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Before the Public Service Commission

of the State of Missouri

Surrebuttal Testimony

of

Blake A. Mertens

July 2017



**Empire District**<sup>™</sup>  
A Liberty Utilities Company

Empire Exhibit No. 105  
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TABLE OF CONTENTS  
SURREBUTTAL TESTIMONY OF  
BLAKE A. MERTENS  
ON BEHALF OF  
THE EMPIRE DISTRICT ELECTRIC COMPANY  
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MISSOURI PUBLIC SERVICE COMMISSION  
CASE NO. EO-2017-0065

SUBJECT	PAGE
I. INTRODUCTION .....	1
II. EXECUTIVE SUMMARY .....	1
III. OPC'S MISREPRESENTATIONS OF EMPIRE'S HEDGING STRATEGY .....	3
IV. COMPARISON AGAINST OTHER MISSOURI IOUS .....	6

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1 **I. INTRODUCTION**

2 **Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

3 A. Blake A. Mertens. My business address is 602 South Joplin Avenue, Joplin,  
4 Missouri.

5 **Q. ARE YOU THE SAME BLAKE MERTENS THAT FILED REBUTTAL**  
6 **TESTIMONY IN THIS CASE ON BEHALF OF THE EMPIRE DISTRICT**  
7 **ELECTRIC COMPANY (“EMPIRE” or “COMPANY”)?**

8 A. Yes.

9 **Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?**

10 A. My testimony will address misrepresentations of Empire’s hedging strategies  
11 presented in the rebuttal testimonies of the Office of the Public Counsel (“OPC”)  
12 witnesses.

13 **II. EXECUTIVE SUMMARY**

14 **Q. PLEASE SUMMARIZE EMPIRE’S POSITIONS IN THIS CASE BEFORE**  
15 **THE MISSOURI PUBLIC SERVICE COMMISSION (“COMMISSION”).**

16 A. Empire employs a balanced approach to managing the risks associated with supplying  
17 fuel to its natural gas generators, a task requiring consideration of many factors. In  
18 this regard, Empire has maintained a consistent and comprehensive Risk Management  
19 Policy (“RMP”) for over 15 years, allowing the Company to address various areas of

1 risk including, but not limited to, price volatility, credit exposure, and volume.  
2 Empire's RMP was designed to (1) provide structure and guidance, (2) allow  
3 flexibility and offer a variety of approved tools and strategies to accommodate  
4 various market conditions, and (3) effectively managing all risks, rather than  
5 singularly focus on price risks. This policy was used to protect Empire from price  
6 volatility and other natural gas risks prior to the implementation of its fuel adjustment  
7 clause ("FAC") and has been kept in place to protect Empire's customers from the  
8 potential of large unpredicted price swings, while overall long-term trends are passed  
9 to customers over the course of time as is evident when the entire 15-year life of the  
10 hedging program is evaluated.

11 No specific instances of imprudence on the part of Empire with regard to its Fuel  
12 Adjustment Clause ("FAC") costs have been identified or quantified by OPC in this  
13 proceeding. Rather, OPC has deemed Empire's entire RMP to be imprudent due to  
14 hedging "losses" incurred during the audit period. This is despite general support of  
15 the policy from Staff and the Commission, and the lack of objection from OPC, in  
16 previous proceedings.

17 In addition, OPC continues to evaluate Empire's hedging program based on perfect  
18 information and identifies hedge transactions as losses, and therefore imprudent, if  
19 the market settled below the transaction price. This oversimplification dismisses the  
20 value and purpose of the hedge, which is to protect against exposure to risk. While a  
21 dollar to dollar comparison may result in the recording of a loss or gain for financial  
22 hedges, Empire's customers continue to benefit from Empire's RMP, which  
23 effectively manages risks and provides price stability. It has never been, nor should it  
24 be, the goal of the RMP to ensure the lowest possible price for fuel, a price no one

1 can predict. Instead, the RMP is designed to identify and mitigate risks including the  
2 impact of price volatility over time. In its analysis, OPC disregards risks associated  
3 with attempts to purchase large volumes on the spot market, such as volume  
4 availability, credit limits, adverse price movement, and credit exposure.

5 For the audit period, as well as the preceding years, Empire has maintained  
6 compliance with its RMP and has effectively managed its natural gas risks through  
7 various market conditions. Empire would have grave concerns regarding the cessation  
8 of its hedging program, as suggested by OPC, and the exposure its customers would  
9 then face.

10 **III. OPC'S MISREPRESENTATIONS OF EMPIRE'S HEDGING STRATEGY**

11 **Q. ON PAGE 4 LINE 17 OF HIS REBUTTAL TESTIMONY, OPC WITNESS**  
12 **JOHN RILEY STATES EMPIRE'S HEDGING STRATEGY IS NOT**  
13 **"PROGRESSIVE DOLLAR COST AVERAGING." DO YOU AGREE?**

14 **A.** No. Although I understand the point Mr. Riley is attempting to make, the term dollar  
15 cost averaging as it relates to commodity hedging may be understood as spreading  
16 hedge positions over time to average the market rather than purchasing in a lump sum  
17 or as needed to meet a predetermined volumetric level. This is simply a semantic  
18 difference likely caused from the difference between dollar cost averaging as it relates  
19 to something akin to retirement stock purchasing and dollar cost averaging as it  
20 relates to commodity hedging. I have also heard this approach referred to as ladder  
21 hedging, installment purchase hedging, and time averaging.

22 **Q. IS THE DIFFERENCE IN "DOLLAR COST AVERAGING"**  
23 **INTERPRETATIONS IMPORTANT AS IT RELATES TO EMPIRE'S FUEL**  
24 **HEDGING PRUDENCY?**

1 A. No. However, Mr. Riley uses this semantic difference as a red herring to misrepresent  
2 Empire's hedging practice of purchasing much of its hedging volume in traditionally  
3 low-cost months as a method to keep costs low. What Mr. Riley describes on page 4  
4 lines 15-17 of his rebuttal testimony is exactly the practice that Empire engages in  
5 and was described on page 4 lines 16-22 in my surrebuttal testimony in Commission  
6 File No. ER-2016-0023. If Mr. Riley would prefer to describe Empire's hedging  
7 method using a different term for his understanding then that is his prerogative, but  
8 that does not mean that Empire is not taking advantage of seasonal pricing to  
9 purchase natural gas hedges.

10 **Q. WHAT ISSUES DO YOU TAKE WITH MR. RILEY'S AND MR.**  
11 **HYNEMAN'S DESCRIPTION OF "LOSSES" AS IT RELATES TO**  
12 **EMPIRE'S HEDGING ACTIVITIES?**

13 A. Simply put, it attempts to evaluate the efficacy of a fuel hedging program simply by  
14 whether the positions beat the market. As indicated in articles cited by Mr. Hyneman  
15 and Mr. Riley and identified in my rebuttal testimony, prospective and fair analysis of  
16 decisions made require a lack of perfect future information. Mr. Hyneman and Mr.  
17 Riley continually pointing to "losses" incurred by Empire during the audit period as  
18 proof of imprudence is evidence in itself that they only take issue with Empire's  
19 hedging activities because Empire did not beat the market. With the exception of Mr.  
20 Riley mistakenly identifying the time frame of a few hedge transactions, as discussed  
21 by Mr. Doll on page 3 of his rebuttal testimony in this case, Mr. Riley and Mr.  
22 Hyneman have not even alleged imprudence of any particular transaction Empire  
23 executed during this audit.

1 Q. PLEASE CONTINUE WITH YOUR EXPLANATION OF THE ERRORS IN  
2 MR. RILEY'S AND MR. HYNEMAN'S DESCRIPTION OF "LOSSES" AS IT  
3 RELATES TO EMPIRE'S HEDGING ACTIVITIES.

4 A. The analogy Mr. Hyneman uses on page 19, lines 22-24, of his rebuttal testimony  
5 vastly oversimplifies this issue. I would expect Mr. Hyneman would see no value in  
6 earthquake insurance so long as no earthquake occurred while he held the policy. The  
7 value of the hedge, not unlike the earthquake insurance, is to mitigate exposure in the  
8 event of a potentially adverse situation. Hedging is not least cost planning (as  
9 acknowledged by the Commission in Rule 4 CSR 240-40.018), rather it is risk  
10 reduction and provides benefits to customers. If the adverse situation does not occur,  
11 the value of the protection must not be devalued. I understand the concern  
12 individuals may have when the market price settles below the transaction price, but  
13 commodity hedging is not about trying to consistently beat the market. Instead, as  
14 acknowledged by the Commission, it is to protect customers and mitigate risk  
15 associated with adverse outcomes. Empire's hedging strategy achieves these  
16 objectives. Empire witness Rob Sager provides additional information on the subject  
17 of losses in his surrebuttal testimony.

18 Q. DO YOU TAKE ANY ISSUE WITH MR. RILEY'S ATTEMPTS TO CLARIFY  
19 A POINT MADE IN YOUR REBUTTAL TESTIMONY REGARDING  
20 EMPIRE'S HEDGING ACTIVITY IN THE SPRING AND FALL?

21 A. Yes. On page 6, line 11, Mr. Riley explains that my rebuttal testimony confuses  
22 transacting in October and November for natural gas with transacting for October and  
23 November. I did not confuse nor mislead this issue. Empire does endeavor to transact  
24 in the shoulder months when forward prices are often times lower for all months, as

1 denoted on page 4 of my surrebuttal testimony in ER-2016-0023 lines 18-22.  
2 Furthermore, Empire rarely purchases natural gas for the shoulder months as it is  
3 difficult to estimate exactly how much natural gas generation will be needed due to  
4 low load requirements. From Mr. Riley's answer on page 6 lines 11-21 it is difficult  
5 to determine whether he would advocate for transacting for October and November;  
6 and although he does indicate that natural gas prices are often cheaper in October and  
7 November, he ought to be made aware that the forward prices also reflect the cheaper  
8 seasonal cost. In short, there are no strategic gains to be had by transacting for  
9 October and November as the forward prices generally reflect these lower prices.  
10 Furthermore, it is difficult to understand Mr. Riley's confusion as to Empire's  
11 seasonal strategy, as my surrebuttal testimony in ER-2016-0023, that he sources in his  
12 rebuttal testimony, continues beyond his quote attributed on page 6 lines 7-10 to  
13 explain that transactions were executed in October and November, not for October  
14 and November. This confusion is a straw man tactic to heap criticism on a strategy  
15 never espoused by Empire as a means to delegitimize Empire's credibility and  
16 hedging strategy.

17 **IV. COMPARISON AGAINST OTHER MISSOURI IOUS**

18 **Q. WHAT CONCLUSIONS DOES MR. RILEY MAKE WHEN JUXTAPOSING**  
19 **EMPIRE'S FUEL HEDGING WITH THAT OF KANSAS CITY POWER &**  
20 **LIGHT (KCPL), KCPL GREATER MISSOURI OPERATIONS COMPANY**  
21 **(GMO), AND AMEREN?**

22 **A.** Mr. Riley concludes that KCPL and GMO both responded to the natural gas market  
23 by ceasing hedging activity.

24 **Q. IS THIS STATEMENT TRUE?**

1 A. I cannot speak to the provenance of those decisions, but it does appear they were the  
2 result of negotiations in rate cases, rather than unprovoked actions from the  
3 companies, like Mr. Riley would lead you to believe from his phrasing on Page 12  
4 lines 6-7 of his rebuttal testimony.

5 **Q. WHEN KCPL AND GMO AGREED TO CEASE THEIR HEDGING**  
6 **PROGRAMS, WERE ANY HEDGING LOSSES PAID BACK TO THEIR**  
7 **CUSTOMERS?**

8 A. I can only be certain as to what is publicly available with respect to their respective  
9 cases, and it does not appear that there were any disallowances resulting in refunds.  
10 Furthermore, the open future positions appear to have been liquidated and passed  
11 through the fuel adjustment clauses.

12 **Q. WHAT ABOUT AMEREN'S HEDGING PROGRAM?**

13 A. Although I don't have many details as to Ameren's hedging policy or technique, it is  
14 worthy to note that in 2016, less than 1% of Ameren's energy generated was provided  
15 by natural gas fired generation.

16 **Q. WHY IS IT IMPORTANT TO NOTE THAT AMEREN DOES NOT HAVE**  
17 **MUCH NATURAL GAS-POWERED GENERATION FOR ITS MISSOURI**  
18 **ELECTRIC CUSTOMERS?**

19 A. The risk exposure is completely different for generation fleets with small percentages  
20 of natural gas turbines. 0.7% of Ameren's Missouri 2016 electric generation is  
21 sourced from natural gas generation, meanwhile Empire's June 2017 twelve-month-  
22 ending generation supplied by natural gas generation was approximately 40% of its  
23 total generation. This difference is important, in that if Ameren were to not hedge  
24 expected natural gas burns, by nature of its generation mix, its customers would not

1 likely be impacted to the degree of Empire's customers. It's important to note that an  
2 increase in natural gas prices will cause market price increases which will impact all  
3 electric customers, but the point being made is that a utility that supplies nearly half  
4 of its generation from natural gas is likely to be impacted more than a utility that  
5 sources less than 1% of its generation from natural gas.

6 **Q. ARE THERE ANY OTHER IMPORTANT POINTS TO MAKE REGARDING**  
7 **EMPIRE'S HEDGING WHEN COMPARED WITH THE OTHER MISSOURI**  
8 **UTILITIES?**

9 A. Yes. Throughout Mr. Riley's and Mr. Hyneman's testimonies they point to other  
10 utilities hedging programs that have been modified or ceased recently as evidence of  
11 this tidal wave of reaction to natural gas prices that they insist Empire has ignored.  
12 Most often, the utilities they reference are natural gas distribution companies. Since  
13 Mr. Hyneman and Mr. Riley are comfortable using natural gas distribution companies  
14 as proxies for the natural gas hedging activities of electric companies, it may be  
15 important to note that Ameren Missouri's natural gas distribution company indicated  
16 in their 2016 10K that they have price hedged 73% of their 2017 expected  
17 requirements by the end of 2016. This is just one more example of OPC refusing to  
18 provide a complete and unbiased analysis and rather choosing to selectively cull  
19 information in an attempt to confirm their claims of imprudence.

20 **Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?**

21 A. Yes.

