the rate case for confidential settlement purposes.

7. Please list and describe the education and experience (including previous testimony or audit reports) related to natural gas financial and physical hedging of the specific Staff auditors or management who concluded that Empire’s natural gas hedging policies and procedures and incurred hedging losses are reasonable and prudent on this Empire FAC audit.

Ashley Sarver –Bachelor of Science degree in Accounting from Missouri State University. This is my first case relating to natural gas financial and physical hedging.

David Roos - Bachelor of Science degree in Chemical Engineering from University of Notre Dame and Masters in Economics from the University of Missouri. Sponsored natural gas hedging as a component of the FAC in the KCPL Rate Case No. ER-2016-0285.

Dana Eaves - Bachelor of Science degree in Business Administration from Columbia College. Specific cases related to risk management policies and financial and physical hedging practices: EO-2011-0390, EO-2011-0285, EO-2013-0114, EO-2013-0407, ER-2014-0057, ER-2016-0179 and ER-2016-0285.

Response to OPC DR#59

John Rogers – Bachelor of Science degree in Engineering Science from University of Notre Dame and Master of Business Administration from University of San Diego. Staff witness for FAC in Case Nos. ER-2010-0036, ER-2009-0090 and ER-2010-0356.

Staff Response to OPC Data Request No. 0059.1

Company Name MO PSC Staff-(All)

Case/Tracking No. EO-2017-0065 Date Requested 4/27/2017

Issue Cost Recovery Mechanism - Fuel Adjustment Clause Requested From Bob Berlin

Requested By Chuck Hyneman - Brief Description Staff's Audit Scope

Description Reference OPC DR 59 part 5 and Staff's response below: Q. Is the specific criteria that Staff relied upon to determine that Empire's continuation of its natural gas hedging program was reasonable and prudent consistent with the criteria used by Staff in the previous GMO and KCPL rate cases? If not, why not? A. Yes. a. Please list each and every criteria used by Staff to determine that Empire's natural gas hedging activities and hedging losses were prudent and reasonable. Please include all audit steps taken, documents relied upon, analysis made, etc. b. Please list each and every criteria used by Staff to determine that GMO and KCPL should cease its natural gas hedging activities in these companies 2016 rate cases..

Response Staff response: a. It is Staff's opinion that OPC may have confused the regulatory standards that must be met during a fuel adjustment clause ("FAC") prudence audit compared to the regulatory standards that are used during a general rate case proceeding. Staff provided the regulatory standard used by Staff in Staff's Sixth Prudence Audit Report ("Staff report") and also in Staff's response to OPC's Data Request No. 0059, part 3. Empire District Electric's ("EDE") FAC was authorized by the Commission in 2008, 2010, 2011, 2012, 2015, and 2016 general rate cases as detailed in Staff's report. As an outcome of these general rate cases, tariff sheets were approved for the cost and revenue components that would be accounted for in Empire's Fuel Adjustment Rate ("FAR"). Commission approved tariff sheets have the force and effect of law. EDE's FAC tariff sheets specifically allows EDE to account for prudently incurred hedging gains and losses in its FAC as a component "FC = Fuel Costs Incurred to Support Sales". During its prudence audit, in this case, Staff reviewed all relevant tariff sheets, risk management policies, data requests and financial results of EDE's hedging activities during the review period in an effort to determine if Empire was prudent in its actions related to fuel hedging activities. In the context of Staff's prudence audit, Staff determined that Empire did not act imprudently in its hedging activities. In the context of a FAC prudence audit, Staff cannot recommend EDE discontinue its fuel hedging activities because changes to the FAC can only be approved by the Commission in a general rate case. If OPC or other parties are unhappy with the prudently incurred results of EDE's hedging practices, those parties should address this matter in EDE's next general rate case proceeding and seek removal of hedging activities from the FAC component FC. b. OPC mischaracterizes Staff's position in these cases. Staff actually recommended the following; "Staff recommends the Commission order GMO to suspend all of its hedging activities (cross hedging and natural gas fuel hedging) associated with natural gas." The word "suspend" is different than "cease". A suspension would have allowed GMO and KCP&L to resume its hedging activities at an appropriate time. This is why Staff recommended hedging language remain in the companies' FAC tariffs. Commission approval would not have been required to resume such hedging activities. Answered by: Dana Eaves

Staff Response to OPC Data Request No. 0059.2

Case/Tracking No. EO-2017-0065

Date Requested 4/27/2017

Issue Cost Recovery Mechanism - Fuel Adjustment Clause

Requested By Chuck Hyneman

Description Reference OPC DR 59 part 6 and Staff's response below: 6. If Staff recommended the Missouri electric utility KCPL – Greater Missouri Operations (GMO) should no longer engage in natural gas financial hedges, why is it taking a different approach with Empire and supporting Empire's continuation of its natural gas financial hedging program? Staff did not take a different approach for GMO and Empire. Staff did not recommend GMO to stop hedging. Staff moved from its stated position in the rate case for confidential settlement purposes. Also reference the rebuttal testimony of Staff witness Dana Eaves in GMO's ER-2016-0156 GMO rate case: ER-2016-0156 Dana Eaves Rebuttal page 4: Q. What is Staff's recommendation concerning GMO's natural gas hedging activities? A. Staff recommends the Commission order GMO to suspend its natural gas hedging activities and approve Staff's proposed language for GMO's FAC which would allow GMO to resume its natural gas hedging for fuel it uses in its generators to produce energy should energy market conditions change and warrant such a resumption. Given that Staff recommended "the Commission order GMO to suspend its natural gas hedging activities" in the ER-2016-0156 rate case, please explain in as great a detail as possible why Staff states in this case, and in response to OPC DR 59 part 6 that "Staff did not recommend GMO to stop hedging.". OPC sees these two positions as directly contradictory and inconsistent. If that is not the case, please explain why that is not the case.

Response Staff response: The actual question asked by OPC in its Data Request No. 59, part 6 was; "6 If Staff recommended the Missouri electric utility KCPL – Greater Missouri Operations (GMO) should no longer engage in natural [g]as financial hedges, why is it taking a different approach with Empire and supporting Empire's continuation of its natural gas financial hedging program?" Staff interpreted OPC's question to mean GMO should stop all of its hedging activities. Staff's position in that case was as follows; "Staff recommends the Commission order GMO to suspend all of its hedging activities (cross hedging and natural gas fuel hedging) associated with natural gas." Suspend is different than cease. A suspension would have allowed GMO to resume its hedging activities. Accordingly Staff recommended hedging language remain in its FAC tariff sheets so that the company would not have required commission approval to resume hedging activities. Also see Staff's response to OPC's data Request No. 59.1 for further discussion of this issue. Answered by: Dana Eaves

DR 59.3 to Staff

1. Please list and describe in as great a detail as possible each and every specific reason, fact or circumstance why Staff recommended to the Commission that KCPL and or GMO “suspend” its natural gas hedging activities in these utilities most recent rate case.
2. For each of the reasons, facts or circumstances provided in number 1 above, does the Staff believe that the same facts and circumstances apply to Empire in this FAC case? If not, please explain.
3. Does the Staff believe it is “reasonable” for Empire to incur and charge its Missouri ratepayers \$10 million in hedging losses in this FAC period? If yes, please explain. If no, why did Staff not propose an adjustment to Empire’s FAC costs in this audit period?
4. Does the Staff believe it is “prudent” for Empire to incur and charge its Missouri ratepayers \$10 million in hedging losses in this FAC period? If yes, please explain. If no, why did Staff not propose an adjustment to Empire’s FAC costs in this audit period?
5. Please cite to all Missouri statute(s) that guided Staff’s prudence audit and recommendations of Empire’s current FAC charges.
6. Please cite to all court decision(s) that Staff believes it must follow and that guided Staff’s prudence audit and recommendations of Empire’s current FAC charges.
7. Does the Staff believe that the burden of proof that guided its audit, audit report and audit recommendations is a creature of statute? If so, please provide the statute.
8. Does the Staff believe that the burden of proof that guided its audit, audit report and audit recommendations is a creature of regulation? If so, please provide the regulation.
9. Reference the following statement made by Staff in response to DR 59. 1a. “-It is Staff’s opinion that OPC may have confused the regulatory standards that must be met during a fuel adjustment clause (“FAC”) prudence audit compared to the regulatory standards that are used during a general rate case proceeding. A. Please list each and every regulatory standard that Staff believes must be met during a FAC audit and provide the basis for this belief. B. Please list each and every regulatory standard that Staff believes must be met during a “general rate proceeding” and provide the basis for this belief. C. Please explain the authority relied upon by Staff that these standards are different for a FAC audit and a rate case audit.
10. In the context of a FAC audit, does the Staff consider and apply the term “reasonable” the same as considers and applies the term “prudent”? If not, please describe in as great a detail as possible any differences the Staff believes exists in these terms and how they are applied in a) a rate case and b) in a FAC audit.
11. Is it true that Staff recommended KCPL and GMO “suspend” its natural gas hedging program because it was not reasonable for KCPL and GMO to continue to engage in financial hedging in the current natural gas market? If not, please explain why not?
12. Is it true that Staff recommended KCPL and GMO “suspend” its natural gas hedging program because it was not prudent for KCPL and GMO to continue to engage in financial hedging in the current natural gas market? If not, please explain why not?
13. Is it true that since Staff did not recommend that Empire suspend or modify its hedging program in its current FAC audit that Staff believes it is reasonable for Empire to continue to engage in its current hedging program and pass on to its Missouri regulated customers \$10 million in hedging losses in this FAC period? If yes, please list and describe the specific audit evidence obtained by Staff that caused it to believe this \$10 million in hedging losses is reasonable and prudent.

Staff Answer:

1. In KCP&L Greater Missouri Operations Company’s (GMO) Case No. EO-2011-0390, Staff recommended GMO stop its cross-hedging activities and recommended a disallowance of \$18,755,865, plus interest as a result of Staff’s finding of imprudent decisions related to natural gas hedges to mitigate risk associated with its future purchases in the spot power market. The Commission did not approve the Staff’s proposed disallowance as it found GMO’s actions to be prudent. The Commission also ordered the Staff to organize workshops that would address overall hedging activities by all regulated utilities in

Missouri. Workshops were held with no specific recommendations being ordered by the Commission as a result of File No. EO-2013-0101.

In Case Nos. ER-2016-0285 and ER 2016-0156, Staff made recommendations that the Commission order KCP&L and GMO to suspend its cross-hedging and natural gas fuel hedging activities. Staff maintained its concerns related to KCP&L and GMO's cross hedging (hedge energy prices with futures contracts) activities however, Staff would not have recommended the suspension of the natural gas fuel hedging portion but for the fact Staff was told by KCP&L and GMO personnel that its hedging activities were so intertwined that if it ceased the cross-hedging portion it would also cease its natural gas fuel hedging as well. Staff still maintains KCP&L's and GMO's cross-hedging is fundamentally flawed, by the inability of KCP&L and GMO to share the risk of energy price with a power supplier that would be willing to share the risk by contracting a fixed price. KCP&L and GMO instead utilize market price as a substitute for bilateral purchased power contract(s) which still avails KCP&L and GMO to market price fluctuations. Staff did not know for certain what the price of energy or fuel commodity prices will be in the future. Therefore, Staff was reluctant to recommend a complete discontinuation of fuel hedging practices during the most recent KCP&L and GMO rate cases. Staff wanted to maintain a path for KCP&L and GMO to resume fuel hedging practices, if market forces change dramatically by retaining language in each utility's FAC tariff sheets.

2. No. Empire District Electric Company (Empire) does not cross-hedges its energy price risk with NYMEX natural gas futures contracts. Staff maintains its view that hedging natural gas fuel with NYMEX natural gas futures contracts provides some level of risk protection for the Company and its customers.
3. Yes. Staff understands that Empire does not engage its fuel hedging practices to "make money" but rather to mitigate its price risk related to natural gas and other fuels it uses to produce electric energy from its electric generating facilities. Simply losing money in a given period for these types of financial transactions is not an indication that Empire's fuel hedging practices are imprudent.
4. Yes, see answer to question 3.
5. Missouri statute Section 386.266.4(4) RSMo (Supp. 2013) (Supp. 2015) and Commission Rule 4 CSR240-20.090(7).
6. State ex rel. Associated Natural Gas Co. v. Public Service Commission of State of Missouri.
7. Yes, Missouri statute Section 386.266.4(4) RSMo (Supp. 2013) (Supp. 2015) and Commission Rule 4 CSR240-20.090(7). Staff's prudence report explains the appropriate regulatory standards that apply to the prudence review.
8. State ex rel. Associated Natural Gas Co. v. Public Service Commission of State of Missouri. Staff's prudence report explains the appropriate regulatory standards that apply to the prudence review.
9. Staff does not maintain a listing of regulatory standards it uses during a general rate case or a FAC prudence review. Staff statement refers to the contrast between a general rate case and a FAC prudence review. During a general rate case Staff has a broader latitude in determining if a cost or revenue is appropriate for recovery, such as, is it reoccurring, necessary, or is required to be annualized or normalized, during a prudence review. In a general rate case an electric utility can seek to establish

fuel adjustment clause. During a general rate case certain cost and revenue items are determined to be appropriate for inclusion in the fuel adjustment clause and compliance tariffs and these are approved by the commission. During a prudence review of these costs and revenues, Staff only seeks to determine if the decisions the company made concerning approved FAC cost and revenue items are prudent. Staff could recommend the discontinuation of FAC cost and revenue items, but such a recommendation can only be taken up by the Commission in a general rate case.

10. Staff has not compared or contrasted these terms but rather relies on the facts and circumstances in the context of an issue to determine the relevance of each term.
11. No. See response to item 1.
12. No, See response to item 1.
13. Yes. Staff reviewed Empire's FAC tariff sheets and Empire is allowed to account for prudently incurred hedging gains and losses in its FAC rider. Staff also reviewed Empire's Risk Management policies to determine if it complied with all aspects of its approved risk management policies. Staff found no instances that Empire was not in compliance of these policies. Staff did analyze Empire's hedging results and found Empire did incur losses during the review period. Staff did not recommend an adjustment based on the losses incurred.

**STATE OF NEW HAMPSHIRE
BEFORE THE
PUBLIC UTILITIES COMMISSION**

Docket No. DG 14-____

Liberty Utilities (EnergyNorth Natural Gas) Corp.

**DIRECT TESTIMONY
OF
FRANCISCO C. DAFONTE**

May 19, 2014

1 **Q. Mr. DaFonte, please state your name, business address and position with Liberty**
2 **Utilities (EnergyNorth Natural Gas) Corp. (“EnergyNorth” or “the Company”)**

3 A. My name is Francisco C. DaFonte. My business address is 15 Buttrick Road,
4 Londonderry, New Hampshire 03053. My title is Senior Director, Energy Procurement.

5
6 **Q. Mr. DaFonte, please summarize your educational background, and your business**
7 **and professional experience.**

8 A. I attended the University of Massachusetts at Amherst where I majored in Mathematics
9 with a concentration in Computer Science. In the summer of 1985 I was hired by
10 Commonwealth Gas Company (now NSTAR Gas Company), where I was employed
11 primarily as a supervisor in gas dispatch and gas supply planning for nine years. In 1994,
12 I joined Bay State Gas Company (now Columbia Gas of Massachusetts) where I held
13 various positions including Director of Gas Control and Director of Energy Supply
14 Services. At the end of October 2011, I was hired as the Director of Energy Procurement
15 by Liberty Energy Utilities (New Hampshire) Corp. and promoted to Sr. Director in July
16 2013. In this capacity, I provide gas procurement services to EnergyNorth.

17
18 **Q. Mr. DaFonte, are you a member of any professional organizations?**

19 A. Yes. I am a member of the Northeast Energy & Commerce Association, the American
20 Gas Association, the National Energy Services Association and the New England Canada
21 Business Council.

1 **Q. Mr. DaFonte, have you previously testified in regulatory proceedings?**

2 A. Yes, I have testified in a number of proceedings before the New Hampshire Public
3 Utilities Commission, the Massachusetts Department of Public Utilities, the Maine Public
4 Utilities Commission, the Indiana Utility Regulatory Commission, the Georgia Public
5 Service Commission, the Missouri Public Service Commission and the Federal Energy
6 Regulatory Commission.

7
8 **Q. Mr. DaFonte, what is the purpose of your testimony in this proceeding?**

9 A. The purpose of my testimony is to present the Company's proposal to modify its existing
10 commodity hedging program to better stabilize the cost of natural gas supplies acquired to
11 serve its customers. Further, my testimony will discuss the continuation and modification
12 of the Company's Fixed Price Option (FPO) program. The Company is seeking approval
13 by the Commission to implement the modified hedging plan this summer for effect in the
14 peak winter period of 2014-2015.

15
16 My testimony provides an overview of the current commodity hedging program, the
17 historical performance of the program, recent market trends along with gas commodity
18 hedging and describes in detail the specific program EnergyNorth is seeking to implement
19 on behalf of its customers.

1 **Q. Mr. DaFonte, can you provide a general overview of the Company's current**
2 **hedging program?**

3 A. Yes. The Company's current program, which was approved by Commission Order
4 25,094, uses various financial risk management tools and underground storage in order to
5 provide more price stability in the cost of gas to firm sales customers and to fix the cost
6 of gas for participants in the Company's FPO Program. It is not intended to achieve
7 reductions in customers' overall gas costs.

8
9 The Company may use derivatives (swaps, call and put options) and/or physical supplies
10 to hedge the price for a portion of its gas supply portfolio for the period from November
11 through April of each year¹. The Company may use a combination of financial hedges,
12 storage withdrawals and fixed price contracts to hedge a monthly target hedge percentage.
13 The purchase and sale of derivatives may be either physical or financial.

14
15 The peak period hedge target volume is determined using the specific monthly hedge
16 percentages listed below as a portion of the Company's total firm sales forecast for each
17 month listed. The total volume hedged includes financial, fixed price contracts and
18 storage volumes and is based on a percentage of the most recent firm sales forecast, as of
19 March 1st of each year, prior to the start of the execution of the strategy for a given
20 period. Hedge volumes may be revised based on the most recent firm sales forecast as of

¹ The Company terminated its hedging for the months of October and May per the Commission's order in DG 13-251.

1 October 1st. If the hedge volume changes by more than 5%, based on the new forecast,
2 then the remaining execution volumes are adjusted proportionately for the remainder of
3 the term of the strategy starting in November. The total financial hedge volume will be
4 calculated as the firm sales volumes multiplied by the volume target below minus
5 forecasted storage withdrawals minus fixed priced physical contracts.

6
7 The following monthly hedge percentages are used to set the total hedge volume target²:

9 November	25%
10 December	33%
11 January	33%
12 February	33%
13 March	33%
14 April	25%

15
16 **Q. Mr. DaFonte, has the hedging program worked as intended?**

17 A. Yes. Since its inception, and through subsequent revisions, the program has insulated
18 customers from significant price volatility during periods when natural gas prices
19 fluctuated considerably, as was its intention. However, the cost to provide this stability
20 has been significant; over the last 10 years, the various New York Mercantile Exchange
21 ("NYMEX") hedging programs employed by EnergyNorth have resulted in total net
22 losses of over \$65,000,000. As shown in the table below, the majority of the losses came
23 during periods of extreme volatility when it is more expensive to purchase "insurance" in
24 the form of hedges in the market. However, 2008/2009 as the NYMEX volatility began to
25 decrease along with futures prices, the costs to hedge also decreased and thus the losses

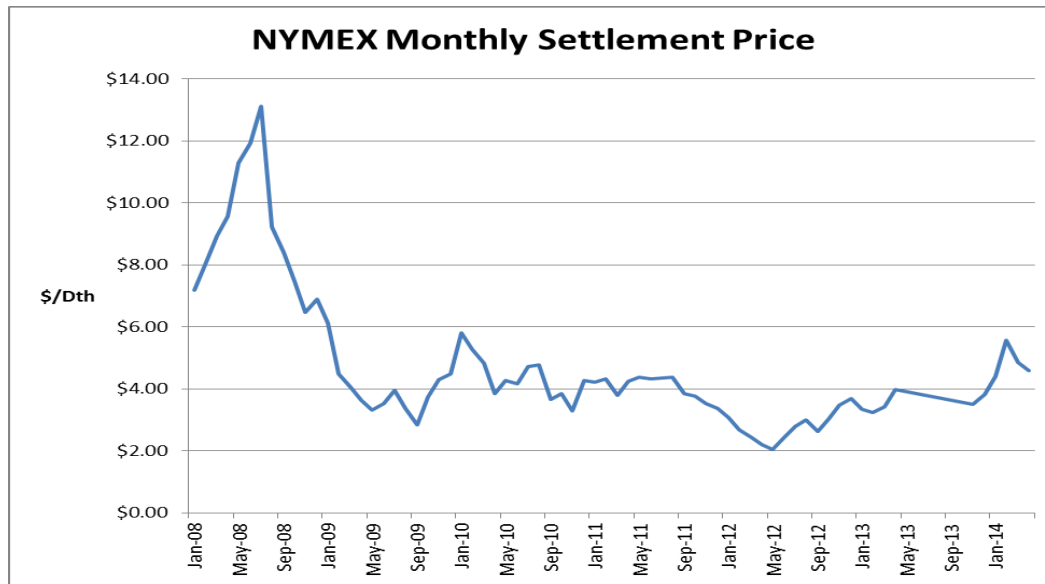
1 were less significant. In fact, there were modest gains this past winter with the slight run
 2 up in the NYMEX.

EnergyNorth Natural Gas		
10-Year Actual Hedging (Gain)/Loss History		
For the Ten Years Ending Winter 2013/2014		
<u>Year</u>	<u>Docket</u>	<u>(Gain)/Loss</u>
2013/2014	DG 13-251	\$ (1,184,841)
2012/2013	DG 12-265	\$ 2,031,210
2011/2012	DG 11-192	\$ 6,802,122
2010/2011	DG 10-230	\$ 8,380,371
2009/2010	DG 09-162	\$ 14,539,907
2008/2009	DG 08-106	\$ 21,454,126
2007/2008	DG 07-093	\$ 7,634,496
2006/2007	DG 06-121	\$ 14,580,576
2005/2006	DG 05-141	\$ (6,715,079)
2004/2005	DG 04-152	\$ (1,924,464)
Ten-year Net		\$ 65,598,424.00

² The volume targets were reduced by 50% per the per the Commission's order in DG 13-251.

1 **Q. Mr. DaFonte, Could you illustrate what has happened to natural gas futures prices**
2 **since 2008?**

3 A. As shown in the graph below, the NYMEX reached a peak price of approximately \$13.00
4 per Dth in 2008. Since that time, the NYMEX futures prices have dropped precipitously.
5 In fact, Since January 2009, the average settlement price for the NYMEX has been
6 approximately \$3.85 per Dth.



9 With the clear lack of price volatility, hedging of the NYMEX would have little benefit to
10 consumers. As further evidence of the continued projected stability in the NYMEX
11 natural gas futures market, as of May 6, 2014 the first future month that was trading over
12 \$5.00 on the NYMEX was January 2020.

1 **Q. Mr. DaFonte, to what do you attribute this decline in NYMEX natural gas prices**
2 **and price volatility?**

3 A. The single most influential factor in the reduction and stability of natural gas prices has
4 been the emergence of shale gas in both the supply area and the market area. The
5 proliferation of shale gas has led directly to numerous pipeline projects being constructed
6 to deliver these volumes into the market and has also forced some pipelines to reverse
7 flow on their systems and move gas back into the Gulf Coast, which had traditionally
8 been the source of natural gas flow into major markets in the Northeast.

9
10 **Q. Mr. DaFonte, does the current hedging program help to minimize price spikes in the**
11 **New England Market area?**

12 A. No. The current hedging program is intended to minimize price volatility with regard to
13 supply area purchases. In fact, all Over-the-Counter (OTC) swaps and options entered
14 into by the Company for its hedging program are based on the Henry Hub pricing point
15 for natural gas futures contracts located in the supply area in Louisiana. The Henry Hub
16 price and correlating NYMEX price is seen as setting the “basis” price for the North
17 American natural gas market. As such, any purchases made in the market area, such as
18 New England, must reflect the cost to deliver the gas to the ultimate purchase location,
19 known as the “basis differential” from the Henry Hub or NYMEX. This basis differential
20 is also impacted greatly by any pipeline restrictions or limitations in getting gas to a
21 specific market area relative to the demand in that market area. This is the case in the
22 capacity constrained New England market and is the primary reason why natural gas

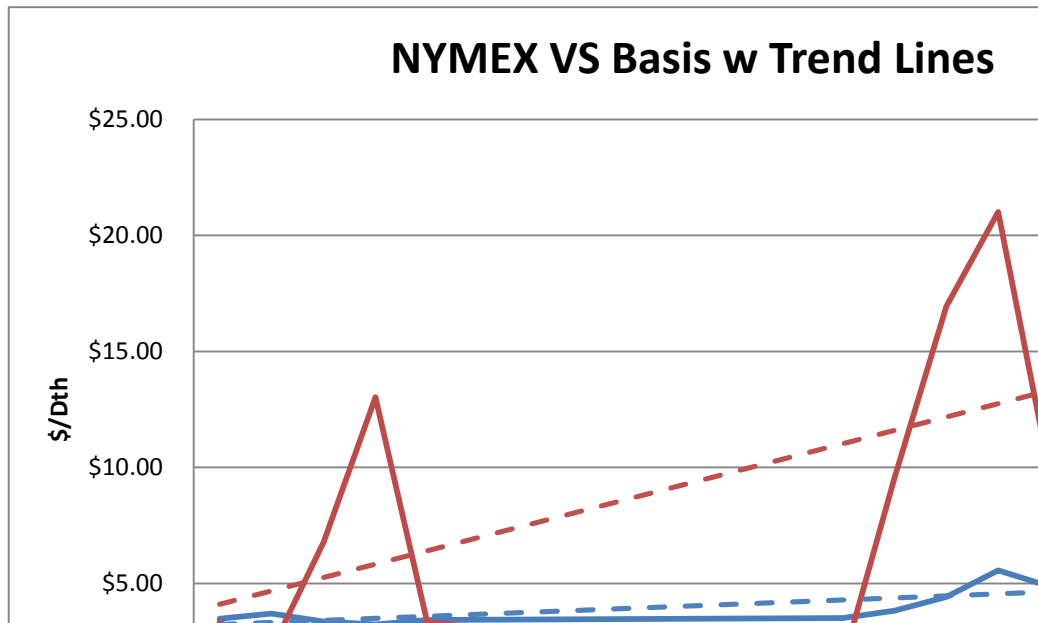
1 prices spiked up to and remained at all-time highs in the New England market this past
2 winter. Simply put, there is much more demand than pipeline capacity available to serve
3 the New England market during the peak winter periods and the current hedging of
4 supply area purchases does nothing to address this market area volatility.

5
6 To summarize, while the current hedging program focuses on minimizing futures price
7 volatility, it cannot hedge against price spikes attributable to a run up in the basis
8 differential. As a result, the current hedging program does not provide value to the
9 Company's customers.

10
11 **Q. Mr. DaFonte, how has the volatility in the NYMEX compared to the volatility in the**
12 **market area basis?**

13 A. As shown in the chart below comparing the NYMEX to the basis differential over the
14 past 2 years, the basis has been much more volatile and the trend lines indicate a pattern
15 of escalation never before seen in the New England market.

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For the winter of 2013-2014, the basis differential in the New England market escalated precipitously from \$1.57 in November to an all-time high of \$16.94 in January only to be surpassed by a new all-time high of \$21.00 in February. At the same time the NYMEX price escalated from \$3.50 in November to a peak of \$5.56 in February. The increase in the basis of roughly \$19.50 from November to February dwarfed the corresponding increase in the NYMEX for the same period of \$2.00. This approximately nine-fold increase relative to the NYMEX had a much more significant impact on customer rates than the NYMEX escalation. Moreover, while the Henry Hub spot price peaked at around the \$8.00 level, the New England spot prices were peaking over \$90.00 per Dth. These severe basis differential price spikes are clear indicators that a capacity shortfall exists in the New England market.

1 **Q. Mr. DaFonte, given that the hedging of futures prices does not in and of itself**
2 **minimize price spikes attributable to basis differential increases, would you**
3 **recommend any modifications to the current hedging program?**

4 **A.** Yes. Overall, it is my opinion that the hedging program as currently constituted does not
5 provide customers with meaningful benefits. Currently, customers are paying for the
6 option premiums (insurance against escalating prices) used to hedge future firm purchases
7 at the NYMEX/Henry Hub index price and since there has been very little volatility, the
8 options typically expire “out of the money” and customers do not see any offsetting
9 benefit to the premiums they are paying. In addition, any hedges entered into using OTC
10 swaps, which do not have a specifically identified premium, have been settling above the
11 market causing a net payout at settlement to the swap counterparty. In effect, customers
12 are paying for a hedging program that was developed to manage natural gas price
13 volatility at a time when natural gas supplies were tight and gas prices fluctuated
14 considerably. More recently, the market dynamics have changed with the increase of
15 Shale gas production and the volatility in the NYMEX/ Henry Hub futures has been
16 muted and shows continued signs of stability through 2020.

17
18 The Company proposes to eliminate the current hedging program which focuses
19 exclusively on the hedging of the NYMEX/Henry Hub futures contracts. In its place, the
20 Company would propose to begin hedging the New England basis via the very
21 straightforward purchase of physical fixed basis supply contracts commencing with the
22 winter of 2014-2015.

1 **Q. Mr. DaFonte, please explain how the Company propose to physically hedge the basis**
2 **differential?**

3 A. The Company currently issues a Request for Proposal (RFP) prior to each winter period
4 for the purpose of determining a low cost bidder for its supply purchase requirements.
5 Historically, the bidders have provided the Company with index based pricing for all
6 purchases, whether in the Gulf Coast, the Canadian border or in the market area. It would
7 be the Company's intention to conduct an RFP specifically for market area supplies that
8 would require the bidder to submit a fixed price basis to the NYMEX for all baseload
9 market area supplies required by the Company to satisfy its firm customer needs
10 throughout the winter period.

11
12 The RFP would be issued early in the summer period and would provide the Company
13 with sufficient time to analyze all proposals and select one or more suppliers for the
14 baseload service.

15
16 **Q. Mr. DaFonte, what percentage of overall normal winter requirements would be**
17 **hedged under the Company's proposal?**

18 A. Under normal weather conditions, the Company purchases approximately 1.5 Bcf of
19 baseload market area supply which would be hedged under the Company's proposal. This
20 makes up approximately 14% of all normal winter supply requirements. When combined
21 with the Company's underground storage which is also physically hedged through ratable
22 storage injections through the summer and its LNG and propane storage, the total hedged

1 volumes would be projected to be approximately 4.2 Bcf or 40% of normal winter period
2 requirements. Further, during the coldest and typically more volatile months of
3 December, January and February, the total hedged basis and storage volumes would
4 equate to approximately 57% of all normal winter purchase requirements during those 3
5 months.

6
7 **Q. Mr. DaFonte, would this modified hedging program address all of the volatile**
8 **market area purchases required by the Company during a typical winter period?**

9 A. No. Nearly 50% of the Company's pipeline capacity portfolio is comprised of New
10 England market area capacity with a primary purchase point at Dracut, MA. As discussed
11 earlier, because the Company must make spot or citygate purchases at the end of the
12 Tennessee system, it is susceptible to price spikes brought about by the lack of available
13 capacity and supply in the region. While the Company's hedging proposal is designed to
14 hedge basis prior to the winter period, it is only feasible to hedge the known baseload
15 purchase requirements. The Company will still be required to make daily market area
16 purchases to satisfy changing customer demand due to weather fluctuations. If the
17 Company could predict the actual market area purchases it would require in a given
18 month and day, it could physically hedge additional basis. Unfortunately, since the
19 Company's spot purchases are a function of the weather, it would be impossible to predict
20 the actual purchases required. That is, without the ability to determine the day and volume
21 of a purchase, the Company could be over hedged or under hedged on any given day,
22 which would be considered speculative hedging and would result in significant risk to the

1 Company and its customers. As a result, the Company is not proposing any hedging
2 program for spot purchases.
3

4 **Q. Mr. DaFonte, do you see the Company's modified hedging proposal as a long-term**
5 **solution to price volatility in the New England market?**

6 A. No. Since the volatility in the basis differentials in New England is a direct result of the
7 lack of pipeline infrastructure available to access the abundant shale supplies in the
8 Marcellus and Utica shale plays, the most logical way to address the market area volatility
9 is to develop more pipeline infrastructure that accesses these shale supplies. Fortunately,
10 there are two new proposed pipeline projects that would tap into the shale production and
11 bring more natural gas supplies into the New England market. These new projects will
12 help to mitigate much of the volatility in the New England basis differential.
13 Unfortunately, these projects aren't slated to go into service until 2018 or later. However,
14 the Company's proposed hedging program is very flexible and can be modified to account
15 for the timing of these projects as it only contemplates hedging volumes for one year
16 increments each summer period.

17 **Q. Mr. DaFonte, is the Company proposing to terminate its FPO program?**

18 A. No. The FPO program will continue. However, the Company is proposing to only make
19 the program available to residential customers as they do not have the ability to choose a
20 third party supplier since there is no retail competition available to these customers. All
21 Commercial & Industrial customers do have the ability to choose a third party supplier so
22 they can sign up with a competitive supplier if they would like a fixed price offering or

1 some other creative supply service that meets their business needs.

2
3 **Q. Mr. DaFonte, how do you propose to establish an FPO rate under the Company's**
4 **proposed hedging program?**

5 A. The FPO price has historically been based on the filed peak period Cost of Gas rate plus a
6 premium to recover program costs and to account for the volatility of the unhedged
7 supply used to serve the FPO customers. The Company proposes to continue to calculate
8 the FPO rate in this same fashion by first establishing the COG rate for the peak winter
9 period and then adding a premium to the rate for anyone wishing to sign up for the FPO
10 program.

11
12 **Q. Mr. DaFonte, would the Company use the same premium to establish the final FPO**
13 **rate as it has done most recently?**

14 A. No. The Company is proposing an FPO premium that is higher than it has been
15 historically in order to appropriately reflect the increased volatility in the market area
16 supply prices. Although the Company's proposed hedging program will help to minimize
17 the market area basis, as explained earlier, it cannot hedge the daily spot gas purchases
18 required to meet the demand of its customers due to temperature swings. As was evident
19 this past winter, the daily spot prices can be extremely volatile and that volatility needs to
20 be considered in any premium that is established. The Company will propose an
21 appropriate premium when it files its FPO rate with its peak period COG filing.

1 **Q.** **Does this conclude your direct prefiled testimony in this proceeding?**

2 **A.** Yes, it does.

**STATE OF NEW HAMPSHIRE
PUBLIC UTILITIES COMMISSION**

DG 14-133

LIBERTY UTILITIES (ENERGYNORTH NATURAL GAS) CORP.

D/B/A LIBERTY UTILITIES

Petition to Change Hedging and Fixed Price Option Programs

Order *Nisi* Granting Petition

ORDER NO. 25,691

July 10, 2014

In this order the Commission grants Liberty's request to change its hedging program from one that protects against increased market prices of natural gas to one that protects against increases in the costs to bring that gas to Liberty's service territory. The Commission also grants Liberty's request to eliminate commercial and industrial customers from its fixed price option program. This order is being issued on a *nisi* basis to ensure that all interested parties receive notice of the Commission's order and have the opportunity to request a hearing prior to its effective date.

I. BACKGROUND

Liberty Utilities (EnergyNorth Natural Gas) Corp. d/b/a Liberty Utilities (Liberty) is a public utility that provides natural gas to approximately 90,000 customers in 30 communities across the state. Liberty filed a petition to change its hedging program and its fixed price option (FPO) program. Liberty supported its petition with the direct testimony of Francisco C. DaFonte, Liberty's Senior Director of Energy Procurement.

The Office of the Consumer Advocate (OCA) filed a letter of participation on behalf of residential ratepayers consistent with RSA 363:28.

The petition and subsequent docket filings, other than information for which confidential treatment is requested of or granted by the Commission, are posted to the Commission's website at <http://www.puc.nh.gov/Regulatory/Docketbk/2014/14-133.html>.

II. POSITIONS OF THE PARTIES AND STAFF

A. Liberty

1. Proposed Changes to Liberty's Hedging Program

Liberty's hedging program consists of up front investments that are intended to offset future risks. The risks Liberty seeks to minimize through its current hedging program are increases in the price of natural gas during the winter period. DaFonte testimony at 3. Liberty's current program hedges the price determined by the Henry Hub pricing point for natural gas located in the "supply area" in Louisiana, which correlates with the New York Mercantile Exchange (NYMEX) price. *Id.* at 7. Liberty hedges the Henry Hub or NYMEX price through a mix of financial risk management tools approved in *EnergyNorth Natural Gas Inc.*, Order No. 25,094 (Apr. 29, 2010). DaFonte testimony at 3.

Mr. DaFonte stated that the volatility of the NYMEX prices has largely disappeared, mostly because of the new supplies of shale gas. *Id.* at 7. Mr. DaFonte testified that "the NYMEX/Henry Hub futures ... show continued signs of stability through 2020." *Id.* at 10. Since the price of natural gas has stabilized, "hedging the NYMEX would have little benefit to consumers." *Id.* at 6. Therefore, Liberty proposes to discontinue its current practice of hedging the price of natural gas. *Id.* at 10.

In its place, Liberty proposes hedging the "basis differential." The NYMEX price is known as the "basis." The added cost to deliver that gas into New England is the basis

differential. *Id.* at 7. Mr. DaFonte testified that the price spikes seen during the most recent winters were driven primarily by increases in the basis differential. *Id.* at 9.

Liberty proposes to hedge the basis differential by purchasing “physical fixed basis supply contracts.” *Id.* at 10. Liberty seeks Commission approval to issue requests for proposals and enter into contracts that will set a fixed price for the basis differential. *Id.* These contracts will cover all of the base load supplies that Liberty buys from the New England market area. *Id.* The contracts will insulate Liberty from spikes in the basis differential for these supplies. Mr. DaFonte testified that Liberty will not hedge the basis differential for Liberty’s spot purchases made to cover peak demand on the coldest days. Such purchases are unpredictable and any hedges would be unduly speculative. *Id.* at 12-13.

2. Proposed Changes to Liberty’s Fixed Price Option Program

Liberty’s FPO program allows customers to fix their cost of gas for the winter season through contracts signed at the beginning of the season. Liberty sets the FPO price by adding a small premium to the cost-of-gas rate. DaFonte testimony at 14. Liberty hedges most of the gas required to serve FPO customers, so Liberty remains exposed to some risk for the un-hedged quantity of the FPO program. Therefore, Liberty proposes to reduce that risk by eliminating commercial and industrial (C&I) customers from the FPO program. Liberty stated that C&I customers can buy natural gas from competitive suppliers and can obtain a fixed price in that market. *Id.* at 13-14.

Liberty stated that it will retain the FPO program for residential customers and will operate the program as it has in the past, although it may propose a slightly higher FPO premium in its next winter season cost-of-gas filing. *Id.* at 14.

B. OCA

The OCA filed a response to the petition and to Staff's recommendation stating that the OCA supports the changes requested in Liberty's petition. The OCA agreed that mitigating the basis differential was "reasonable," and stated that eliminating C&I customers from the FPO program was appropriate because they have "other options to mitigate price volatility." June 30, 2014, letter of Rorie E.P. Hollenberg, Assistant Consumer Advocate.

C. Staff Recommendation

Staff filed a memorandum that recommended approval of the revised hedging and FPO programs. Staff stated that the proposed hedging program is "consistent with changing market conditions, particularly changes related to pricing risk and volatility." Staff also found the proposed revisions to the FPO program to be "reasonable." June 23, 2014, Staff Recommendation of Al-Azad Iqbal, Analyst, Gas & Water Division.

III. COMMISSION ANALYSIS

The Commission finds Liberty's proposed change to its hedging program to be reasonable. The Commission accepts Liberty's testimony that the NYMEX natural gas prices are relatively stable and that the recent volatility rests in the basis differential. Liberty's proposal to obtain fixed-price contracts for the basis differential for certain base load supplies is a simple and reasonable way to manage that risk.

The Commission also finds that eliminating C&I customers from Liberty's FPO program is reasonable since C&I customers have other options to reduce their exposure to price volatility. Liberty should not bear the modest risk posed by the un-hedged portion of its gas supplies for C&I customers who participate in the FPO program.

We will issue this order on a *nisi* basis to ensure that all interest parties receive notice of our determination and have the opportunity to request a hearing.

Based upon the foregoing, it is hereby

ORDERED, that Liberty's proposal to discontinue its hedging of NYMEX prices and to begin hedging the basis differential as described in the filing is APPROVED; and it is

FURTHER ORDERED, that Liberty's request to eliminate commercial and industrial customers from the fixed price option program is APPROVED; and it is

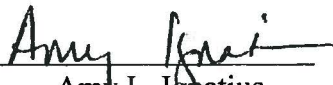
FURTHER ORDERED, that the Petitioner shall cause a summary of this Order *Nisi* to be published once in a statewide newspaper of general circulation or of circulation in those portions of the state where operations are conducted, such publication to be no later than July 18, 2014 and to be documented by affidavit filed with this office on or before August 5, 2014; and it is

FURTHER ORDERED, that all persons interested in responding to this Order *Nisi* be notified that they may submit their comments or file a written request for a hearing which states the reason and basis for a hearing no later than July 25, 2014 for the Commission's consideration; and it is


FURTHER ORDERED, that any party interested in responding to such comments or request for hearing shall do so no later than August 1, 2014; and it is

FURTHER ORDERED, that this Order *Nisi* shall be effective August 8, 2014, unless the Petitioner fails to satisfy the publication obligation set forth above or the Commission provides otherwise in a supplemental order issued prior to the effective date.

By order of the Public Utilities Commission of New Hampshire this tenth day of July,
2014.



Amy L. Ignatius
Chairman




Robert R. Scott
Commissioner



Martin P. Honigberg
Commissioner

Attested by:



Debra A. Howland
Executive Director