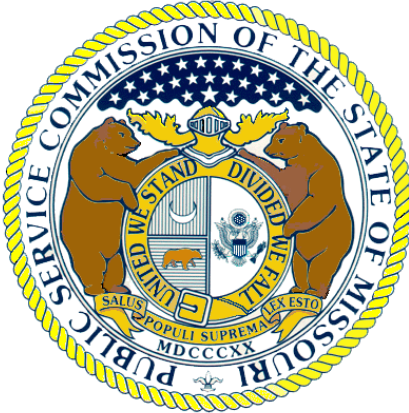


BEFORE THE PUBLIC SERVICE COMMISSION OF THE STATE OF MISSOURI



In the Matter of the Third Prudence Review of)
Costs Subject to the Commission-Approved Fuel)
Adjustment Clause of KCP&L Greater Missouri)
Operations Company)

File No. EO-2011-0390

REPORT AND ORDER

Issue Date: September 4, 2012

Effective Date: September 14, 2012

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OF THE STATE OF MISSOURI**

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APPEARANCES

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APPEARING FOR AG PROCESSING, INC.:

Stuart W. Conrad, Finnegan, Conrad & Peterson, L.C., 3100 Broadway, Suite 1209, Kansas City, Missouri 64111.³

APPEARING FOR THE OFFICE OF THE PUBLIC COUNSEL AND THE PUBLIC:

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¹ Counsel for Dogwood sent the RLJ an e-mail request to be excused from the evidentiary hearing on May 29, 2012, which was granted by the RLJ. This was announced at the hearing. Transcript, p. 25.

² Counsel for SIEUA appeared at the evidentiary hearing, but did not file a post-hearing brief, a reply brief, or proposed findings of fact and proposed conclusions of law.

³ Counsel for AG Processing, Inc. appeared at the evidentiary hearing, but did not file a post-hearing brief, a reply brief, or proposed findings of fact and proposed conclusions of law.

⁴ Public Counsel entered an appearance at the evidentiary hearing, where upon he asked to be excused. The request was granted. Transcript, pp. 25-26. Public Counsel did not file a post-hearing brief, a reply brief, or proposed findings of fact and proposed conclusions of law.

APPEARING FOR THE STAFF OF THE MISSOURI PUBLIC SERVICE COMMISSION:

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REGULATORY LAW JUDGE: Harold Stearley, Deputy Chief Regulatory Law Judge

REPORT AND ORDER

I. Procedural History

On June 9, 2011, the Staff of the Missouri Public Service Commission filed a notice that it had started its third prudence audit of KCP&L Greater Missouri Operations Company's ("GMO") fuel adjustment clause ("FAC"). The Commission issued notice, set a deadline for intervention requests and acknowledged the timeline for completion of the audit and for requests for a hearing pursuant to Commission Rule 4 CSR 240-20.090. On November 29, 2011, after having received an extension of time, Staff filed its report. In its report, Staff alleged that GMO had acted imprudently in association with its hedging future purchases of spot market power by buying options to purchase natural gas. Staff requests the Commission to order GMO to refund monies that it believes GMO has over-collected in its FAC in relation to the alleged imprudent actions.

On December 5, 2011, GMO requested a hearing. A procedural schedule was set that culminated with convening an evidentiary hearing on June 5-6, 2012,⁵ wherein the Commission admitted the testimony of 9 witnesses and received 38 exhibits into evidence. The parties filed post-hearing briefs, proposed findings of fact and conclusions of law and reply briefs. The case was deemed submitted for the Commission's decision on July 27, 2012 when the Commission closed the record.⁶

⁵ EFIS Docket Entry No. 23, *Order Setting Procedural Schedule*, effective December 21, 2011. EFIS is the Commission's Electronic Information and Filing System.

⁶ Reply briefs were filed on this date, and this was the last scheduled filing for this matter. "The record of a case shall stand submitted for consideration by the commission after the recording of all evidence or, if applicable, after the filing of briefs or the presentation of oral argument." Commission Rule 4 CSR 240-2.150(1).

II. Findings of Fact and Conclusions of Law

A. The Parties

Findings of Fact:

1. **KCP&L Greater Missouri Operations Company (“GMO”)** is a Delaware corporation authorized to do business in Missouri with its principal office and place of business located at 1200 Main Street, Kansas City, Missouri 64105. GMO is in the business of owning, controlling and operating electric plant, as defined at § 386.020(14), RSMo, used for generating, transmitting and distributing electricity for sale to the public for light, heat and power. According to Great Plains Energy, Inc.’s (“GPE”)⁷ Form 10-K filed with the United States Securities and Exchange Commission in February, 2010, GMO is “an integrated, regulated electric utility that primarily provides electricity to customers in the state of Missouri [and] also provides regulated steam service to certain customers in the St. Joseph, Missouri area.” GMO has approximately 312,000 customers, including 273,500 residential customers, 38,000 commercial customers, and some 500 industrial, municipal, and other utility customers. To serve these customers, GMO owns 2,182 Megawatt (“MW”) of generating capacity, of which 1,025 MW is coal capacity, 1,094 MW is natural gas-fired combustion turbine capacity, and 63 MW is oil-fired combustion turbine capacity.⁸

2. **Dogwood Energy, L.L.C.** (“Dogwood”) is a limited liability company organized and existing under the laws of the State of Delaware and authorized to conduct business in

⁷ GPE is GMO’s parent company. See File No. EM-2007-0374, Report and Order, effective July 11, 2008.

⁸ EFIS Docket Entry No. 66, *Joint Stipulation of Non-Disputed Material Facts*, filed on June 1, 2012. In Case No. EN-2009-0164 the Commission recognized the name change of Aquila, Inc. d/b/a KCP&L Greater Missouri Operations Company to KCP&L Greater Missouri Operations Company. At different points in time the company now named KCP&L Greater Missouri Operation Company was known as, or did business in Missouri as, Aquila, Inc., Aquila Networks-MPS, Aquila Networks-L&P and KCP&L Greater Missouri Operations Company.

the State of Missouri. Dogwood owns the 650 MW combined cycle generating facility located in Pleasant Hill, Missouri, which is within the service territory of GMO.⁹

3. AG Processing, Inc. (“AGP”) is an agricultural cooperative and a large manufacturer and processor of soybean meal, soy-related food products, and other grain products throughout the central and upper Midwest, including the State of Missouri. AGP is the largest cooperative soybean processing company in the world, the third-largest supplier of refined vegetable oil in the United States and the third-largest commercial feed manufacturer in North America. AGP operates a major processing facility in St. Joseph, Missouri.¹⁰

4. Sedalia Industrial Energy Users Association (“SIEUA”) is an unincorporated voluntary association consisting of large commercial and industrial users of natural gas and electricity in Sedalia, Missouri and in the surrounding area.¹¹

5. The Office of the Public Counsel (“Public Counsel”) “may represent and protect the interests of the public in any proceeding before or appeal from the public service

⁹ EFIS Docket Entry No. 4, *Application to Intervene*, filed June 29, 2011.

¹⁰ In re Aquila, Inc., *Report and Order*, effective May 27, 2007, File No. ER-2007-0004, 2007 WL 1663103, 6, 257 P.U.R.4th 424 (Mo. P.S.C. 2007). GMO’s FAC was established in File Number ER-2007-0004. Commission Rule 4 CSR 240-3.161(10) provides that parties to the rate case in which the Commission established GMO’s fuel adjustment clause are automatically parties to this prudence audit, without the necessity of having to apply for intervention. AGP was made an automatic party pursuant to this rule.

¹¹ *Id.* As with AGP, SIEUA was made an automatic party pursuant to Commission Rule 4 CSR 240-3.161(10). Members of SIEUA are as follows: Pittsburgh Corning Corporation, a manufacturer of cellular glass insulation at its manufacturing facility in Sedalia, Missouri; Waterloo Industries, a manufacturer of tool storage equipment in Sedalia, Missouri; Hayes-Lemmerz International, a manufacturer of automobile wheels in Sedalia, Missouri; EnerSys Inc. a manufacturer of industrial batteries in Warrensburg, Missouri; Alcan Cable Co. a manufacturer of aluminum electrical conductors in Sedalia, Missouri; Gardner Denver Corporation a manufacturer of industrial compressors and blowers in Sedalia, Missouri; American Compressed Steel Corporation, a scrap metal recycling facility near Sedalia, Missouri; and ThyssenKrupp Stahl Company, a manufacturer of specialty and precision aluminum castings in Warrensburg and Kingsville, Missouri. Counsel for SIEUA confirmed that its members remain essentially the same, except for the change of one of the member’s names. Transcript, pp. 153-154.

commission.”¹² Public Counsel “shall have discretion to represent or refrain from representing the public in any proceeding.”¹³

6. The Staff of the Missouri Public Service Commission (“Staff”) is a party in all Commission investigations, contested cases and other proceedings.¹⁴ Staff is represented by Staff Counsel.¹⁵

7. Automatic Parties: Pursuant to Commission Rule 4 CSR 240-3.161(10), parties to the rate case in which the Commission established GMO’s Fuel Adjustment Clause are automatically made parties to this action without the necessity of applying for intervention.¹⁶ The majority of those parties, from File Number ER-2007-0004, withdrew from this action.¹⁷ Two of the automatic parties did not withdraw - the County of Jackson, Missouri and the Federal Executive Agencies. These two parties did not participate in any manner throughout this proceeding and are subject to dismissal.¹⁸

Conclusions of Law - Jurisdiction, Burden of Proof and Prudence Standard:

Jurisdiction

GMO is an electric corporation pursuant to section 386.020(15), RSMo Supp. 2010,

¹² Section 386.710(2), RSMo 2000; Commission Rules 4 CSR 240-2.010(15) and 2.040(2).

¹³ Section 386.710(3).

¹⁴ Section 386.250(7) grants the Commission all necessary powers, express or implied, in the Public Service Commission Law to carry out its statutory mandates. Implied powers include employing an independent Staff. Commission employees (Staff) are also expressly mentioned in Sections 386.135, .150, .200, .240, .320, .480 and Section 393.140, RSMo 2000.

¹⁵ Commission Rules 4 CSR 240-2.010(21) and 2.040(1).

¹⁶ EFIS Docket Entry Number 3, *Order Acknowledging Automatic Parties*, issued and effective on June 23, 2011.

¹⁷ EFIS Docket Entry Number 22, *Order Granting Leave to Withdraw*, issued and effective on December 21, 2012; EFIS Docket Entry Number 27, *Order Granting Leave to Withdraw*, issued and effective on January 9, 2012. The automatic parties that withdrew were: the Missouri Department of Natural Resources, the City of St. Joseph, the Consumers Council of Missouri, AARP, the City of Kansas City, and Union Electric Company d/b/a Ameren Missouri.

¹⁸ Commission Rules 4 CSR 240-2.090 and .116.

and subsequently is a public utility within the meaning of 386.020(43), RSMo Supp. 2010.¹⁹ As a public utility, GMO is subject to the personal jurisdiction, supervision, control and regulation of the Commission under Chapters 386 and 393 of the Missouri Revised Statutes.²⁰ The Commission's subject matter jurisdiction over a FAC request is established under Section 386.266, RSMo Supp. 2010.

Burden of Proof and Presumption of Prudence

When Section 386.266.4(4), RSMo Supp. 2010, creates a "prudence review" it does not define who has the burden of proof. However, it is well settled law that in rate cases, where a utility has the burden of proof to justify its proposed rate increase, there is initially a presumption that its expenditures, comprising one component of its revenue requirement, are prudent.²¹ This presumption can be rebutted upon a showing of serious doubt as to the prudence of the expenditure, at which point the utility must dispel this doubt and prove the questioned expenditure is prudent.²² This presumption regarding expenses; however, does not change the fact that the utility company, in that rate case, retains the burden of proof to establish that its proposed rates are just and reasonable. But this is not a rate case wherein GMO came to the Commission bearing the burden of proof to set just and reasonable rates.

To properly examine the interaction of the burden of proof and the presumption of prudence for Staff's prudence review of GMO's hedging costs, the Commission must bear

¹⁹ The parties have stipulated to this. EFIS Docket Entry No. 66, *Joint Stipulation of Non-Disputed Material Facts*, filed on June 1, 2012.

²⁰ EFIS Docket Entry No. 66, *Joint Stipulation of Non-Disputed Material Facts*, filed on June 1, 2012.

²¹ *State ex rel. Public Counsel v. Public Service Comm'n*, 274 S.W.3d 569, 586 (Mo. App. 2009).

²² *Id.*; *State ex rel. Associated Natural Gas Company v. Public Service Commission of the State of Missouri*, 954 S.W.2d 520, 528 (Mo.App.1997); *In the Matter of Union Electric Company*, 27 Mo.P.S.C. (N.S.) 183, 193 (1985) (*quoting Anaheim, Riverside, etc. v. Federal Energy Regulatory Commission*, 669 F.2d 779, (D.C. Cir. 1981)).

in mind that the burden of proof has two parts: the burden of production and the burden of persuasion.²³ “The burden of production requires the party to introduce enough evidence on an issue to have that issue decided by a fact-finder.”²⁴ “The burden of persuasion requires the party to convince the fact-finder to favor that party.”²⁵ “A presumption alters who has these various burdens, shifting them from one party to another.”²⁶

The general rule in Missouri is that “when a party against whom a presumption operates introduces evidence controverting a presumed fact, that fact must then be determined from the evidence in the case as if there never was a presumption.”²⁷ This rule only shifts the burden of production, not the burden of persuasion.²⁸ GMO’s burden, if Staff can demonstrate a serious doubt as to the prudence of its hedging costs, becomes one of production and not persuasion. Consequently, Staff maintains the burden of persuasion and the overall burden of proof throughout this proceeding.²⁹

The Commission’s Staff has levied allegations of imprudence against GMO, and it is Staff that is requesting relief in this matter. As the charging party, Staff must first demonstrate serious doubt as to the prudence of GMO hedging costs in order to overcome the presumption of prudence and in order for the claim of imprudence to survive a summary

²³ *Byous v. Missouri Local Government Employees Retirement System Bd. of Trustees*, 157 S.W.3d 740, 745 (Mo. App. 2005).

²⁴ *Id.*

²⁵ *Id.*

²⁶ *Id.*

²⁷ *Id.* at 746.

²⁸ *Id.*

²⁹ *Raisher v. Director of Revenue*, 276 S.W.3d 362, 364 (Mo. App. 2009); *Byous v. Missouri Local Government Employees Retirement System Bd. of Trustees*, 157 S.W.3d 740, 746 (Mo. App. 2005); *Middlemas v. Director of Revenue, State of Missouri*, 159 S.W.3d 515, 517 (Mo. App. 2005) (overruled on other grounds in *Hurt v. Director of Revenue*, 291 S.W.3d 251 (Mo. App. 2009); *R.T. French Co. v. Springfield Mayor’s Comm’n on Human Rights and Community Relations*, 650 S.W.2d 717, 722 (Mo. App. 1983).

determination.³⁰ In order to demonstrate serious doubt, Staff must introduce “substantial controverting evidence” to rebut the presumption of prudence.³¹ “Substantial evidence is that evidence which, if true, has probative force upon the issues and from which the trier of fact can reasonably decide the case on the fact issues.”³²

Should Staff succeed with overcoming the presumption of prudence, then, although GMO has a burden of production to dispel any serious doubt, Staff still bears the burden of proof to conclusively establish imprudence on GMO’s part.³³ In order to carry its burden of proof, Staff must meet the preponderance of the evidence standard.³⁴ This is the minimum burden in a civil case, and in order to meet this standard, Staff must convince the

³⁰ If the presumption is not rebutted, then the issue is never reached. *Jones v. Jones*, 10 S.W.3d 528, 535-536 (Mo. App. 1999). If the presumption is not rebutted, GMO would not have to produce any evidence.

³¹ The Missouri Supreme Court “set forth the general rule that when a presumption is operating against a party, that party need only introduce substantial controverting evidence to rebut that presumption.” *Hoit v. Rankin*, 320 S.W.3d 761, 773 (Mo. App. 2010). See also *Wills v. Townes Cadillac–Oldsmobile, Inc.*, 490 S.W.2d 257, 260 (Mo. banc 1973) and *Michler v. Krey Packing Co.*, 363 Mo. 707, 253 S.W.2d 136, 140 (1952).

³² *Hermel, Inc. v. State Tax Commission*, 564 S.W.2d 888, 895 (Mo. banc 1978).

³³ Even if a presumption is overcome “the burden of proof on the facts and inferences would still rest on petitioner, for it is the moving party seeking affirmative relief.” *Cupples Hesse Corp. v. State Tax Commission*, 329 S.W.2d 696, 702 (Mo. 1959).

³⁴ *Bonney v. Environmental Engineering, Inc.*, 224 S.W.3d 109, 120 (Mo. App. 2007); *State ex rel. Amrine v. Roper*, 102 S.W.3d 541, 548 (Mo. banc 2003); *Rodriguez v. Suzuki Motor Corp.*, 936 S.W.2d 104, 109-110 (Mo. banc 1996), citing to, *Addington v. Texas*, 441 U.S. 418, 423, 99 S.Ct. 1804, 1808, 60 L.Ed.2d 323, 329 (1979).

The validity of the standard of proof a state imposes upon a given judicial proceeding depends upon whether the quantum satisfies the constitutional minimum of fundamental fairness. The least degree of proof due process tolerates depends upon the gravity of the private as counterpoised against the public interests affected and reflects the communal judgment as to how the risk of error shall be distributed between the litigants. The function of the standard of proof as embodied in due process, therefore, is to instruct the factfinder as to “the degree of confidence our society thinks he should have in the correctness of factual conclusions for a particular type of adjudication.” Thus, the standard of proof not only allocates the risk of error between the litigants, but also speaks the relative importance of the ultimate decision. In a criminal proceeding, the transcendent interest of an accused to personal liberty incurs the demand of due process that to minimize the risk of error of the conviction of an innocent person, the other party prove guilt of the accused beyond a reasonable doubt. In the usual civil litigation only private interests are involved, the societal concern in the outcome is minimal, the litigants share the risk of error almost equally—and the factfinder comes to decision on a preponderance of the evidence. (Internal citations omitted). *In re Monnig*, 638 S.W.2d 782, 785 (Mo. App. 1982).

Commission it is “more likely than not” that GMO engaged in imprudent conduct related to its allegation that GMO imprudently used natural gas futures contracts as a means of mitigating risk associated with the costs of natural gas fuel for generation and spot market purchased power.³⁵ It is important to recognize the proper standard for the burden of proof, because there is no burden of proof less than the preponderance of the evidence standard called “serious doubt” that would comply with the Constitutional requirements of due process.³⁶

Staff’s second set of allegations do not refer to alleged imprudence with incurring hedging costs, the cause of action constituting the “prudence review.” These allegations assert violations of: (1) GMO’s accounting practices in relation to an Accounting Authority Order (“AAO”) granted by the Commission;³⁷ (2) the Commission rules pertaining to the Uniform System of Accounts (“USOA”),³⁸ and, (3) GMO’s FAC tariff.³⁹ Staff’s allegations of these violations constitute a complaint, not a “prudence review.”

³⁵ *Byous v. Missouri Local Government Employees Retirement System Bd. of Trustees*, 157 S.W.3d 740, 746 (Mo. App. 2005); *Holt v. Director of Revenue, State of Mo.*, 3 S.W.3d 427, 430 (Mo. App. 1999); *McNear v. Rhoades*, 992 S.W.2d 877, 885 (Mo. App. 1999); *Rodriguez*, 936 S.W.2d at 109 -111; *Wollen v. DePaul Health Center*, 828 S.W.2d 681, 685 (Mo. banc 1992).

³⁶ Missouri courts have rejected other attempts at lowering this standard to only a showing of “probable cause” or “credible evidence.” *Jamison v. Dept. of Social Services, Div. of Family Services*, 218 S.W.3d 399, 411 -412 (Mo. banc 2007).

³⁷ Staff Witness Hyeman has alleged that GMO seeking inclusion of the resulting hedging gains or losses in its FAC in its fifth, sixth and seventh accumulation period Cost Adjustment Factors (“CAFs”), and the manner in which the hedging gains or losses have been accounted for (i.e. account 547 versus 555), violated the terms of the Stipulation and Agreement in ER-2005-0436 (which included an AAO) and thus violated the order approving it. (Hyeman Rebuttal pp 22-24).

³⁸ Staff Witness Eaves has alleged that GMO’s booking of its hedging gains and losses associated with on-peak purchased power in Account 547 is a violation of Commission Rule 4 CSR 240-20.030 (Uniform System of Accounts) because all costs incurred for purchased power - those gains and losses, according to Mr. Eaves, should be recorded in Account 555. (Eaves Direct pp 10-11).

³⁹ Staff Exh. 2, Mantle Rebuttal, pp. 10-11; Staff Exh. 1, Eaves, Direct/Rebuttal, pp. 5-11.

In a complaint case the burden of proof lies solely with the complainant and neither the burden of production, nor the burden of persuasion, shifts.⁴⁰ The complaint portion of Staff's allegations carry with it the burden that Staff prove, at the preponderance of the evidence standard, that it is more likely than not that GMO violated the AAO, violated the rules on the USOA and violated the FAC tariff.

Finally, Article V, Section 18, of the Missouri Constitution requires the Commission to support its findings of fact and conclusions of law with substantial and competent evidence on the record as a whole. Consequently, for Staff to meet its burden of proof at the preponderance of the evidence standard, for its allegation of imprudence and its complaint allegations, it must do so with substantial and competent evidence.

Prudence Standard

The "prudence standard" further qualifies how Staff must meet its burden of proof in relation to its allegations. To determine if GMO's conduct was imprudent, the Commission looks at whether the utility's conduct was reasonable at the time, under all of the circumstances, considering that the company had to solve its problem prospectively rather than in reliance on hindsight.⁴¹ More specifically, Staff must prove, by the preponderance of the evidence, that GMO's conduct was unreasonable at the time, under all of the circumstances, from a prospective viewpoint, not in hindsight. Additionally, "[i]f the company has exercised prudence in reaching a decision, the fact that external factors

⁴⁰ *State ex rel. GS Technologies Operating Co., Inc. v. Public Service Comm'n of State of Mo.*, 116 S.W.3d 680, 695 (Mo. App. 2003).

⁴¹ *State ex rel. GS Technologies Operating Co., Inc. v. Public Service Comm'n*, 116 S.W.3d 680, 694 (Mo. App. 2003); *State ex rel. Associated Natural Gas Co. v. Public Service Comm'n*, 954 S.W.2d 520, 528 -529 (Mo. App. 1997).

outside the company's control later produce an adverse result do not make the decision extravagant or imprudent."⁴²

In order for the Commission to direct a refund for any alleged imprudently incurred costs, it must apply a two-part test. The Commission must find both that: (1) the utility acted imprudently when incurring those costs and, (2) such imprudence resulted in harm to the utility's ratepayers.⁴³ Harm to ratepayers in relation to imprudently incurred costs requires proof of causation, i.e., that the increased costs recovered from the ratepayers were causally related to the alleged imprudent action, and evidence as to the amount those expenditures would have been if the utility acted prudently.⁴⁴

B. Witnesses

Findings of Fact:

8. The Commission finds that any given witness's qualifications and overall credibility are not dispositive as to each and every portion of that witness's testimony. The Commission gives each item or portion of a witness's testimony individual weight based upon the detail, depth, knowledge, expertise and credibility demonstrated with regard to that specific testimony. Consequently, the Commission will make specific weight and credibility decisions throughout this order as to specific items of testimony as is necessary.

⁴² *State ex rel. Missouri Power and Light Co. v. Public Service Comm'n*, 669 S.W.2d 941, 947 -948 (Mo. App. 1984).

⁴³ *State ex rel. Associated Natural Gas Co. v. Public Service Comm'n*, 954 S.W.2d 520, 529 -530 (Mo. App. 1997). "Ultimately, the PSC's standards for the recoverability of ANG's costs arise from the statutory mandate that all charges made by a gas company be just and reasonable. Section 393.130.1. It would be beyond this statutory authority for the PSC to make a decision on the recoverability of costs, based upon a prudency analysis of gas purchasing practices, without reference to any detrimental impact of those practices on ANG's charges to its customers, such as evidence that the costs which ANG is seeking to pass on to its customers are unjustifiably higher than if different purchasing practices had been employed. Therefore the PSC's decision denying recovery of half the premium of the SEECO contract must be deemed unlawful." *Id.*

⁴⁴ *Id.*

9. Any finding of fact reflecting the Commission has made a determination between conflicting evidence is indicative that the Commission attributed greater weight to that evidence and found the source of that evidence more credible and more persuasive than that of the conflicting evidence.

Conclusions of Law – Witness Testimony:

Witness credibility is solely a matter for the fact-finder, “which is free to believe none, part, or all of the testimony.”⁴⁵ An administrative agency, as fact-finder, also receives deference when choosing between conflicting evidence.⁴⁶ In fact, the Commission “may disregard and disbelieve evidence which in its judgment is not credible even though there is no countervailing evidence to dispute or contradict it.”⁴⁷

Appellate courts also must defer to the expertise of an administrative agency when reaching decisions based on technical and scientific data.⁴⁸ And an agency has reasonable latitude concerning what methods and procedures to adopt in carrying out its statutory obligations.⁴⁹ Consequently, it is the agency that decides what methods of expert analysis are acceptable, proper, and credible while satisfying its fact-finding mission to ensure the evidentiary record, as a whole, is replete with competent and substantial evidence to support its decisions.⁵⁰

⁴⁵ *State ex rel. Public Counsel v. Missouri Public Service Comm'n*, 289 S.W.3d 240, 247 (Mo. App. 2009).

⁴⁶ *State ex rel. Missouri Office of Public Counsel v. Public Service Comm'n of State*, 293 S.W.3d 63, 80 (Mo. App. 2009).

⁴⁷ *Veal v. Leimkuehler*, 249 S.W.2d 491, 496 (Mo. App. 1952), citing to *State ex rel. Rice v. Public Service Commission*, 359 Mo. 109, 116-117, 220 S.W.2d 61, 65 (Mo. banc 1949).

⁴⁸ *Citizens for Rural Preservation, Inc. v. Robinett*, 648 S.W.2d 117, 128 (Mo. App. 1982), citing to *Smithkline Corp. v. FDA*, 587 F.2d 1107, 1118 (D.C.Cir.1978); *Cayman Turtle Farm, Ltd. v. Andrus*, 478 F.Supp. 125, 131 (D.C.Cir.1979).

⁴⁹ *Id.* citing to *Natural Resources Defense Council, Inc. v. Nuclear Regulatory Comm'n*, 539 F.2d 824, 838 (2d Cir.1976), *vacated for mootness*, 434 U.S. 1030, 98 S.Ct. 759, 54 L.Ed.2d 777 (1978).

⁵⁰ *Id.*

Additionally, the Commission is entitled to interpret any of its own orders in prior cases as they may relate to the present matter.⁵¹ When interpreting its own orders, and ascribing a proper meaning to them, the Commission is not acting judicially, but rather as a fact-finding agency.⁵² Consequently, factual determinations made with regard to the Commission's prior orders receive the same deference shown in relation to all of the Commission's findings of fact. Indeed, even where there are mixed questions of law and fact, a reviewing court views the evidence in the light most favorable to the Commission's decision.⁵³

C. GMO's FAC and Its Accumulation Periods

Findings of Fact:

10. The Commission approved the acquisition of Aquila, Inc. ("Aquila") by Great Plains Energy, Inc. ("GPE") and, subsequently, Aquila was renamed KCP&L Greater Missouri Operations Company ("GMO" or "Company"). This acquisition became effective July 14, 2008. The Commission first authorized a Fuel Adjustment Clause ("FAC") for Aquila in Case No. ER-2007-0004 on May 27, 2007. Following GPE's acquisition of Aquila and the renaming of Aquila to GMO, the Commission has approved continuation of the FAC with modifications in its orders in GMO's general rate cases, File Numbers ER-2009-0090 and ER-2010-0356.⁵⁴

⁵¹ *State ex rel. Beaufort Transfer Co. v. Public Service Commission of Missouri*, 610 S.W.2d 96, 100 (Mo. App. 1980). *State ex rel. Missouri Pacific Freight Transport Co. v. Public Service Commission*, 312 S.W.2d 363, 368 (Mo. App. 1958); *State ex rel. Orscheln Bros. Truck Lines v. Public Service Commission*, 110 S.W.2d 364, 366 (1937).

⁵² *Id.*

⁵³ *State ex rel. Coffman v. Pub. Serv. Comm'n*, 121 S.W.3d 534, 541-542 (Mo. App. 2003). See also *State ex rel. Inter-City Beverage Co., v. Mo. Pub. Serv. Comm'n*, 972 S.W.2d 397, 401 (Mo. App. 1998).

⁵⁴ EFIS Docket Entry No. 66, *Joint Stipulation of Non-Disputed Material Facts*, filed on June 1, 2012. Staff Exh. 16, [Third] Prudence Review of Costs Related to the Fuel Adjustment Clause for the Electric Operations of KCP&L Greater Missouri Operations Company, pp. 1-2. Before it was acquired by GPE, GMO was named Aquila, Inc., and before that, Utilicorp United, Inc. *Id.*

11. A FAC is defined by statute as “an interim energy charge, or periodic rate adjustments outside of general rate proceedings to reflect increases and decreases in its prudently incurred fuel and purchased-power costs, including transportation.”⁵⁵ It is also described as a “mechanism that allows an electrical utility to make periodic rate adjustments outside of a general rate proceeding that accords with changes in its prudently incurred fuel and purchased-power costs.”⁵⁶

12. The Commission-authorized FAC for GMO included two annual price adjustments and a 95% pass-through cap to encourage efficient management. Each 6-month adjustment period is referred to as an "accumulation period." These features continue to characterize GMO's FAC.⁵⁷

13. GMO's FAC allows GMO to recover from its ratepayers 95% of its prudently incurred variable fuel and purchased power costs above a base amount that is set in a general rate case. Likewise, 95% of any reduction of GMO's fuel and purchased power costs below the base amount is returned to ratepayers through the FAC.⁵⁸

14. GMO's fuel and purchased power costs are accumulated during six-month accumulation periods; each of which is followed by a 12-month recovery period during which the under-recovery or over-recovery is flowed through to ratepayers by an increase or decrease in the Cost Adjustment Factor ("CAF").⁵⁹

15. Adjustments to the CAF are designed to offset the under-recovery or over-recovery by the end of the 12-month recovery period. GMO's FAC is also designed to true-

⁵⁵ Section 386.266.1, RSMo Supp. 2010.

⁵⁶ *Praxair, Inc. v. Public Service Comm'n*, 346 S.W.3d 377, 378 (Mo .App. 2011).

⁵⁷ EFIS Docket Entry No. 66, *Joint Stipulation of Non-Disputed Material Facts*, filed on June 1, 2012.

⁵⁸ *Id.*

⁵⁹ *Id.*

up any over-recoveries or under-recoveries during recovery periods. Any disallowance made by the Commission due to a prudence review is accounted for as an adjustment to the next CAF filing.⁶⁰

16. As required by statute and Commission rule, GMO's FAC is subject to prudence reviews at intervals not longer than 18 months.⁶¹

17. Staff filed its first Prudence Review Report in File No. EO-2009-0115. That report covered the first two six-month accumulation periods of GMO's FAC - the period June 1, 2007 through May 31, 2008.⁶²

18. Staff did not recommend any disallowance in the first prudence review. In its report, Staff noted regarding hedging that "the Company attempts to hedge against the fluctuations of natural gas, coal and diesel prices." The *Report* went on to state with respect to natural gas hedging costs:

The Company had a net loss through its natural gas hedging program of approximately \$7 million for the June 1, 2007 to May 31, 2008 time period of this audit. The program had losses through the months of June 2007 through March 2008 – the first 10 months of the audit year. In the last two months of the audit year, the company's hedging program produced a gain of approximately \$1.5 million.⁶³

⁶⁰ *Id.*

⁶¹ *Id.* See Section 386.266.4(4), RSMo Supp. 2010, and Commission Rule 4 CSR 240-20.090(7).

⁶² *Id.* Staff Exh. 14, [First] Prudence Review of Costs Related to the Fuel Adjustment Clause for the Electric Operations of KCP&L Greater Missouri Operations Company, June 1, 2007 through May 31, 2008. See also Staff Exh. 16, [Third] Prudence Review of Costs Related to the Fuel Adjustment Clause for the Electric Operations of KCP&L Greater Missouri Operations Company, pp. 1-2.

⁶³ *Id.* Staff did not assert that fuel costs, or purchased power costs or hedging costs were imprudent, nor did Staff have any reason to believe that these costs were unreasonable or excessive. Transcript, pp. 333-334.

19. The first prudence report did not expressly refer to the cross-hedging of purchased power spot market price risk with financial instruments based on natural gas futures.⁶⁴

20. Staff filed its second Prudence Review Report in File No. EO-2010-0167. That report covered the third and fourth six-month accumulation periods of GMO'S FAC - the period June 1, 2008 through May 31, 2009.⁶⁵

21. Staff did not recommend any disallowance in the second prudence review. Staff's report included a section headed, "Financial Hedges of Natural Gas." The *Report* went on to state with respect to natural gas hedging costs:

The Company had a net gain, i.e., it was able to purchase natural gas at a price lower than the market price, through its natural gas hedging program of approximately **** ---HC---** for the June 1, 2008 to May 31, 2009 time period of this audit. The program had a gain or increase of approximately **** ---HC---** through the months of June 1, 2008 through December 31, 2008 – the first seven months of the prudence review period. In the last five months of the prudence review period, the company's hedging program produced a loss or decrease of approximately **** ---HC---**. Because the company's financial hedging program is used to avoid market fluctuations in natural gas prices, there will be times that GMO benefits and times that they do not. If it was found that GMO had been imprudent in its financial hedges and natural gas fuel purchases, ratepayer harm could result from an increase in fuel costs recovered through the FAC. The Company had a net loss through its natural gas hedging program of approximately \$7 million for the June 1, 2007 to May 31, 2008 time period of this audit. The program had losses through the months of June 2007 through March 2008 – the first 10 months of the audit year. In the last two months of the audit year, the company's hedging program produced a gain of approximately \$1.5 million.⁶⁶

⁶⁴ *Id.*

⁶⁵ *Id.*; Staff Exh. 15, [Second] Prudence Review of Costs Related to the Fuel Adjustment Clause for the Electric Operations of KCP&L Greater Missouri Operations Company; Staff Exh. 16, [Third] Prudence Review of Costs Related to the Fuel Adjustment Clause for the Electric Operations of KCP&L Greater Missouri Operations Company, pp. 1-2.

⁶⁶ *Id.* The highly confidential amounts need not be disclosed as they are not necessary for the disposition of the issues in this matter. Staff did not assert that fuel costs, or purchased power costs or hedging costs were imprudent, nor did Staff have any reason to believe that these costs were unreasonable or excessive. Transcript, pp. 333-334.

22. The second prudence report did not expressly refer to the cross-hedging of purchased power spot market price risk with financial instruments based on natural gas futures.⁶⁷

23. The prudence review at issue in this matter, GMO's third, involves the fifth, sixth and seventh six-month accumulation periods of GMO's FAC ("prudence review period"). The fifth accumulation period started June 1, 2009 and ended November 30, 2009, the sixth accumulation period started December 1, 2009 and ended May 31, 2010, and the seventh accumulation period started June 1, 2010 and ended November 30, 2010. Thus, the 18-month prudence review period at issue in this matter is from June 1, 2009 through November 30, 2010.⁶⁸

24. In Staff's third prudence report, it recommended the disallowance of \$18,755,865 reflecting GMO's use of natural gas hedges to mitigate risk associated with its future purchases in the spot power market. Staff characterized that practice as imprudent. Staff recommended that GMO be required to refund that amount, plus interest at the short term rate, to ratepayers through the FAC.⁶⁹

25. The third prudence review is the first FAC prudence review in which Staff has specifically alleged that Aquila or GMO's cross-hedging activities related to the use of natural gas futures contracts to hedge spot purchased power costs were imprudent.⁷⁰

26. In its *Position Statement* filed on May 25, 2012, Staff revised the amount of its proposed disallowance and refund recommendation. Staff stated: "GMO must refund \$14.9

⁶⁷ *Id.*

⁶⁸ *Id.*; Staff Exh. 16, [Third] Prudence Review of Costs Related to the Fuel Adjustment Clause for the Electric Operations of KCP&L Greater Missouri Operations Company, pp. 1-2; Staff Exh. 1, Eaves Direct, Schedule 1, p. 12.

⁶⁹ EFIS Docket Entry No. 66, *Joint Stipulation of Non-Disputed Material Facts*, filed on June 1, 2012.

⁷⁰ *Id.*

million, with interest at its short-term borrowing rate, to ratepayers through its FAC mechanism.”⁷¹

Conclusions of Law – FAC’s Generally

Section 386.266 authorizes any electrical corporation to apply for rate schedules authorizing an interim energy charge, or periodic rate adjustments outside of general rate proceedings to reflect increases and decreases in its prudently-incurred fuel and purchased-power costs, including transportation.⁷² The Commission has the power to approve, modify, or reject such adjustment mechanisms, and if approved, the FAC must include provisions for an annual true-up which shall accurately and appropriately remedy any over- or under- collections, including interest at the utility's short-term borrowing rate, through subsequent rate adjustments or refunds.⁷³ Additionally, Section 386.266.4(4), RSMo Supp. 2010, and Commission Rule 4 CSR 240-20.090(7) require the Commission to undertake a prudence review of GMO's FAC no less frequently than at eighteen-month intervals. Any imprudently-incurred costs must be refunded, plus the interest at the utility's short-term borrowing rate.⁷⁴ Once such an adjustment mechanism is approved it remains in effect until such time as the Commission authorizes the modification, extension, or discontinuance of the mechanism in a general rate case or complaint proceeding.⁷⁵

⁷¹ *Id.*

⁷² Section 386.266.1, RSMo Supp. 2010.

⁷³ Section 386.266.4 and .4(2), RSMo Supp. 2010.

⁷⁴ Section 386.266.4(4), RSMo Supp. 2010. See also *State ex rel. Noranda Aluminum, Inc. v. Public Service Comm'n*, 356 S.W.3d 293, 313 (Mo. App. 2011).

⁷⁵ Section 386.266.5, RSMo Supp. 2010.

D. General Hedging Principles

27. Hedging is defined as a method of reducing the risk of loss caused by price fluctuation. It consists of the purchase or sale of equal quantities of the same or similar commodities, approximately simultaneously, in two different markets with the expectation that a future change in price in one market will be offset by an opposite change in the other market.⁷⁶

28. Hedging is also defined as taking a position in a futures market opposite to a position held in the cash market to minimize the risk of financial loss from an adverse price change; a purchase or sale of futures as a temporary substitute for a cash transaction that will occur later.⁷⁷

29. Hedging is a process of protecting oneself against risk.⁷⁸

30. Hedging employs various techniques but, basically, involves taking equal and opposite positions in two different markets as offsets to one another.⁷⁹

31. A hedge is constructed by linking a futures or derivative transaction with a similar cash or physical transaction.⁸⁰

32. It is the simultaneous offsetting of physical and futures positions that neutralizes market volatility.⁸¹

⁷⁶ Staff Exh. 1, Eaves Direct, Schedule 1, p. 12; Staff Exh. 10, Staff's Third Prudence Review of Costs Related to the Fuel Adjustment Clause for the Electric Operations of KCP&L Greater Missouri Operations Company – June 1, 2009 through November 30, 2010, p. 12; GMO Exh. 1, Blunk Direct, pp.12-13.

⁷⁷ GMO Exh. 1, Blunk Direct, pp.12-13. According to the CME Group, only 9,018 of the 76,864,334 natural gas contracts traded on the NYMEX in 2011 were ultimately delivered as physical natural gas at Henry Hub, representing only about 0.01% of the contracts. *Id.* Hubs create a common point for commercial trading contracts to settle with or without going to physical delivery.

⁷⁸ GMO Exh. 1, Blunk Direct, p.13.

⁷⁹ *Id.*

⁸⁰ GMO Exh. 2, Blunk Surrebuttal, p. 8.

⁸¹ GMO Exh. 1, Blunk Direct, p. 15; GMO Exh. 2, Blunk Surrebuttal, p. 8; Transcript, pp. 135-136.

33. When constructing a hedge, two transactions must be performed: (1) buy what you sell, and (2) sell what you buy.⁸²

34. Every hedge has two sides to the transaction, a gain and a loss. For example, when the price of natural gas decreases in a financially-hedged transaction for purchased power, then the natural gas hedge decreases in value and the underlying hedge for purchased power has an offsetting non-cash increase in value (i.e., the market prices of purchased power are decreasing).⁸³

35. For financial instruments, the cash settlement is easy to identify because it is cash settled. The other side of the hedge is non-cash, but it impacts the company.⁸⁴

36. By comparing the value of the transaction when the hedge was placed with the value of the transaction when the hedge was closed, you can determine the physical market change for each hedge.⁸⁵

37. Not all hedges result in a hedge settlement.⁸⁶

38. You cannot determine the success or failure of a hedging program by looking only at the futures market transactions.⁸⁷

39. Cross hedging is a risk management strategy that involves offsetting a position in one commodity with an equal position in a different commodity with similar price movements.⁸⁸

⁸² GMO Exh. 2, Blunk Surrebuttal, p. 8; Transcript, pp 117-119. See also Schedule WEB-9.

⁸³ GMO Exh. 3, Bresette Surrebuttal, p. 10. GMO Exh. 2, Blunk Surrebuttal, p. 8. See also Schedule WEB-9.

⁸⁴ GMO Exh. 3, Bresette Surrebuttal, p. 10.

⁸⁵ GMO Exh. 2, Blunk Surrebuttal, p. 10.

⁸⁶ GMO Exh. No. 3, Bresette Surrebuttal, p. 11.

⁸⁷ GMO Exh. 2, Blunk Surrebuttal, p. 11.

⁸⁸ GMO Exh. 1, Blunk Direct, p.15; Transcript, p. 268-269.

40. Cross hedging entails using a futures contract for one commodity whose spot price moves very closely with the spot price of another commodity to be hedged.⁸⁹

41. Cross hedging is often used in markets where there is no active futures trading for the commodity of concern.⁹⁰

42. The National Rural Electric Cooperative Association, American Public Power Association and Large Public Power Council have concurred that “Cross-commodity hedging is commonplace.”⁹¹

43. Any two goods or commodities may be cross-hedged as long as they are correlated enough to create a hedge position and as long as the prices for those goods or commodities move in the same direction.⁹²

44. Cross hedging is not the same as speculating in the stock market hoping to generate cash to pay a future variable expense. If the price of the underlying commodity and the price to be hedged are perfectly correlated, you can construct a perfect hedge resulting in price certainty for the hedged commodity.⁹³

45. Hedge effectiveness in the context of futures contracts is most commonly demonstrated using correlation methodology.⁹⁴

⁸⁹ GMO Exh. 8, Woo Direct, p. 11.

⁹⁰ GMO Exh. 1, Blunk Direct, p.15; GMO Exh. 8, Woo Direct, p. 11.

⁹¹ GMO Ex No. 1, Blunk Direct, p.15-18; GMO Ex No. 2, Blunk Surrebuttal, p. 35; GMO Ex No. 17; Tr. 307. Cross hedging has been taught by the Electric Power Research Institute (“EPRI”) since the mid-1990s (GMO Ex No. 2, Blunk Surrebuttal, p. 35; GMO Ex. No. 17.), and numerous Staff personnel, including Dana Eaves and Charles Hyneman, have attended webinars presented by PGS Energy Training where this cross hedging technique was explained and taught. (Transcript, pp. 256-257; GMO Ex No. 2, Blunk Surrebuttal, pp. 33-36, Schedule WEB-15, pp. 1-8; GMO Ex No. 7, Rush Surrebuttal, p. 23.).

⁹² Transcript, pp. 268-269, 327; GMO Exh. 8, Woo Direct, pp. 11-12; GMO Exh. 19, CME Group, Derivatives and Hedge Accounting.

⁹³ GMO Exh. 8, Woo Direct, p. 12.

⁹⁴ Transcript, pp. 324, 327, GMO Exh. 3, Bresette Surrebuttal, p. 9-10; GMO Exh. 8, Woo Direct; GMO Exh. 9 Woo Surrebuttal.

46. To be a “highly effective” hedge, or a prudent hedge, the financial instrument used to hedge a transaction must be “highly correlated” to the risk being hedged.⁹⁵

47. There are two main criteria accepted by the accounting industry to determine if a hedge is highly effective; (1) the R-squared or R^2 method and (2) the Dollar Offset Method, also referred to as the “slope” of the relationship.⁹⁶

48. R-squared is a statistic that measures the strength of the relationship between two data sets. Specifically, it gives the proportion, or if multiplied by 100, the percent, of the variability in one data set explained by the variability in another data set. The R-squared is the squared correlation coefficient (R-value). For example, an R-squared of 0.80 means changes in natural gas prices explain 80% of the changes in electricity prices.⁹⁷

49. Application of a correlation analysis with the R-squared method can be used *ex ante* to determine the effectiveness of a cross hedge.⁹⁸

50. It is improper to use an *ex post* price correlation to determine the prudence of a cross hedging decision made *ex ante*. The relevant price correlation is based on the price data available when making an *ex ante* hedging decision.⁹⁹

51. Under the Dollar Offset test, a post-validation test, the change in value of the derivative is compared to the change in value of the hedged item. Hedges that yield a ratio

⁹⁵ GMO Exh. 3, Bresette Surrebuttal, pp. 9-10. This has been referred to as regression analysis or the calculation of regressive coefficients, i.e. “R-values” and “R-squared” values. GMO Exh. 8, Woo Direct, pp. 10, 17-18, 26; GMO Exh. 9, Woo Surrebuttal, pp. 5, 7; GMO Exh. 22, Proctor Surrebuttal from File Number ER-2009-0090, p.5.

⁹⁶ GMO Exh. 3, Bresette Surrebuttal, p. 9; GMO Exh. 2, Blunk Surrebuttal, pp. 12.

⁹⁷ GMO Exh. 3, Bresette Surrebuttal, p. 9-10; GMO Exh. 2, Blunk Surrebuttal, pp. 22.

⁹⁸ Transcript, pp. 324, 327, GMO Exh. 2, Blunk Surrebuttal, pp. 22-24; GMO Exh. 3, Bresette Surrebuttal, pp. 9-10; GMO Exh. 8, Woo Direct; GMO Exh. 9 Woo Surrebuttal. See also GMO Exh. 19, CME Group, Derivatives and Hedge Accounting, p. 3.

⁹⁹ GMO Exh. 9, Woo Surrebuttal, p. 3.

within the range of 80-120 percent¹⁰⁰ are deemed highly effective. A more technical way to state this test is that the slope of the relationship between the variables must be between negative 0.8 and negative 1.25.¹⁰¹

52. While there is no single, definitive test prescribed by Financial Accounting Standard 133, that generally addresses accounting and reporting standards for financial derivative instruments, *ex post* validation of the effectiveness of a hedge can be performed using the Dollar Offset Method per the “80/125” rule. Thus, the actual gains and losses of the derivative(s) should fall within the 80% to 125% of the gains/losses for the hedged item.¹⁰²

53. A second post-validation study involves examining the total effective rate by examining the total variable costs of the hedged commodities over time to see if the hedge neutralized the risk. Examining the total allows consideration of both sides of the hedge. If the total effective rate demonstrates that the risk has been mitigated, then the hedge is effective.¹⁰³

54. A third post validation study involves determining the cost of the hedge. If the cost of the hedging insurance to cover the risk is less than 30%, the hedging insurance was worth the cost.¹⁰⁴

¹⁰⁰ The test has been referred to interchangeably as both the 80-120 rule and the 80-125 rule.

¹⁰¹ GMO Exh. 3, Bresette Surrebuttal, p. 9; GMO Exh. 2, Blunk Surrebuttal, p. 12; See also GMO Exh. 19, CME Group, Derivatives and Hedge Accounting, p. 3.

¹⁰² GMO Exh. 19, CME Group, Derivatives and Hedge Accounting, p. 3.

¹⁰³ GMO Exh. 1, Blunk Direct, p. 31-33.

¹⁰⁴ Transcript, pp. 117-120.

55. Post-validation studies cannot be used to determine prudence because they are performed in hindsight. However, they can be used to provide confirmation of a hedge's effectiveness.

56. A perfect or completely effective hedge has a mathematical correlation of 1.¹⁰⁵

57. While futures contracts derive their value from certain underlying physical markets, they likely will not be perfectly correlated with the daily physical markets for the same commodity at the same location.¹⁰⁶ Similarly, futures contracts will likely not be perfectly correlated with daily physical markets for different commodities.

58. The Securities and Exchange Commission has informally prescribed that a highly-effective hedge requires that the derivatives and hedged items exhibit a correlation coefficient of at least 0.90 or an R-squared value greater than or equal to 0.80.¹⁰⁷

59. As a "rule of thumb," a strong correlation or relationship exists for hedging when there is an R-value falling in the range of 0.85 to 1.0 or -0.85 to -1.0.¹⁰⁸ This translates to an R-squared value ranging between 0.7225 to 1.0.

¹⁰⁵ GMO Exh. 8, Woo Direct, p. 16.

¹⁰⁶ GMO Exh. 2, Blunk Surrebuttal, p. 46.

¹⁰⁷ GMO Exh. 2, Blunk Surrebuttal, pp. 22-24, and Schedule WEB-13; GMO Exh. 3, Bresette Surrebuttal, pp. 9-10; GMO Exh. 19, CME Group, Derivatives and Hedge Accounting, p. 3. It should be noted that in May of 2010, the Financial Accounting Standards Board proposed changes to hedge accounting practices in "Topic 815" that are expected to be implemented in 2013. FASB has determined that current hedge accounting qualifications should be less rigorous and more qualitative as opposed to current quantitative measures to assess the *ex ante* effectiveness of the hedge. FASB has proposed that the *ex ante* expectation of hedge effectiveness be reduced from "highly" to "reasonably" effective. GMO Exh. 19, CME Group, Derivatives and Hedge Accounting, p. 4; GMO Exh. 21, ASC – Topic 815.

¹⁰⁸ Transcript pp. 315-325; GMO Exh. 18, Data Request No. 0118, directed to and answered by Staff Witness Dana Eaves.

60. An R-squared less than 0.80 or a slope that is not in between negative 0.8 and 1.25 does not mean you cannot cross-hedge, it just means that the hedge must be accounted for differently.¹⁰⁹

61. Hedging costs represents the net of purchasing a derivative and selling that derivative.¹¹⁰

62. When hedging with futures or forward contracts, unrealized gains and losses are incurred from the date of entering the futures or forward contracts until the date the contracts are cash settled. At that time, unrealized gains or losses are converted to realized gains or losses.¹¹¹

63. Hedging is an activity similar to purchasing insurance. Losses in a hedging program are not unanticipated and do not suggest that the hedging program is unreasonable or imprudent. Hedging losses are recognized as a possible result of prudent efforts to dampen upward volatility.¹¹²

64. Hedging losses cannot be known until “after the fact,” or in hindsight.¹¹³

E. GMO’s Cross-Hedging with Natural Gas Futures

Findings of Fact:

65. In addition to, or in place of, energy generated by its native capacity described above in Finding of Fact Number 1, GMO also purchases power on the spot

¹⁰⁹ GMO Exh. 2, Blunk Surrebuttal, p. 23; GMO Exh. 3, Bresette Surrebuttal, p. 9; Staff Exh. 12, Statement of Financial Accounting Standards No. 133, Accounting for Derivatives Instruments and Hedging Activities, Financial Accounting Standards Board, June 1998.

¹¹⁰ GMO Exh. 3, Bresette Surrebuttal, p. 17.

¹¹¹ GMO Exh. 3, Bresette Surrebuttal, p. 5.

¹¹² GMO Exh. 1, Blunk Direct, p. 30. Transcript, pp. 164, 226-235. See also Commission Rule 4 CSR 240-40.018, Natural Gas Price Volatility Mitigation.

¹¹³ Transcript, p. 231.

market when prices are such that purchased power is the least cost alternative for serving its native load.¹¹⁴

66. Daily on-peak, spot market electricity price is defined as the daily average of hourly electricity prices during the 16 hour on-peak period of 0600 through 2200 (6:00 a.m. through 10:00 p.m.) Monday through Friday excluding holidays.¹¹⁵

67. The Commission authorized a FAC for GMO on May 27, 2007, in Case No. ER-2007-0004, finding that fuel and purchased power costs constituted approximately 46% of GMO's test year operations and maintenance expenses; that GMO's fuel and purchased power costs increased on average between 13% and 20% annually; that GMO had "heavy reliance" on both purchased power and gas-fired generation; that the purchased power and natural gas markets were characterized by "high volatility"; and that these factors were outside of GMO's control.¹¹⁶

68. GMO has sufficient generation to supply its native load, but some of its generation is at a higher cost and usually cannot beat market price.¹¹⁷

69. Spot market purchased power currently represents about 35.8% of the energy sold at retail by GMO.¹¹⁸

¹¹⁴ EFIS Docket Entry No. 66, *Joint Stipulation of Non-Disputed Material Facts*, filed on June 1, 2012; GMO Exh. 5, Heidtbrink Direct, pp. 4-5.

¹¹⁵ GMO Exh. 1, Blunk Direct, p. 28; GMO Exh. 9, Woo Surrebuttal, pp. 2.

¹¹⁶ EFIS Docket Entry No. 66, *Joint Stipulation of Non-Disputed Material Facts*, filed on June 1, 2012.

¹¹⁷ Transcript, p. 347. GMO Exh. 5, Heidtbrink Direct, pp. 4-5.

¹¹⁸ EFIS Docket Entry No. 66, *Joint Stipulation of Non-Disputed Material Facts*, filed on June 1, 2012.

70. As long as spot market prices for electricity are lower than GMO's cost to generate energy with its own generation, GMO should be buying electricity on the spot market.¹¹⁹

71. Additional generation capacity would not eliminate GMO's electricity and natural gas spot market price risks.¹²⁰ Building additional generation is not a viable short-term alternative to purchasing power on the spot market.¹²¹

72. During the FAC prudence audit period, purchasing power on the spot market was prudent for GMO to meet their customers' needs. It was the least cost alternative because GMO's generation was much more expensive.¹²²

73. Natural gas prices and power prices are affected by natural gas price volatility.¹²³

¹¹⁹ Transcript, pp. 205, 207-208; Staff Witness Mantle testified that she didn't believe that Staff had ever said that GMO over-relied on spot market electricity. *Id.* at 205. Staff Exh. 2, Mantle Rebuttal, p.6. Staff Witness Mantle testified that if GMO did not utilize the least cost electricity that Staff would allege the GMO was imprudent for failing to do so. *Id.*

¹²⁰ GMO Exh. 2, Blunk Surrebuttal, pp. 6-8. Transcript, pp. 132-133. "The utility can use the turbine to produce electricity or procure the same amount from the electricity spot market. The per MWh cost resulting from the utility's least-cost decision is the lesser of (a) the electricity spot price, or (b) the turbine's per MWh fuel cost, which is turbine's heat rate times the natural gas spot price. Since this per MWh cost varies with both spot prices, generation ownership does not eliminate spot price risks." GMO Exh. 8, Woo Direct, pp. 6-7.

¹²¹ *Id.* The is no evidence it the record providing a cost benefit analysis as to whether construction or purchase of new generation could be a viable short-term or long-term alternative to support these options as viable alternatives. It is clear, however, that acquiring additional capacity cannot even be accomplished in the short-term as a least-cost alternative to purchased power. It is also clear that additional generation would not eliminate market risks for natural gas or electricity prices. See also Tr. 122-124, 132, 205, 211-212, 361-362.

¹²² Transcript, p. 206. Staff Witness Mantle testified that GMO "should have put steel in the ground back in 2000 when the Aries plant was built," and had GMO "acquired a combined cycle plant in 2000, its fleet would be more efficient and it now would be buying less spot market electricity." Staff Exh. 2. Mantle Rebuttal, pp. 5-6; Transcript, pp. 206-207. However, the current management of GMO did not take over the day-to-day operations of the company until after the merger was completed on July 14, 2008, and GMO cannot be faulted for past management decisions of the former Aquila, Inc. in relation to this prudence review. Ms. Mantle also testified that this argument, the need for additional capacity, was not the basis for the disallowance it had proposed in this case. Transcript, p. 207.

¹²³ GMO Exh. 3, Bresette Surrebuttal, p. 4.

74. The New York Mercantile Exchange (“NYMEX”) prices for natural gas directly affect the electric contract prices.¹²⁴

75. Natural gas prices are very closely associated with the average systems prices in the Southwest Power Pool (“SPP”) region.¹²⁵

76. Natural gas prices and electric power prices are correlated. For most on-peak hours, natural gas is on the margin meaning wholesale power prices are set by the cost of the last gas-fired unit to be dispatched.¹²⁶

77. As demonstrated by the SPP’s “State of the Market Reports,” SPP has long believed there is a strong link between natural gas and electricity markets.¹²⁷

78. Dr. Michael Proctor, formerly of the Commission Staff, also reviewed the correlations between the electric and natural gas markets in the 2009 GMO rate case, File Number ER-2009-0090. Dr. Proctor was asked if higher natural gas prices result in higher spot-market electricity prices in the SPP electricity markets, and he concluded that 87.23% (regression coefficient) of the total variation in SPP’s electricity prices for the years 2003 through 2008 was explained by variation in natural gas prices. He further stated that there was little doubt that natural gas prices drove electricity prices for most of the hours of the year in the SPP region.¹²⁸

¹²⁴ GMO Exh. 4, Clemens Surrebuttal, p. 3.

¹²⁵ GMO Exh. 8, Woo Direct, p. 20.

¹²⁶ GMO Exh. 5, Heidtbrink Direct, pp. 4-5.

¹²⁷ GMO Exh. 1, Blunk Direct, p. 10.

¹²⁸ GMO Exh. 22, *Filing Memorandum with Exhibits*, Surrebuttal Testimony of Michael Proctor, filed April 9, 2009, EFIS Docket Entry No. 173 in Case ER-2009-0090, p. 5; GMO Ex. No. 2, Blunk Surrebuttal, p. 31; GMO Exh. 7, Rush Surrebuttal, pp. 11-12. In Dr. Proctor’s analysis, SPP annual average electricity prices were compared to the annual average natural gas prices at the Henry Hub. The Henry Hub is the largest centralized point for natural gas spot and futures trading in the United States. The Henry Hub is the pricing point for natural gas futures contracts traded on the New York Mercantile Exchange (NYMEX). It is a point on the natural gas pipeline system in Erath, Louisiana. It interconnects with nine interstate and four intrastate pipelines.

79. It is well accepted in the electric industry by marketers, energy buyers and strategic planners that the best indication of what electric prices will be in the future is reflected in future natural gas prices.¹²⁹

80. Natural gas market price uncertainty affects GMO in two primary ways: (1) a direct impact on the price it pays for the natural gas it consumes, and (2) the effect natural gas pricing has on the market price for electricity.¹³⁰

81. There is no formalized market that allows GMO to buy electric futures contracts in the Southwest Power Pool region that could serve as a hedge,¹³¹ so GMO uses natural gas derivatives to mitigate price exposure to natural gas and purchased power price volatility.¹³²

82. While the spot electricity market is hourly, NYMEX natural gas futures, that settle monthly, can be used to cross hedge the daily on-peak price when a reasonable time period is considered.¹³³ This cross-hedging technique is widely accepted within the electric industry.¹³⁴

¹²⁹ GMO Exh. 1, Blunk Direct, p. 15-18; GMO Exh 2, Blunk Surrebuttal, p. 35; GMO Exh. 7, Rush Surrebuttal, p. 25; GMO Exh. 17, Blunk Response to Staff Data Request No. 0089; Transcript, pp. 307, 329.

¹³⁰ GMO Exh. 1, Blunk Direct, p. 24.

¹³¹ EFIS Docket Entry No. 66, *Joint Stipulation of Non-Disputed Material Facts*, filed on June 1, 2012; Transcript, p. 210-211; Staff Exh. 16, Prudence Review of Cost Related to the Fuel Adjustment Clause for the Electric Operations of KCP&L Greater Missouri Operations Company, June 1, 2009 through November 30, 2012, File No. EO-2011-0390, p. 9.

¹³² GMO Exh. 2, Blunk Surrebuttal, p. 7; GMO Exh. 3, Bresette Surrebuttal, p. 4. The price movement of natural gas futures contracts is not affected by whether GMO uses cross hedges or direct hedges. GMO's customer load or MWh requirement is also not affected by whether GMO uses cross hedges or direct hedges. GMO Exh. 2, Blunk Surrebuttal, p. 7

¹³³ GMO Ex No. 2, Blunk Surrebuttal, p. 17-18; GMO Exh. 9, Woo Surrebuttal, p. 3 (and in its entirety).

¹³⁴ See Finding of Fact Number 79 and the associated Footnote.

83. GMO's hedging program is designed to mitigate adverse upward price volatility in natural gas and power.¹³⁵ Stated in terms of risk, GMO uses natural gas derivatives to hedge natural gas price risk and "on peak" purchased power price risk.¹³⁶

84. In order to offset the risk of price spikes in electricity, GMO enters into natural gas futures contracts for the BTU-equivalent of the purchased power it expects to buy. Together, these two actions create the hedge – the physical purchase of the spot purchased power, and the entering into the natural gas futures contracts for a BTU equivalent amount of natural gas that can be sold in the future.¹³⁷

85. Buying the purchased power is referred to as the "physical side" of the hedge. Buying the natural gas futures contracts is sometimes referred to as the "derivative side" of the hedge transaction. At the same time that GMO buys its purchased power, it also has natural gas futures contracts that it can sell to offset the increased price for electricity.¹³⁸

86. The three most significant benefits of using NYMEX natural gas futures contracts and options to hedge electricity price risk are liquidity,¹³⁹ minimal counterparty credit risk¹⁴⁰ and contract size.¹⁴¹

¹³⁵ GMO Exh. 1, Blunk Direct, p. 24.

¹³⁶ GMO Exh. 1, Blunk Direct, p.28.

¹³⁷ *Id.*; GMO Exh. 2, Blunk Surrebuttal, pp. 8-10.

¹³⁸ GMO Exh. 1, Blunk Direct, pp. 14-15; GMO Ex. 2, Blunk Surrebuttal, pp. 8-11; Transcript pp. 112-136.

¹³⁹ GMO Exh. 1, Blunk Direct, pp. 18-19. NYMEX natural gas contracts can easily be bought or sold quickly because there are large numbers of buyers and sellers ready and willing to trade at any time during market hours. Because of high trading volumes there tend to be low spreads between asking and selling prices which results in little to no premium when entering or exiting a position. *Id.* See also GMO Exhibit 5, Heidtbrink Direct, p. 5; Transcript pp. 122-124.

¹⁴⁰ *Id.* The NYMEX uses a central counterparty clearing model. All trades are cleared through the Exchange clearinghouse which becomes the ultimate counterparty, acting as the "buyer to every seller" and the "seller to every buyer." Counterparty credit risk is shared among clearing members, who represent some of the largest names in financial services. Consequently, the NYMEX has received and maintains an AA+ long-term counterparty credit rating from Standard & Poor's. *Id.*

¹⁴¹ *Id.* One NYMEX natural gas contract represents 10,000 MMBTUs of natural gas. That is roughly equivalent to one (1) megawatt hour (MWh) of electricity. Given the liquidity of the NYMEX there is essentially no premium for entering or exiting a position as small as one MWh. That liquidity gives GMO the ability to fine tune its hedge position as expectations change. *Id.*

87. Besides the benefits of using the NYMEX, there is another benefit of combining GMO's projected natural gas usage with natural gas equivalent volumes for its projected purchased power requirements. It manages the risk that while the total load served might equal the projection, the supply mix between GMO's natural gas-fired generation and purchased power might be different than projected.¹⁴²

88. Entering into purchased power contracts, as opposed to hedging in the futures market, loses the benefits of using NYMEX natural gas futures contracts. Power agreements are not good secondary markets due to the lack of flexibility and the additional costs, or penalties, associated with those bilateral contracts.¹⁴³

89. When constructing a hedge for spot purchased power, the Company performs two transactions that are directly and inseparably linked. The gain or loss in the physical position is offset by the gain or loss in the futures market.¹⁴⁴

90. This method provides a hedge or insurance against skyrocketing electric prices,¹⁴⁵ and as demonstrated by GMO's informal survey, other electric companies across the country use this cross-hedging technique when necessary to mitigate the price risk of spot purchased power.¹⁴⁶

¹⁴² GMO Exh. 1, Blunk Direct, p. 19.

¹⁴³ Staff Ex. No. 2, Mantle Rebuttal, pp. 1-6; Tr. 122-124, 132, 211-212, 361-362. No party provided a cost-benefit analysis support power agreements being a least-cost alternative. Staff only made conclusory statements in this regard. *Id.*

¹⁴⁴ GMO Exh. 2, Blunk Surrebuttal, pp. 8-10 and Schedule WEB-9; Transcript, pp. 135-137.

¹⁴⁵ GMO Exh 1, Blunk Direct, pp. 14-15; GMO Ex. 2, Blunk Surrebuttal, pp. 8-11; Transcript pp. 112-136.

¹⁴⁶ GMO Exh. No. 17; GMO Ex. No. 2, Blunk Surrebuttal, p. 37, and Schedule WEB-17. GMO's informal survey revealed that about one-half of the electric companies responding to the survey have used this cross-hedging technique to mitigate the price risk associated with the spot purchase power market. The list of those using this technique included Arizona Public Service, Florida Power & Light, Madison Gas & Electric, Mississippi Power—Southern Company, Portland General, and Ameren Missouri. For example, GMO's email survey includes a response from Ameren's Wil Cooper that indicates that Ameren "used natural gas derivatives (futures, options, forwards etc.) to cross hedge electricity price risk." *Id.*

91. GMO designates its natural gas derivatives as economic hedges.¹⁴⁷

92. Under an economic hedge, the change in fair value is recorded to a derivative asset or liability with the offset to the income statement in the period the change in fair value occurs.¹⁴⁸

93. GMO's hedging program first divides the hedge volume into two parts. One-third of the volume is not hedged but is left to primarily absorb the risk of requirements being less than projected and secondarily float with the market. The remaining two-thirds are hedged under two hedging programs, Kase and Company, Inc.'s HedgeModel and ezHedge.¹⁴⁹

94. The approach of the HedgeModel program is to identify statistically favorable points at which to hedge. The strategy can be thought of as a three-zone strategy comprised of high price, normal price and low price zones. The high price zone identifies prices that are threatening to move upward. In this price zone actions are taken to protect against unfavorable high price levels, mostly through the use of options-related tactics. The normal price zone identifies prices that are in a "normal" range, neither high enough to warrant protecting price, nor low enough to be considered "opportunities." No action is taken whenever prices are deemed to be in the normal price range. The low price zone identifies prices that are statistically low. In this zone, actions are taken to capture favorable forward prices as the market moves into a range where the probability of prices remaining at or below these levels is decreasing. While the main focus in the high price

¹⁴⁷ GMO Exh. No. 3, Bresette Surrebuttal, p. 4.

¹⁴⁸ *Id.*

¹⁴⁹ GMO Ex No. 1, Blunk Direct, p. 26-29; Transcript, pp. 103-106, 125-137.

zone is defensive, to set a maximum or ceiling on prices, in the low price zone the focus is on capturing attractive prices.¹⁵⁰

95. Kase's ezHedge generates hedging signals based on market cycles and uses a volume averaging approach, similar to dollar cost averaging. The model divides a price range into five zones based on an evaluation of percentile levels over a range of look-back periods. It selects the look-back length based on market behavior relative to the highest and lowest zones. This approach results in hedges being placed under all but the most favorable conditions, in which volumes are left unhedged. The volume averaging aspect results in more frequent hedges when prices are in the lower priced zones and fewer hedges are in the higher price zones.¹⁵¹

96. ezHedge usually results, over time, in all of the volumes placed in that program being hedged. On the other hand, if prices do not fall low enough, or if prices stay too high, there is a possibility that certain contract months could go unhedged when using HedgeModel. Combining ezHedge with HedgeModel helps ensure that at least a modest portion of the exposure has a high probability of being hedged.¹⁵²

97. The primary purpose for leaving one-third of the forecast volume requirements unhedged is to provide a cushion for the possibility that actual requirements may turn out to be less than projected. GMO updates its projected requirements monthly. If the projected requirements are determined to be significantly different than prior projections, hedge volumes may be adjusted. If the volumes increase, the increases are added to the volume available to hedge. If the volumes decrease but the decrease is not

¹⁵⁰ Id.

¹⁵¹ Id.

¹⁵² Id.

material and GMO already has the two-thirds hedged, those hedges that exceed the two-thirds are liquidated. If the decrease were material, GMO would develop a remediation strategy.¹⁵³

98. GMO may hedge up to 67 percent of the sum of projected natural gas usage and projected on peak natural gas equivalent for purchased power.¹⁵⁴

99. The primary purpose for leaving one-third of the forecast volume requirements unhedged is to provide a cushion for the possibility that actual requirements may turn out to be less than projected.¹⁵⁵

100. GMO's natural gas hedging program is oriented toward finding a balance between the need to protect against high prices and the opportunity to purchase gas at low prices.¹⁵⁶

101. GMO's hedging plan is not designed to benefit the company, but to benefit the customers by protecting the customers from large swings in both purchased power and natural gas costs. It is not designed to make money for the shareholders, but to act as an insurance policy and protect against the volatility in the purchased power and natural gas markets.¹⁵⁷ GMO's shareholders don't make money by hedging since the gains or losses in the physical market are largely offset by the opposite gains or losses in the derivative

¹⁵³ *Id.* at 29.

¹⁵⁴ *Id.*

¹⁵⁵ *Id.*

¹⁵⁶ GMO Ex No. 1, Blunk Direct, p. 26.

¹⁵⁷ Transcript, pp. 124-125, GMO Ex No. 1, Blunk Direct, pp. 31-32; GMO Exh 7, Rush Surrebuttal, p. 27; Schedules TMR-7, TMR-8

market and the gains or losses in the derivative market are passed along to consumers through the FAC just as are the gains or losses in the physical market.¹⁵⁸

102. GMO's hedging program has been specifically designed to take into account changing market conditions.¹⁵⁹

103. There is no evidence that demonstrates that GMO's hedging program during this FAC review period was rigid or market-insensitive.¹⁶⁰

104. The Commission intended for GMO to continue to hedge price risk to protect its customers,¹⁶¹ and examining GMO's hedging program as a whole, the program has been successful because it has decreased total costs and reduced volatility.¹⁶²

105. Aquila, now GMO, began hedging in 2004. Beginning in 2005, Staff and interveners have investigated GMO's hedging practices.¹⁶³ Four rate cases and two FAC

¹⁵⁸ *Id.*, GMO Exh. No. 2, Blunk Surrebuttal, Schedule WEN-9. See also Transcript pp. 243-244- similarities between the use of a FAC and a PGA.

¹⁵⁹ GMO Exh. 1, Blunk Direct, pp. 24-35; Transcript, pp. 125-129.

¹⁶⁰ Staff argued that "GMO's hedging program actually increased the risk to the ratepayers because it was – and is –insensitive to the market." Staff Brief at 20. This criticism first appeared in the case in Staff's Position Statement. Staff Position Statement at 1. However, this allegation is not based upon any evidence presented by Staff witnesses, and it is not correct. Ms. Lena Mantle indicated during cross-examination that this criticism, to the best of her knowledge, was not included anywhere in her testimony or other Staff witness's testimony. Transcript, pp. 209-10. The Commission has reviewed Staff's testimony for references to "insensitivity" or "rigid" in the testimony of Staff witnesses Mantle, Eaves and Hyneman. The Commission did not find any allegations that the current GMO hedging program is "insensitive to the market" or "rigid", as alleged by Staff counsel. The only reference that is remotely close is Mr. Hyneman's discussion of Staff's position in the 2005 Aquila rate case where Staff suggested that the One-Third Program was "too systematic and too rigid." Staff Ex No. 3, Hyneman Rebuttal, p. 15, lines 7-9. GMO specifically stopped utilizing its One-Third Program in favor of the Kase Program in order to employ a less rigid and more market sensitive approach to its hedging decisions. GMO Ex. No. 5, Heidtbrink Direct, pp. 5-7.

¹⁶¹ GMO Exh. 1, Blunk Direct, p. 22; GMO Exh. 2, Blunk Surrebuttal, pp. 39-40; GMO Exh. 5, Heidtbrink Direct, p. 9-10; GMO Exh. 7, Rush Surrebuttal, pp. 4-5; GMO Exh. 22.

¹⁶² GMO Exh. 1, Blunk Direct, pp. 31, 35; GMO Exh. 5, Heidtbrink Direct, p. 3; GMO Exh. 20, Graph - Total Variable Fuel and Purchased Power Cost; Transcript, pp. 335-337.

¹⁶³ GMO Exh. 1, Blunk Direct, p. 4; GMO Exh. 4, Clemens direct, pp. 4-10; GMO Exh. 5, Heidtbrink Direct, p. 5; GMO Exh. 7, Rush Surrebuttal, p. 11, 16-19; Staff Exh. 15, [Second] Prudence Review of Costs Related to the Fuel Adjustment Clause for the Electric Operations of KCP&L Greater Missouri Operations Company; Staff Exh. 16, [Third] Prudence Review of Costs Related to the Fuel Adjustment Clause for the Electric Operations of KCP&L Greater Missouri Operations Company. See also File Numbers ER-2005-0436, ER-2007-0004, ER-2009-0090, EO-2009-0115, EO-2010-0167 and ER-2010-0356.

prudence reviews have been conducted since the beginning of the company's hedging practices, and no party to these actions has previously asserted that GMO's hedging practices were imprudent.¹⁶⁴

106. GMO has tried to keep the Commission's Staff apprised of each step in the process of developing its hedging strategy by inviting Staff's participation in the overview of the program.¹⁶⁵

F. The Prudence of GMO's Use of Natural Gas Hedges

Findings of Fact:

107. The Prudence Review Period is June 1, 2009 to November 30, 2010. Consequently, pursuant to the prudence standard, to evaluate GMO's prudence the Commission must examine what GMO knew at the time it placed the hedges, i.e., the time period prior to the review period.

108. The relevant time period to evaluate prudence for this FAC review period is the time frame encompassing the 18-month interval prior to June 1, 2009.¹⁶⁶

109. The 12 months preceding (*ex ante*) the review period, June 2008 through May 2009, best represents the time period from which to evaluate what GMO knew at the time

¹⁶⁴ *Id.* See also GMO Ex. No. 4, Clemens Surrebuttal, pp. 4-10; GMO Ex. No. 5, Heidtbrink Direct, pp. 3-10; GMO Ex. No. 6, Rush Direct, pp. 8-10; Staff Ex No. 3, Hyneman Rebuttal, p. 10; GMO Ex Nos. 13, 14 and 15; Transcript, pp. 221-226.

¹⁶⁵ GMO Ex No. 7, Rush Surrebuttal, pp. 24-25. Transcript, pp. 215, 218. There is substantial testimony in the record delineating the full history of Aquila/GMO's hedging program – See GMO Ex. No. 4, Clemens Surrebuttal, pp. 4-10; GMO Exh. 5, Heidtbrink Direct, pp.3-10. See also Footnote No. 163. While this evidence is not relevant to the prudence determination of GMO's current hedging program, it is relevant to establish that GMO has redesigned its hedging program to address the concerns expressed by Staff in File Number ER-2005-0436. It is also relevant to establish that Staff has been fully aware of GMO's hedging practices. In support of Finding of Fact Number 106 the Commission incorporates that testimony as findings of fact by reference, as if fully set out herein.

¹⁶⁶ GMO Exh. 9, Woo Surrebuttal, p. 9.

when making the decision to use natural gas derivatives as a cross hedge for electricity price risk.¹⁶⁷ GMO, on average places its hedges about 11 to 12 months in advance.¹⁶⁸

110. The Commission's Staff did not conduct any completely prospective, or forward-looking, analyses when it calculated the correlation coefficient between SPP electric prices and the NYMEX natural gas settlement prices. Staff's calculations were either totally in hindsight, or a mixed hindsight and forward-looking analysis. Consequently, Staff's analyses are irrelevant for purposes of determining the prudence of GMO's hedging activities for the relevant prudence review period.¹⁶⁹

111. The correlation coefficient, or R-value, between SPP's electric prices and the NYMEX natural gas settlement price for the 12 months preceding the FAC audit review period is 0.9411. This is within the timeframe in which the decision makers at GMO would have been making the decision to cross-hedge their electric prices using natural gas futures. That equates to an R-squared of 0.89 (0.9411 x 0.9411), which means that 89% of

¹⁶⁷ GMO Exh. 2, Blunk Surrebuttal, pp. 23-24.

¹⁶⁸ Transcript, p. 131-132.

¹⁶⁹ Staff performed three studies to determine if GMO's cross-hedging was prudent. Two of those studies were totally in hindsight. The first examined the twelve month period of November 2010 through October 2011, which produced a correlation coefficient of 0.617. (Staff Exh. 1, Eaves Direct/Rebuttal, pp. 15-16.) The second looked at one-day's data (16 hours) - August 9, 2009 - and compared what GMO paid for peak spot market electricity and the actual NYMEX natural gas monthly settlement price. (Id. at pp.16-18). This showed that a flat monthly market price compared to hourly fluctuations on the spot market for one day and demonstrated no correlation. This study, however, is also in hindsight, improperly compares one monthly settlement price to hourly spot-market fluctuations and this study cannot be replicated. If this study was used, it would invalidate all hedging programs because all hedging programs use futures that settle less frequently than the physical market. (GMO Ex No. 2, Blunk Surrebuttal, pp. 13-17). In Staff's third study, Staff compares SPP Electricity Prices with the NYMEX natural gas settlement prices from February 2007 through August 2011. Staff's Witness Dana Eaves, while disagreeing that these two markets are "highly correlated," concedes there is a "strong positive association" or "correlation" between natural gas futures and the spot market for the period February 2007 through August 2011.¹⁶⁹ (Staff Exh. 1, Eaves Direct/Rebuttal, p. 15). Staff's third study is a mixed forward-looking review and hindsight review. Staff's analysis yielded a correlation coefficient of 0.8941 or an R-Squared value of 0.799. (Staff Exh. 1, Eaves Direct/Rebuttal, p. 15.)¹⁶⁹ Staff's third analysis, although improper in time frame, still demonstrates that GMO's hedge falls within industry standards for highly effective hedges. It does not escape the Commission that Staff performed its hindsight analysis in hindsight, i.e., Staff alleged GMO was imprudent before conducting any actual analysis. (Transcript, p. 311-312.)

the change in the electricity prices was explained by the changes in the natural gas prices for this period.¹⁷⁰ This R-squared value exceeds the SEC R-squared threshold of 0.80 for determining a hedge is “highly effective.”¹⁷¹ This R-squared value also exceeds the rule of thumb threshold for high correlation of an R-value of 0.85 and R-squared of 0.7225.

112. Because GMO can generate electricity with its turbines or procure the same amount of electricity from the spot market, to determine the least cost alternative, GMO must determine the per MWh procurement cost, which is the turbines’ heat rate times the natural gas spot price.¹⁷²

113. The heat rate, or the efficiency at which a power plant converts fuel into electricity, must be considered when determining the volume of fuel to hedge.¹⁷³

114. GMO uses the market implied heat rate from its market model to convert its expected energy purchases from Megawatt hours (“MWh”) of electricity to Million British Thermal Units (“MMBTUs”) of natural gas.¹⁷⁴

115. The weighted average heat rate that was used to determine the potential volume of GMO’s cross hedges was 8,517 BTU/kWh or 8,517,000 BTU/MWh or 8.517 MMBTU/MWh.¹⁷⁵

¹⁷⁰ See GMO Exh. 2, Blunk Surrebuttal, p. 22, 24.

¹⁷¹ GMO Exh. 2, Blunk Surrebuttal, p. 24. GMO used data contained in Staff’s workpapers to make this calculation. *Id.*

¹⁷² GMO Exh. 8, Woo Direct, pp. 7-8.

¹⁷³ GMO Exh. 2 Blunk Surrebuttal, p. 6. See also Staff Exh. 2, Mantle Rebuttal, pp. 7-8.

¹⁷⁴ GMO Exh. 1, Blunk Direct, p. 28; GMO Exh. 2 Blunk Surrebuttal, pp. 40-41.

¹⁷⁵ GMO Exh. Blunk Surrebuttal, pp. 6-7. The evidence in the record concerning GMO’s generation fleet, while lacking specificity, establishes that GMO has several simple-cycle combustion turbines that enable it to meet its peak loads. GMO Exh. 5, Heidtbrink Direct, p. 4. However, the weighted average heat rate of GMO’s generation fleet provides an accurate assessment of the efficiency of GMO’s generation for purposes of determining procurement costs of spot market electricity. GMO knows its generation capabilities and its likely spot purchased power requirements. Transcript, pp. 133-134. See also Schedule WEB-9 for an example of the mechanics of how futures contracts are used to cross hedge GMO’s on-peak purchased power using the heat rate.

116. GMO's witness, Dr. Woo, determined the correlation between the daily on-peak per MWh procurement cost of a utility that owns natural-gas-fired generation and the daily natural gas price at Henry Hub.¹⁷⁶ Dr. Woo chose the AMRN and AECI nodes for his correlation analysis.¹⁷⁷ Because the utility's per MWh procurement cost depends on the heat rates of the generation fleet, Dr. Woo's assessment assumes three heat rates: (1) 7 MMBTU/MWh for a relatively new combined cycle gas turbine; (2) 9 MMBTU/MWh for a relatively new combustion turbine; and (3) 11 MMBTU/MWh for a relatively old combustion turbine.¹⁷⁸ The results of his study are presented in the following table:¹⁷⁹

Period	AMRN			AECI		
	7 MMBTU/MWh	9 MMBTU/MWh	11 MMBTU/MWh	7 MMBTU/MWh	9 MMBTU/MWh	11 MMBTU/MWh
18 Month: Dec. 2007 - May 2009	0.921	0.886	0.860	0.937	0.906	0.879
12 Month: June 2008 - May 2009	0.926	0.909	0.895	0.937	0.922	0.908
28 Month: Feb. 2007 - May 2009	0.903	0.847	0.795	0.921	0.871	0.820

Rearranging Dr. Woo's table chronologically, latest to earliest time period, is as follows:

Period	AMRN			AECI		
	7 MMBTU/MWh	9 MMBTU/MWh	11 MMBTU/MWh	7 MMBTU/MWh	9 MMBTU/MWh	11 MMBTU/MWh
28 Month: Feb. 2007 - May 2009	0.903	0.847	0.795	0.921	0.871	0.820
18 Month: Dec. 2007 - May 2009	0.921	0.886	0.860	0.937	0.906	0.879
12 Month: June 2008 - May 2009	0.926	0.909	0.895	0.937	0.922	0.908

¹⁷⁶ Henry Hub is the primary natural gas market driving the delivered natural gas price for GMO. GMO Exh. 22, Surrebuttal Testimony of Dr. Michael Proctor in File Number ER-2009-0090, pp. 6-7.

¹⁷⁷ GMO Exh. 9, Woo Surrebuttal, pp. 14-15. SNL Financial has identified 7 nodes as representative of the SPP market. Of those 7 nodes, GMO primarily transacts at AMRN and AECI. These are the proper pricing nodes for the correlation analysis. *Id.* at 11. No party offered any evidence to controvert this fact. "AMRN" is the Ameren node. AECI is the Associated Electric Cooperative, Inc. For a description of AECI, see File No. EO-93-259, Report and Order, issued September 17, 1993, 1993 WL 719871.

¹⁷⁸ GMO Exh. 9, Woo Surrebuttal, pp. 14-15.

¹⁷⁹ *Id.*

117. Dr. Woo's analyses establishes that the daily per MWh procurement cost and the daily Henry Hub natural gas price are highly correlated for the relevant prudence review period supporting the use of cross hedging to effectively manage the per MWh procurement cost risk.¹⁸⁰

118. Comparing the trend between the 28, 18, and 12-month periods just prior to the review period demonstrates that the correlation coefficients between the daily per MWh procurement cost and the daily Henry Hub natural gas price were strengthening as the time period for placing the hedges was approaching.

119. As the table of Dr. Woo's calculations demonstrates, even the most inefficient turbines, those having the highest per MWh procurement cost, satisfy the rule of thumb threshold for there being high correlation between spot market electricity prices and natural gas prices. And, by the time the 12-month pre-prudence review period is reached all but one (the most inefficient turbine) of the correlation coefficients satisfy the higher SEC test for having a highly correlated hedge.

120. Dr. Woo's calculations further demonstrate that the correlation coefficients for the 12-month period prior to the review period, using the 9 MMBTU/MWh heat rate (the heat rate closest in comparison to GMO's weighted average heat rate of 8.517 MMBTU/MWh), exceeds the SEC R-squared threshold of 0.80 and the rule of thumb

¹⁸⁰ GMO Exh. 9, Woo Surrebuttal, pp. 13-15.

threshold R-value of 0.85 and R-squared of 0.7225 for determining a hedge is highly correlated and highly effective.¹⁸¹

121. GMO's Witness Dr. Woo testified that a "highly effective" hedge between natural gas prices and daily on-peak electricity prices would demonstrate a correlation coefficient of approximately 0.8.¹⁸² Dr. Woo states this is because daily spot market electric prices can be highly volatile, with potentially large daily fluctuations.¹⁸³ Dr. Woo supports his conclusions with extensive mathematical analysis.¹⁸⁴ The correlation coefficients for the 18-month and 12-month period prior to the prudence review period satisfy Dr. Woo's test to be a highly effective hedge.¹⁸⁵

122. Staff Witness Eaves advocates for a perfect correlation of 1.0 (or almost perfect all of the time) before hedging between natural gas prices and daily on-peak electricity prices could be highly effective.¹⁸⁶ Witness Eaves stated that he believed this

¹⁸¹ GMO's weighted heat rate average reflects turbine efficiencies that are better than the 9 MMBTU/MWh heat rate being used for comparison. It is a reasonable inference that the correlation coefficients for GMO's generators would be even higher and would reflect a stronger correlation or more highly effective hedge.

¹⁸² GMO Exh. 9, Woo Surrebuttal, pp. 3, 7.

¹⁸³ See Finding of Fact Number 67 – the parties stipulated that the purchased power and natural gas markets were characterized by high volatility.

¹⁸⁴ GMO Exh. 8, Woo Direct; GMO Exh. 9, Woo Surrebuttal.

¹⁸⁵ Dr. C. K. Woo, is an economist and an expert on cross-hedging of natural gas futures contracts and spot purchase power. He received his PhD from the University of California-Davis, and he specializes in public utility economics, applied microeconomics and applied finance. He has 30 years of experience in the electricity industry, and has testified and prepared expert testimony for use in regulatory and legal proceedings in California, British Columbia and Ontario. He has published over 100 reference articles on electricity deregulation, procurement, risk management, and numerous other topics. More specifically, he has published sixteen professional journal articles on electricity procurement and risk management. GMO Exh. 8, Woo Direct, pp. 1-4.

¹⁸⁶ Transcript, pp. 313-332. Mr. Eaves holds a BS Degree in Business Administration with an emphasis in accounting. He has worked for the Commission as a Regulatory Auditor since April, 2001. He has participated in numerous cases before the Commission. According to Staff Witness Mantle, Mr. Eaves is currently the most knowledgeable person on the Commission's Staff with regard to electricity price hedging. Transcript, p. 203.

was because there were other drivers, like coal, that should be factored into the analysis.¹⁸⁷

Witness Eaves disagrees with the accounting profession and the electric industry profession that finds if you have a correlation of 0.80 (R-squared) or above that you can effectively hedge natural gas and electricity prices.¹⁸⁸ There is no industry publication, nor is there a Commission order or opinion, that requires a perfect, or almost perfect, correlation coefficient before it would be prudent to cross hedge electricity prices with natural gas prices.¹⁸⁹ Mr. Eaves opinion is not supported by the industry. Staff offers no evidence to support a perfect correlation test other than Mr. Eaves opinion.

123. While natural gas prices should be correlated on a monthly basis with spot market electricity prices, these prices do not have to be perfectly correlated because of the impact that monthly load variations can have on electricity prices.¹⁹⁰

124. Using the first post-validation test, i.e., the Dollar Offset test, GMO demonstrated that the estimated physical market change of value for on-peak electricity

¹⁸⁷ Transcript, pp. 348-350. In relation to the perfect correlation Mr. Eaves advocated for, he testified that the Commission should look at the outcome of the hedging program. Examining the outcome is a hindsight analysis and not appropriate under the prudence standard.

¹⁸⁸ Transcript, p. 320, 323. Mr. Eaves also took issue with the application of FAS 133, stating it should not apply to regulated utilities. Transcript, pp. 321-322. However, this is in direct contradiction with the language in the AAO which requires these hedging costs to be recorded on a Mark-To-Market basis, as required by Financial Accounting Standard No. 133. EFIS Docket Entry No. 66, *Joint Stipulation of Non-Disputed Material Facts*, filed on June 1, 2012. File No. ER-2006-0436, EFIS Docket Entry No. 244, *Nonunanimous Stipulation and Agreement*, Paragraph 17, filed January 31, 2006. See also Transcript, pp. 171-178; GMO Exh. 12, Transcript of Proceedings, On-the-Record Presentation, February 9, 2006, Volume 7, pp. 149-152.

¹⁸⁹ Transcript, p. 326.

¹⁹⁰ GMO Exh. 22, Surrebuttal Testimony of Dr. Michael Proctor in File Number ER-2009-0090, pp. 6-7. Dr. Proctor holds Bachelors, Masters and Ph.D. degrees in Economics. He has held positions as an Assistant Professor of Economics at Purdue University and the University of Missouri-Columbia. He was previously a member of the PSC's Staff, and held positions as the Chairman of SPP's Regional State Committee's Cost Allocation Working Group and Chairman of the Organization of Midwest ISO States' Financial Transmission rights Working Group.

was 109.6% of the actual change in the value of the natural gas cross hedges. This falls within the range of 80-120 percent highly effective range for this test.¹⁹¹

125. Applying the second post-validation test involves examining the total effective rate by examining the total variable fuel and purchased power cost. GMO demonstrated that for the relevant prudence review period, total costs dropped to values lower than the prior prudence review periods. Purchased power costs did not skyrocket.¹⁹²

126. The third post-validation study establishes that the cost of the hedge to cover the risk during the prudence review period was 9%. This cost falls within the industry range of being less than 30%. The hedging insurance was worth the cost.¹⁹³

127. GMO's hedges did what they were supposed to do. GMO's hedging strategy achieved the goal of avoiding rate risk from skyrocketing fuel and purchased power prices.¹⁹⁴ The electricity price movement was offset by a similar movement in the price of natural gas.¹⁹⁵ GMO's hedge program protected its customers from large unexpected upward market price fluctuations while holding the cost of natural gas and purchased power below budget.¹⁹⁶ No harm resulted to GMO's ratepayers.¹⁹⁷

¹⁹¹ GMO Exh. 2, Blunk Surrebuttal pp. 12-13, 24; Schedules WEB-8 and WEB-9. The Commission's Staff offered no evidence on post-validation studies; however, Staff Counsel, in its Reply Brief, argues that performing a post-validation test "opened the door to hindsight." EFIS Docket Entry No. 129, Staff's Reply Brief, p.9. Staff Counsel is incorrect. While the post-validation study cannot be used to determine the prudence of GMO's hedging program the existence of this test does not change the prudence standard. Post-validation tests are instead used to confirm the effectiveness of a hedging program and demonstrate that no harm was caused by the hedging program.

¹⁹² GMO Exh. 1, Blunk Direct, pp. 31-33; GMO Exh. 20, Graph - Total Variable Fuel and Purchased Power Cost; Transcript, pp. 335-338. For the period 2008 through 2011 the \$/MWh equivalent value constructed from actual results was slightly less than the budgeted value. GMO Exh. 1, Blunk Direct, p. 32

¹⁹³ Transcript, pp. 117-120.

¹⁹⁴ GMO Exh. 1, Blunk Direct, pp. 31-35.

¹⁹⁵ GMO Exh. 2, Blunk Surrebuttal pp. 12-13.

¹⁹⁶ GMO Exh. 1, Blunk Direct, pp. 32-33; Transcript, pp. 316-317.

¹⁹⁷ The post-validation tests confirm there was no harm to the ratepayers.

Conclusions of Law - The Prudence of GMO's Hedging Practices

The substantial and competent evidence on the record as a whole supports the conclusion that the Commission's Staff failed to produce substantial controverting evidence demonstrating serious doubt, as required, to rebut the presumption of prudence with regard to GMO's hedging practices for the prudence review period of June 1, 2009 through November 30, 2010. While the parties agreed that correlation analysis was the industry-accepted method for evaluating if the hedge between natural gas futures and spot market purchased power prices was highly effective and prudent, Staff offered no proper analysis pursuant to the prudence standard that was prospective, or forward-looking. Staff failed to analyze whether the utility's conduct was reasonable at the time, under all of the circumstances, considering that the company had to solve its problem prospectively rather than in reliance on hindsight. Because all of Staff's studies were totally in hindsight, or else a mixed hindsight and prospective study, none are relevant to the Commission's determination. The Commission's analysis could end at this point because Staff failed to rebut the presumption of the prudence of GMO's hedging practices and the burden of production never shifted to GMO to require it to offer any evidence on the prudence of its hedging practices.

Although not required, GMO, in response to Staff's allegations, did produce substantial and competent evidence demonstrating that its hedging program was prudent by industry standards. GMO's prospective correlation coefficient analyses demonstrate that its hedging practices during the review period were prudent. GMO's analyses produced correlation coefficients that satisfied Dr. Woo's test, the "Rule of Thumb" test, and the SEC's test for highly effective hedges. The only test not satisfied was Staff Witness

Eave's perfect correlation test; a test that is not accepted by the industry and that was fully discredited.

Additionally, post-validation tests, while not a measure of prudence, confirm that GMO's hedging accomplished the goal of avoiding rate risk from skyrocketing fuel and purchased power prices, i.e. the ratepayers benefited from the hedging program. During the FAC audit period in this case, GMO chose to enter into a hedge to protect its customers against skyrocketing electric prices. GMO chose this approach based upon: (a) its own professional judgment that hedging was the prudent thing to do to protect its customers, (b) the policy statement contained in Commission's *Natural Gas Price Volatility Mitigation Rule* (4 CSR 240-40.018) that encourages local distribution companies to hedge, and (c) Commission orders and other signals received from the regulatory community that hedging was expected or at least strongly encouraged.¹⁹⁸

While not included in the parties' issues list, Staff Counsel, at the evidentiary hearing and in its post-hearing brief, raised another argument regarding GMO's conduct. That argument was that GMO had over-relied on purchased power due to its lack of sufficient efficient generation capacity. However, as the record demonstrates, Staff's witnesses testified that: (1) this argument, the need for additional capacity, was not the basis for the disallowance it had proposed in this case; (2) no Staff witness testified that GMO over-relied on spot market electricity; (3) as long as spot market prices for electricity are lower than GMO's cost to generate energy with its own generation, GMO should be buying electricity on the spot market; and (4) during the FAC prudence audit period, purchasing power on the spot market was prudent for GMO to meet its customers' needs. Moreover, it

¹⁹⁸ *Id.* See also Findings of Fact Numbers 83-106.

was established that additional generation capacity would not eliminate GMO's electricity and natural gas spot market price risks – neither building nor buying natural gas-fired power plants protects either the Company or its customers from power market prices in a market driven by the price of natural gas.¹⁹⁹

In addition to increased capacity, Staff also suggested that another alternative to spot market purchased power was to enter into purchase power agreements. However, entering such contracts eliminates the liquidity and flexibility associated with spot market purchases and can result in additional costs or penalties if modifications are required.²⁰⁰ Neither of these alternatives, increased capacity nor purchased power agreements, are realistic methods of hedging electric prices in the near term since the lead times on such projects are several years. And no party offered any evidence to demonstrate a cost-benefit analysis of how either of these alternatives would be least cost alternatives as opposed to spot market purchased power. There is no competent or substantial evidence to supports Staff's additional arguments.

The substantial and competent evidence on the record as a whole supports the conclusion that GMO's hedging practices during the relevant review period were prudent. They were reasonable at the time, under all of the circumstances, considering that GMO had to solve its problem prospectively rather than in reliance on hindsight. The substantial and competent evidence on the record as a whole also supports the conclusion that no harm came to GMO's ratepayers in relation to GMO's hedging practices.

¹⁹⁹ See Findings of Fact Numbers 70-72; Staff Ex. No. 2, Mantle Rebuttal, pp. 1-6; Tr. 122-124, 132, 205, 211-212, 361-362.

²⁰⁰ See Findings of Fact Numbers 86-88.

G. GMO's Accounting for Its Hedging Costs

Findings of Fact:

128. In the Non-Unanimous Stipulation and Agreement in Aquila's 2005 rate case, File No. ER-2005-0436, the Signatory Parties, including Aquila (now GMO) and Staff, agreed to the following language in the Stipulation and Agreement for an Accounting Authority Order ("AAO"):

Accounting Authority Order

17. The Signatory Parties agree, for accounting and ratemaking purposes, that hedge settlements, both positive and negative, and related costs (e.g. option premiums, interest on margin accounts, and carrying cost on option premiums) directly related to natural gas generation and on-peak purchased power transactions under a formal Aquila Networks- MPS hedging plan will be considered part of the fuel cost and purchased power costs recorded in FERC Account 547 or Account 555 when the hedge arrangement is settled. These hedging costs will continue to be recorded on a Mark-To-Market basis, as required by Financial Accounting Standard No. 133, with an offsetting regulatory asset FERC Account 182.3 or regulatory liability FERC Account 254 entry that recognizes the change in the timing of value recognition under Financial Accounting Standard No. 71 . Aquila agrees there will be no rate base treatment afforded to hedging expenditures recorded on the Mark-To-Market basis. Aquila agrees to maintain separate accounting in Accounts 547 and 555 to track the hedging transaction expenditures recorded under this agreement.²⁰¹

129. No party objected to the Nonunanimous Stipulation and Agreement.²⁰²

130. No party sought to modify or supplement the language of the AAO.²⁰³

131. "Staff's Suggestions In Support Of Nonunanimous Stipulation and Agreement," filed on February 7, 2006 in Case No. ER-2005-0436, state:

²⁰¹ EFIS Docket Entry No. 66, *Joint Stipulation of Non-Disputed Material Facts*, filed on June 1, 2012. File No. ER-2006-0436, EFIS Docket Entry No. 244, *Nonunanimous Stipulation and Agreement*, Paragraph 17, filed January 31, 2006.

²⁰² See File No. ER-2005-0436.

²⁰³ *Id.*

As part of the Stipulation (paragraph 17) the Signatory Parties agree Aquila should be permitted to match its natural gas and purchased power hedging transaction settlements and associated hedging costs with the cost of fuel for accounting and ratemaking purposes and, therefore, as part of this Stipulation, if the Commission accepts the Stipulation, the Commission must grant Aquila an accounting authority order to do so. This accounting authority is acceptable to the Staff and should be implemented by the Commission because it allows Aquila to track the benefits and related costs for its hedging program consistent with how fuel costs are developed and be in compliance with generally accepted accounting principles once the Commission grants the authority.²⁰⁴

132. No party objected to, or sought to clarify the language in, Staff's Suggestions, as quoted in the above Finding of Fact.²⁰⁵

133. At the On-the-Record Presentation, held on February 9, 2006, Staff Witness Robert Schallenberg provided the following sworn testimony, in pertinent part, explaining the AAO to which the Signatory Parties agreed:

What that does, there is an – in accounting terms it's called FASB 133. If you buy a financial instrument related to a commodity, between the time you buy it and the time it closes or settles, you are required to adjust it on your books as to its market value, unless it is tied to a physical transaction. In fact, we call FASB 133, it's related to speculation. You're buying financial instruments without having physical transactions just hoping that the thing will settle in the money or you'll sell it while it's in the money. So you're just speculating on a financial transaction without any physical control.

Our utilities, and that would include not only electrics but natural gas, under risk management that I'm aware of, they tie the financial transaction to the physical transaction, so that if they've agreed to buy a certain amount of gas at a certain time, they have gone and gotten a financial transaction to hedge that to a price certain, not that the physical price will fluctuate, but when you look at that and combine it with the financial transaction, it will result in a price that's fixed.

²⁰⁴ Transcript, pp. 166-170; GMO Exh. 11, *Staff's Suggestions in Support of Nonunanimous Stipulation and Agreement*, Paragraph 4, EFIS Docket Entry No. 249 in File No. ER-2005-0436. Official notice was also taken of this public document. Transcript, pp. 371-373.

²⁰⁵ See File No. ER-2005-0436. Presumably, Staff, who is Staff Counsel's client, reviewed and approved of this filing. Commission Rule 4 CSR 240-2.080 makes clear that any attorney signing a pleading is representing that he or she is so authorized to act.

By making that connection, and that's what this portion of the stipulation is, they do not have to adjust their books based on the market value fluctuations of that financial instrument. And so it was designed to, one, allow Aquila to use what's called FASB 171, which is a regulatory one, so they no longer have to do a mark to market, **and it also makes the connection between the physical transaction and the financial transaction for fuel expense more definite, so it can actually be booked as fuel expense.**²⁰⁶

Generally speaking, I'd say probably the main cause for the need is that their external auditor claims that they needed more documentation than we have. The reason you won't normally see it is, most of the other utilities' external auditors have not insisted on an Accounting Authority Order.

Now, the practice that's reflected in this agreement is consistent with the practice that's taking place in our other utilities. It's just that their external auditors have not insisted on language in a Commission Order to the same extent that Aquila has a requirement.²⁰⁷

But I also want to point out, though, **this agreement has the benefit of tying the financial instrument as fuel expense so -- and without that, they would actually book the financial instrument in another account, and you would [be] susceptible to the argument that the financial instrument and the gain could be separated from fuel expense.**²⁰⁸

(Emphasis added).

134. No party objected to, or sought to clarify, Staff's sworn testimony, as quoted in the above Finding of Fact.²⁰⁹

²⁰⁶ Transcript, pp. 171-178; GMO Exh. 12, Transcript of Proceedings, On-the-Record Presentation, February 9, 2006, Volume 7, pp. 149-152.

²⁰⁷ *Id.*

²⁰⁸ *Id.* All of the Signatory Parties to the Nonunanimous Stipulation and Agreement in File No. ER-2005-0436 entered appearances at the On-the-Record Presentation held on February 9, 2006. *Id.* It is worthy of note that the last sentence of this passage makes clear that granting the AAO precluded the argument that hedging cost should be booked separate from fuel cost. Official notice was also taken of this public document. Transcript, pp. 371-373.

²⁰⁹ See File No. ER-2005-0436. It should be noted that Staff Counsel raised two objections with regard to the Regulatory Law Judge ("RLJ") asking Staff Witness Hyneman to explain Staff's position on the accounting methods authorized in the AAO approved in File No. ER-2005-0436. The first was the parol evidence rule. (Transcript, pp. 185-187, 368-371). That objection was overruled because the issue involves a Commission order, specifically an AAO, not a contract. The second objection was that Mr. Schallenberg should have been called to witness stand to explain his prior testimony. At the evidentiary hearing, Staff provided no legal basis for this objection rendering it an improper objection. In its post-hearing brief, Staff cites to Commission Rule 4 CSR 240-2.130(10) for the proposition that Staff did not have a reasonable opportunity to respond to the two public records in ER-2005-0436, which the RLJ inquired about – public documents Staff now claims, by

135. The AAO applied to Aquila's, now GMO's, hedging program, which included both natural gas and purchased power hedging.²¹⁰

136. The AAO provided that GMO's natural gas and purchased power hedging transaction settlements and associated hedging costs would be matched with the cost of fuel for accounting and ratemaking purposes.²¹¹

137. The physical transaction and the financial transaction of GMO's hedging program were connected by means of the AAO to be specifically recorded as being fuel costs.²¹²

138. The AAO provided that hedge settlements and related costs, both positive and negative, were to be included.²¹³

reference to the rule, were not disclosed prior to the hearing. Staff's belated argument is erroneous. First, Staff is the party that interjected this issue into the case when it alleged GMO engaged in deceptive accounting practices in relation to what GMO was authorized to do in the AAO. The inquiry was relevant to interpreting the Commission's order approving that AAO and the AAO itself. Second, Staff's chosen witness for this matter, Mr. Hyneman, testified that he was the "primary auditor for Aquila's hedging program" in ER-2005-0436. (Transcript p. 166). Mr. Hyneman claimed expertise in interpreting the AAO, and he was Staff's chosen witness on this issue. He was Staff's witness raising the allegation that GMO violated the terms of the AAO. (Staff Exh. 3, Hyneman Rebuttal, pp. 15-27, Transcript, p.167). Mr. Hyneman was the appropriate witness to offer an explanation of Staff's prior position on the hedging practices and the accounting methods for the hedging costs authorized by the Commission with the AAO. Mr. Hyneman was given a full and fair opportunity to address the documents delineating Staff's position on the AAO. Finally, Staff's contention that it was unaware of its own prior position on what the AAO authorized, and that Staff's own prior position needed to be disclosed to Staff, so Staff could have a greater opportunity to respond to itself at the hearing, is meritless. Commission Rule 4 CSR 204-2.130(2) allows documents that are part of a public record to be received into evidence by reference and without production. Staff's claim that the filings and testimony in ER-2005-0436 (which are not only a matter of public record and fully disclosed in the primary case involved in this dispute raised by Staff, but which include a document authored and filed by Staff and sworn testimony provided by Staff) somehow surprised it at the evidentiary hearing is beyond comprehension.

²¹⁰ GMO Exh. 11, *Staff's Suggestions in Support of Nonunanimous Stipulation and Agreement*, Paragraph 4, EFIS Docket Entry No. 249 in File No. ER-2005-0436. Official notice was also taken of this public document. Transcript, pp. 371-373.

²¹¹ GMO Exh. 11, *Staff's Suggestions in Support of Nonunanimous Stipulation and Agreement*, Paragraph 4, EFIS Docket Entry No. 249 in File No. ER-2005-0436.

²¹² GMO Exh. 12, Transcript of Proceedings, On-the-Record Presentation, February 9, 2006, Volume 7, pp. 149-152.

²¹³ GMO Exh. 11, *Staff's Suggestions in Support of Nonunanimous Stipulation and Agreement*, Paragraph 4, EFIS Docket Entry No. 249 in File No. ER-2005-0436.

139. Staff and GMO understood that the practice of accounting authorized by the AAO was consistent with the practice taking place in other regulated utilities.²¹⁴ No other party to File No. ER-2005-0436 disputed this fact.

140. Staff and GMO understood that the accounting practices authorized in the AAO were in compliance with generally accepted accounting principles once the Commission granted the AAO.²¹⁵ No other party to File No. ER-2005-0436 disputed this fact.

141. The Commission approved the AAO in ER-2005-0436.²¹⁶

142. In the Stipulation and Agreement as to Certain Issues in Case No. ER-2007-0004, the Signatories, including Aquila (now GMO) and the Staff, agreed:

Hedge Costs. Aquila agrees not to seek recovery of its 2006 hedge settlement losses of \$11.5 million in this or any future regulatory proceedings. The Signatories agree that ultimate settlement values of Aquila's hedge contracts in place on March 27, 2007 for the period June 1, 2007 through December 31, 2009 will be subject to the provisions of any fuel cost recovery mechanism approved by the Commission in this case. However, the ultimate settlement values will not be subject to challenge as to a prudence disallowance relative to Aquila's original decisions to enter into these hedge positions. The market values for these contracts as of March 27, 2007 are reflected on the attached Schedule 1. In the event that the Commission does not implement a fuel cost recovery mechanism for Aquila, then the treatment for hedge costs shall be determined in a future proceeding. While Aquila believes that its current hedging practices are prudent, Aquila acknowledges that its continued use of its current hedging practices is subject to a prudence review and potential disallowances relative to hedge positions taken after March 27, 2007.²¹⁷

²¹⁴ GMO Exh. 12, Transcript of Proceedings, On-the-Record Presentation, February 9, 2006, Volume 7, pp. 149-152.

²¹⁵ GMO Exh. 11, *Staff's Suggestions in Support of Nonunanimous Stipulation and Agreement*, Paragraph 4, EFIS Docket Entry No. 249 in File No. ER-2005-0436; See also Transcript, pp. 166-170.

²¹⁶ File No. ER-2005-0436: EFIS Docket Entry Number 253, *Order Approving Stipulation and Agreement*, issued February 23, 2006, Effective March 1, 2006.

²¹⁷ File No. ER-2007-0004: EFIS Docket Entry No. 215, *Stipulation and Agreement as to Certain Issues*, filed April 4, 2007. File No. ER-2011-0390: EFIS Docket Entry No. 66, *Joint Stipulation of Non-Disputed Material Facts*, filed on June 1, 2012.

143. None of the non-signatory parties to the Stipulation and Agreement as to Certain Issues objected to or opposed the agreement.²¹⁸

144. The Commission approved the Stipulation and Agreement as to Certain Issues in File No. ER-2007-0004, Effective April 22, 2007.²¹⁹

145. In the Commission's Order Clarifying Report and Order issued on May 22, 2007 in File No. ER-2007-0004 (Aquila's 2007 rate case), the Commission stated:

On May 17, 2007, the Commission issued its Report and Order. In that order, at page 44, the Commission stated that "it would be improper to allow Aquila to flow hedging costs or demand costs associated with any purchased power contract through its fuel adjustment clause." Hedging costs and demand costs are also referred to collectively on page 43. **In each instance the phrase "hedging costs" was inadvertently included.** The language in question was only intended to address appropriate treatment of demand costs.

The treatment of hedging costs was addressed by the parties in the Stipulation and Agreement as to Certain Issues (Stipulation and Agreement). On April 12, 2007, the Commission approved the Stipulation and Agreement. **Under the Stipulation and Agreement, prudently incurred hedging costs will flow through the fuel adjustment clause,** but Aquila's 2006 hedge settlement losses of \$11.5 million were expressly excluded. The Stipulation and Agreement further provides that the ultimate settlement values of Aquila's hedge contracts in place on March 27, 2007, will not be subject to prudence review. Any hedge position taken after March 27, 2007, however, is subject to a prudence review and potential disallowance. (Emphasis added).²²⁰

(Emphasis added).

²¹⁸ The Commercial Group, Ameren Missouri, Jackson County, and the City of Kansas City, all filed statements of non-opposition. File No. ER-2007-0004: EFIS Docket Entry Numbers 216-219.

²¹⁹ File No. ER-2007-0004: EFIS Docket Entry No. 224, *Order Approving Stipulation and Agreement as to Certain Issues*, Effective April 22, 2007.

²²⁰ File No. ER-2007-0004: EFIS Docket Entry No. 368, *Order Clarifying Report and Order*, Effective May 27, 2007; File No. ER-2011-0390: EFIS Docket Entry No. 66, *Joint Stipulation of Non-Disputed Material Facts*, filed on June 1, 2012. Official notice was also taken of this public document. Transcript, pp. 371-373. "And since we've had quite a bit of testimony that's been heavily reliant on these prior cases, the Commission's going to take official notice of ER-2005-0436, ER-2007-0004, ER-2009-009, EO-2009-0115, EO-2010-0167 and ER-2010-0356, and specifically that would be official notice of any Stipulations & Agreements, any Commission Orders approving those, any filings in association with those, like suggestions in support thereof, for example, and any witness testimony admitted in those cases." *Id.*

146. No party to Case No. ER-2007-0004 objected to the Commission's clarification of how prudently incurred hedging costs were to be flowed through the FAC.²²¹

147. Tariffs were filed to implement the FAC.²²²

148. The Prudence Review Period of June 1, 2009 to November 30, 2010, covers three six-month accumulation periods. Tariff Sheet Nos. 124 - 127 were the first GMO FAC tariff sheets and these were effective through August 31, 2009. Tariff Sheet Nos. 127.1 - 127.5 were applicable to service provided September 1, 2009 through June 30, 2011.²²³ The tariff sheets in operation during that relevant time frame include the following pertinent language:²²⁴

For the first three months - June 1, 2009 to September 1, 2009:

P.S.C. Mo. No. 1, Original Sheet 124

"Costs eligible for Fuel Adjustment Clause (FAC) will be the Company's allocated variable Missouri Jurisdictional cost for the fuel component of the Company's generating units, purchased power energy charges, and emission

²²¹ See File No ER-2007-0004. "Staff's Recommendation Regarding Aquila's Tariff Sheets and Staff's Position on Hedging Costs," filed on May 22, 2007, states in pertinent part:

The Staff agrees with how the Commission has clarified the treatment of hedging costs in its May 22, 2007 *Order Clarifying Report and Order*, since the **Staff had anticipated the Commission's Report and Order would allow the recovery of hedging costs in any fuel adjustment clause or other fuel cost recovery mechanism the Commission might order.**

Further, the Staff states that the Commission's clarification of the treatment of hedging costs in its *Order Clarifying Report and Order* carries out the Staff's intent when it entered into the *Stipulation and Agreement as to Certain Issues*.²²¹

(Emphasis added).

File No. ER-2007-0004: EFIS Docket Entry No. 370, *Staff's Recommendation Regarding Aquila's Tariff Sheets and Staff's Position on Hedging Costs*, filed May 22, 2007. Official notice was also taken of this public document. Transcript, pp. 371-373.

²²² GMO Exh. 7, Rush Surrebuttal, Schedule TMR-1, TMR-2, TMR-4, TMR-5; Staff Exh. 13.

²²³ GMO Exh. 6, Rush Direct, pp. 4-5.

²²⁴ *Id.*; GMO Exh. 7, Rush Surrebuttal, Schedule TMR-1, TMR-2, TMR-4, TMR-5; Staff Exh. 13;

allowance costs. Eligible costs do not include the purchased power demand costs associated with purchased power contracts.”

P.S.C. Mo. No. 1, Original Sheet 125

F = Actual variable cost of fuel in FERC Accounts 501 & 547

P = Actual cost of purchased energy in FERC Account 555

For the remaining fifteen months – September 1, 2009 through November 30, 2010:

P.S.C. Mo. No. 1, Original Sheet 127.1

“Costs eligible for Fuel Adjustment Clause (FAC) will be the Company’s allocated variable Missouri Jurisdictional cost for the fuel component of the Company’s generating units, **including costs associated with the Company’s fuel hedging program**; purchased power energy charges, including applicable transmission fees; applicable Southwest Power Pool (SPP) costs, and emission allowance costs – all as incurred during the accumulation period.

These costs will be offset by off-system sales revenues, applicable net SPP revenues, and any emission allowance revenues collected during the accumulation period. Eligible costs do not include the purchased power demand costs associated with purchased power contracts in excess of one year.

P.S.C. Mo. No. 1, Original Sheet 127.2 and 127.3

FC = Fuel Costs Incurred to Support Energy Sales:

- The following costs reflected in Federal Energy Regulatory Commission (FERC) Account Numbers 501 & 502: coal commodity and railroad transportation, switching and demurrage charges, applicable taxes, natural gas costs, alternative fuel (i.e. tires and bio-fuel), fuel additives, quality adjustments assessed by coal suppliers, **fuel hedging cost (hedging is defined as realized losses and cost minus realized gains associated with mitigating volatility in the Company's cost of fuel, including but not limited to, the Company's use of futures, options and over-the-counter derivatives including, without limitation, futures contracts, puts, calls, caps, floors, collars, and swaps)**, fuel oil adjustments included in commodity and transportation costs, broker commissions and fees associated with price hedges, oil costs, ash disposal revenues and expenses, fuel used for fuel handling, and settlement proceeds, insurance recoveries, subrogation recoveries for increased fuel expenses **in Account 501.**

- The following costs reflected in FERC Account Number 547: natural gas generation costs related to commodity, oil, transportation, storage, fuel losses, **hedging costs**, fuel additives, fuel used for fuel handling, and settlement proceeds, insurance recoveries, subrogation recoveries for increased fuel expenses, broker commissions and fees **in Account 547**.

EC = Net Emissions Costs:

- The following costs reflected in FERC Account Number 509 or any other account FERC may designate for emissions expenses in the future: Emission allowances costs and revenues from the sale of SO₂ emission allowances.

PP = Purchased Power Costs:

- Purchased power costs reflected in FERC Account Numbers 555, 565, and 575: **Purchased power costs**, settlement proceeds,²²⁵ insurance recoveries, and subrogation recoveries for increased purchased power expenses **in Account 555**, excluding SPP and MISO administrative fees and excluding capacity charges for purchased power contracts with terms in excess of one (1) year.

OSSR = Revenues from Off-System Sales:

- Revenues from Off-system Sales shall exclude long-term full & partial requirements sales associated with GMO.

(Emphasis added).

149. The Commission-approved AAO in ER-2005-0436 coupled with the Commission's authorization to flow prudently-incurred hedging costs through the FAC and the pertinent tariff language demonstrate that prudently incurred costs of both sides of the hedge, the physical transaction and the financial transaction were linked so they could be booked as fuel expense in account 547.

150. The pertinent tariff language for the first three months of the prudence review period makes clear that only the actual cost of purchased energy was to be recorded in FERC Account 555, not the costs associated with hedging, which were developed consistently with, and linked with, the cost of fuel to be booked as fuel expense.

²²⁵ There is no evidence in the record that the term "settlement proceeds" is related to hedging practices. GMO witness Rush testified that these words were included in the PP description to cover any yet unknown changes to the way purchased power price volatility is mitigated. GMO Exh. 7, Rush Surrebuttal, p. 20.

151. Since File No. ER-2005-0436, the settlement costs (both gains and losses) attributable to natural gas hedges for gas to be burned in its generating facilities, as well as natural gas hedges made to mitigate the risk of peak purchased power price volatility, have been recorded in Account 547.²²⁶

152. The FAC tariff language was changed in GMO's Rate Case No. ER-2009-0090, at the suggestion of Staff, to add more clarity to the components contained in the FAC. The purpose of this was to add clarity as to what costs should be included in the FAC. As such, if specific costs are not included in the descriptions, they may be subject to exclusion from recovery.²²⁷

153. Since the Company has been recording the settlement gains or losses associated with its hedging program to Account 547 since the 2005 rate case, and since these costs were expressly included in the FAC in Case No. ER-2007-0004, the tariff listed hedging costs in the description of FAC includable costs in Account 547. GMO, and apparently the Staff, did not see the need to explicitly include the word hedging in the description of Account 555. This is because the hedge settlement costs have been booked to Account 547 since the Company was ordered to record those costs above the line in Case No. ER-2005-0436.²²⁸

154. Consistent with the Commission's orders and GMO's FAC tariffs, GMO accounts for the natural gas hedge costs associated with its cross-hedging practice in Account 547 because at the time the hedges actually settle, the determination of whether

²²⁶ GMO Exh. 6, Rush Direct, p. 5.

²²⁷ GMO Exh. 6, Rush Direct, pp. 3-4, 7. The Commission does not believe that when the parties modified this language that they intended to exclude prudently incurred hedging costs, regardless if the hedge costs resulted from hedging to mitigate the price of natural gas for generation or if the hedge costs resulted from hedging to mitigate the cost of purchased power. In fact, these costs are indistinguishable because the hedge serves both purposes.

²²⁸ GMO Exh. 6, Rush Direct, p. 8.

or not the Company will generate or purchase power has not yet been made since that determination is based upon a review of the least cost option.²²⁹ Consequently, all hedge settlements costs are natural gas settlement costs and are properly recorded in the 547 account, the natural gas account.²³⁰

155. GMO specifically records these natural gas hedging costs in a separate FERC subaccount, Account 547105. Throughout GMO's rate cases and FAC semi-annual filings, GMO has consistently recorded the hedge settlement costs in FERC subaccount, Account 547105.²³¹

156. GMO fully complied with the language of the AAO, the Commission's orders and the tariffs by recording the hedge settlements for natural gas for generation to FERC Account 547. Natural gas hedge settlements to mitigate power price volatility were also appropriately recorded to FERC Account 547. The dual purpose of the cross hedge does not change the nature of the commodity being hedged, i.e. natural gas is fuel.²³²

157. The actual price of purchased power is recorded in FERC Account 555. This includes the non-cash gain or loss from the spot market or physical side of the hedge. The

²²⁹ GMO Exh. No. 7, Rush Surrebuttal, pp. 10-11.

²³⁰ *Id.*

²³¹ GMO Exh. No. 7, Rush Surrebuttal, p. 11.

²³² GMO Witness Bryan Bresette testified that If GMO had started by booking its cross hedges as Staff is now saying it should, it would have had a very perverse impact on the pre-merger FAC. Since the pre-merger FAC did not include revenue from Account 447, GMO's customers would have effectively paid double for all electricity that was hedged. They would have paid when the physical electricity was purchased and recorded in Account 555, and they would have also paid for the futures contract as it was recorded in Account 555 but they would not have received the revenue from the sale of the futures contract because it would have been recorded in Account 447. GMO Exh. 3, Bresette Surrebuttal, p. 15.

unrealized gain related to purchased power is included in FERC Account 555 because the Company paid less per MWh to external electricity suppliers.²³³

158. GMO did not incur any hedge settlements directly related to on-peak purchased power transactions that would have been appropriately charged to FERC Account 555.²³⁴

159. GMO has consistently disclosed its accounting practices with regard to its hedging practices.²³⁵

160. GMO maintains its books and records in accordance with Federal Energy Regulatory Commission's ("FERC") Uniform System of Accounts ("USOA").²³⁶

²³³ GMO Exh. 3, Bresette Surrebuttal, pp. 13-14. The cost for the natural gas is recorded in Account 547. The cost of the purchased power is recorded in Account 555. Since both of these accounts are accumulated in the FAC, the customers' risk of spiking power prices is offset with the hedge adjustments from the natural gas derivatives. The key, as with hedging in general, is the net effect. GMO Exh. 1, Blunk Direct, p. 13-15. GMO includes both sides of the hedges in its FAC. The natural gas derivative cash settlement is in FERC Account 547 as a component of Fuel Costs and the non-cash change in value is in FERC Account 555 as a component of Purchased Power Costs. GMO Exh. 3, Bresette Surrebuttal, p. 11. Under the Company's method, the customer is not harmed since any potential loss in FERC Account 547 is offset the non-cash gain in FERC Account 555 and both are included in the FAC. GMO Exh. 3, Bresette Surrebuttal, p. 15.

²³⁴ GMO Exh. 3, Bresette Surrebuttal, p. 20. As explained by Mr. Bresette, there are instances where the hedge costs associated with the electricity that is hedged using NYMEX natural gas futures contracts are appropriately included in the "PP = Purchased Power Costs" component of the FAC. Sometimes GMO will convert a natural gas cross hedge to an electricity forward. When that happens, the hedge adjustment from the natural gas contract that effectively fixed the future price of electricity through the cross hedge is recorded in Account 547 and included in the "FC = Fuel Costs Incurred to Support Sales" component of the FAC. The price fix which began as a natural gas cross hedge is converted from one derivative to another derivative. It is converted from a NYMEX futures contract for natural gas to a forward contract for electricity. Much like the hedge adjustment recorded in Account 547 which occurred because the natural gas market had moved from the time the hedge was initiated to the time it was closed. The Company is locked into a price for electricity that ends up being either less or more than the prevailing spot price for electricity. That non-cash opportunity gain or loss on the electricity forward which began as a NYMEX natural gas futures contract is included in Account 555 and the PP = Purchased Power Costs" component of the FAC. GMO Ex. No. 3, Bresette Surrebuttal, p. 12.

²³⁵ GMO Exh. 13, Data Request No. 0029 in File No. EO-2011-0390; GMO Exh. 14, Data Request No. 0029 in File No. EO-2010-0167 (HC); GMO Exh. 15, Data Request No. 0030 in File No. EO-2009-0115. See also GMO Exh. 3, Bresette Surrebuttal, Schedule RAB-1 for copies of GMO's derivative footnote from 2006 – 2011. The Staff members who prepared the Third Prudence Review Report were Dana Eaves, Leon Bender, Matthew Barnes and David Roos. Three members of Staff's management, Staff witness Lena Mantle and Staff Counsel reviewed the Report. Staff Witness Mantle's testimony that any given member of this team would not be knowledgeable about GMO's disclosures in its answers to Staff's Data Requests is not credible. See Transcript, pp. 191-196, 220-225, 254-255.

²³⁶ GMO Exh. 3, Bresette Surrebuttal, p. 15-16; GMO Exh. 6, Rush Direct, p. 6.

161. GMO's accounting treatment of its hedging program is in accordance with the Generally Accepted Accounting Principles ("GAAP") and FERC accounting.²³⁷

162. Because GMO has complied with the "Uniform System of Accounts Prescribed for Public Utilities and Licensees subject to the provisions of the Federal Power Act, as prescribed by the Federal Energy Regulatory Commission (FERC)," it has also complied with Commission Rule 4 CSR 240-20.030.

163. GMO discloses its accounting methods in the notes to the financial statements of GMO's FERC Form 1.²³⁸ In GMO's FERC Form 1, GMO discloses the fair value of these contracts that are subject to regulatory treatment. In addition, the Company has consistently disclosed the gain or loss on the contracts which mitigate both fuel and power price risk, and which are recorded to fuel expense (i.e. FERC Account 547).²³⁹ In the derivative footnote in the FERC Form, GMO discloses the hedging program and the purpose of the program. GMO typically states:

GMO's risk management policy is to use derivative instruments to mitigate price exposure to natural gas price volatility in the market. The fair value of the portfolio relates to financial contracts that will settle against actual purchases of natural gas and purchased power.

²³⁷ *Id.*; Schedule RAB-2, Independent Auditors' Reports. The Company has been audited by Staff for two previous FAC audit periods and had its rates and operations reviewed in four rate cases, and the Company also has external auditors who have given GMO unqualified statements related to its books and records during the relevant time period of the prudence review. Deloitte & Touche, LLP, the Company's external auditors, have stated in these opinions: "In our opinion, such regulatory-basis financial statements present fairly, in all material respects, the assets, liabilities, and proprietary capital of the Company [years ending December 31, 2009 and December 31, 2010] in accordance with the accounting requirements of the Federal Energy Regulatory Commission as set forth in the Uniform System of Accounts and published accounting releases." GMO Exh. No. 3, Bresette Surrebuttal, Schedule RAB-2, pp. 5-7.

²³⁸ GMO Ex. 3, Bresette Surrebuttal, pp. 7-8.

²³⁹ GMO Ex 3, Bresette Surrebuttal, Schedule RAB-1 for copies of GMO's derivative footnote from 2009 – 2011.

In a table in the footnote, the Company discloses the fair value of the natural gas hedges recorded in a regulatory account and the amount of gain or loss recorded in fuel expense in 2009 and 2010.²⁴⁰

164. In GMO's FERC Form 1, Paragraph 13, Derivative Instrument, GMO also provides a disclosure that in GMO's 2005 Missouri electric rate case, it was agreed that the settlement costs of these contracts would be recognized in fuel expense and be included in GMO's FAC.²⁴¹

165. GMO has followed the USOA rules for booking its hedge costs, and it has consistently done so since 2005.

166. Four rate cases and two FAC prudence reviews have been conducted since the beginning of the company's hedging practices, and no party to these actions has previously asserted that GMO has engaged in any improper accounting practices.²⁴²

167. Despite Staff's allegations that hedging costs related to spot market purchased power have been improperly accounted for and should not be recovered through the FAC, the Commission's Staff testified that it is not opposed to GMO recovering the prudently incurred hedging costs associated with purchased power through its FAC.²⁴³

²⁴⁰ GMO Ex. 3, Bresette Surrebuttal, p. 7.

²⁴¹ GMO Ex 3, Bresette Surrebuttal, Schedule RAB-1 for copies of GMO's derivative footnote from 2009 – 2011.

²⁴² GMO Exh. 1, Blunk Direct, p. 4; GMO Exh. 4, Clemens direct, pp. 4-10; GMO Exh. 5, Heidtbrink Direct, p. 5; GMO Exh. 7, Rush Surrebuttal, p. 11, 16-19; Staff Exh. 15, [Second] Prudence Review of Costs Related to the Fuel Adjustment Clause for the Electric Operations of KCP&L Greater Missouri Operations Company; Staff Exh. 16, [Third] Prudence Review of Costs Related to the Fuel Adjustment Clause for the Electric Operations of KCP&L Greater Missouri Operations Company. See also File Numbers ER-2005-0436, ER-2007-0004, ER-2009-0090, EO-2009-0115, EO-2010-0167 and ER-2010-0356 See also GMO Ex. No. 4, Clemens Surrebuttal, pp. 4-10; GMO Ex. No. 5, Heidtbrink Direct, pp. 3-10; GMO Ex. No. 6, Rush Direct, pp. 8-10; Staff Ex No. 3, Hyneman Rebuttal, p. 10; GMO Ex Nos. 13, 14 and 15; Transcript, pp. 221-226.

²⁴³ Transcript, p 247.

Conclusions of Law Regarding GMO's Accounting for Its Hedging Costs

The Commission ordered that all of GMO's prudently incurred hedging costs would be recovered through its FAC.²⁴⁴ The Commission prescribed the accounting treatment for GMO's hedging costs by means of the AAO to ensure the physical and financial transactions would be connected and booked as fuel costs. The Commission's Staff has alleged that GMO engaged in improper accounting in order to improperly recover hedging costs associated with purchased power, while at the same time has testified that it is not opposed to GMO recovering its prudently incurred hedging costs associated with purchased power through its FAC.²⁴⁵ And, the record reflects that GMO has properly, and openly, accounted for its hedging costs, consistent with the Uniform System of Accounts, previous stipulations and agreements, and orders of the Commission.

The substantial and competent evidence on the record as a whole supports the conclusions that GMO's accounting practices: (1) were authorized by the Commission-approved AAO and the relevant tariffs; (2) are not misleading or deceptive; and (3) do not result in distorted financial statements. The substantial and competent evidence on the record as a whole also supports the conclusions that GMO has consistently followed the USOA, FERC's accounting standards, the GAAP, and the Commission's rules for booking its hedging costs since the inception of its hedging program. The substantial and

²⁴⁴ Given that all prudently incurred hedging costs should be passed through the FAC mechanism, it should not matter in which account, Account 547 or Account 555 the hedge costs associated with the cross-hedging program were booked. Both accounts include hedging-related entries, and all prudently incurred hedging costs are supposed to be flowed through the FAC, as directed by the Commission's *Order Clarifying Report and Order* in the 2007 Aquila rate case, and agreed to by the parties to the Aquila 2005 stipulation. See also Finding of Fact 13 – the parties stipulated that “GMO's FAC allows GMO to recover from its ratepayers 95% of its prudently incurred variable fuel and purchased power costs above a base amount that is set in a general rate case.”

²⁴⁵ Staff's inconsistent positions do not aid its credibility. The evidence further supports that Staff has been aware of GMO's accounting practices throughout the implementation of GMO's hedging program.

competent evidence on the record as a whole further supports the conclusion that GMO did not improperly attempt to over-collect unauthorized or imprudent hedging costs from its customers – GMO’s ratepayers were not harmed.

IV. Final Decision

In making this decision, the Commission has considered the positions and arguments of all of the parties. After applying the facts, as it has found them, to the law to reach its conclusions, the Commission, upon its impartial and independent review of the whole record, has reached the following final decision.

The Commission’s Staff has failed to provide substantial controverting evidence to rebut the presumption of the prudence of GMO’s hedging practices. The Commission’s Staff has failed to meet its burden, by a preponderance of the evidence, of proving the GMO was imprudent with its hedging practices during the prudence review period of June 1, 2009 through November 30, 2010. The Commission’s Staff has failed to meet its burden, by a preponderance of the evidence, of proving GMO engaged in improper accounting practices in violation of the Accounting Authority Order from File Number ER-2005-0436. The Commission’s Staff has failed to meet its burden, by a preponderance of the evidence, of proving that GMO violated the Uniform System of Accounts. The Commission’s Staff has failed to meet its burden, by a preponderance of the evidence, of proving GMO violated its Fuel Adjustment Clause Tariff. All of Staff’s allegations, and the relief sought by Staff, will be denied.

In this proceeding, GMO suggested that additional guidance from the Commission regarding the appropriateness of the use of natural gas hedging by electric utilities such as GMO would be helpful. GMO also suggested that the Commission implement a process to

avoid similar disputes over its hedging programs in the future. Having considered the request, the Commission agrees that this is a reasonable approach, and will open an investigatory docket to review policies or procedures with regard to electric companies' hedging programs that will hopefully assist the utilities with developing effective hedging programs that serve the public interest by mitigating the rising costs of fuel.

THE COMMISSION ORDERS THAT:

1. The Staff of the Missouri Public Service Commission's ("Staff") allegations of imprudence on the part of KCP&L Greater Missouri Operations Company ("GMO") are denied.
2. The Staff's allegations that GMO engaged in improper accounting practices in violation of the Accounting Authority Order from File Number ER-2005-0436 are denied.
3. The Staff's allegations that GMO violated the Uniform System of Accounts are denied.
4. The Staff's allegations that GMO violated its Fuel Adjustment Clause Tariff are denied.
5. The Staff's request for relief, that GMO provide a refund to its customers, is denied.
6. The Commission shall open a working docket to review policies or procedures with regard to electric companies' hedging programs.

7. This Report and Order shall become effective on September 14, 2012.
8. This file shall be closed on September 15, 2012.

BY THE COMMISSION



Steven C. Reed
Secretary

(S E A L)

Gunn, Chm., Jarrett, Kenney,
and Stoll, CC., concur and certify
compliance with the provisions
of Section 536.080, RSMo 2000.

Dated at Jefferson City, Missouri,
on this 4th day of September, 2012.