BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

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

EMPIRE'S INITIAL POST-HEARING BRIEF

COMES NOW The Empire District Electric Company ("Empire" or "Company"), by and through counsel, and respectfully submits its Initial Post-Hearing Brief for consideration by the Missouri Public Service Commission ("Commission"):

Introduction

The overwhelming weight of the evidence demonstrates that Empire's hedging policy, and all costs flowed through Empire's Fuel Adjustment Clause ("FAC") for the period of March 1, 2015 through August 31, 2016 (the audit period in this case), were prudent. The Commission's FAC rule defines fuel and purchased power costs as "prudently incurred and used fuel and purchased power costs, including transportation" and states that "(p)rudently incurred costs do not include any increased costs resulting from negligent or wrongful acts or omissions by the utility." 4 CSR 240-20.090(1)(B). There is no credible evidence to support the allegation of the Office of the Public Counsel ("OPC") that Empire's customers paid increased costs resulting from negligent or wrongful acts or omissions – or otherwise imprudent acts or omissions – by Empire.

OPC has also failed to demonstrate, or even address, the overall impact of Empire's hedging program and/or the overall fuel costs flowed through to Empire's customers through the FAC. Total net fuel and purchased costs for the review period were $217,448,739, with total energy costs of $193,631,266 flowed through the FAC. Starting with the FAC period immediately prior to the audit period for this case, and continuing through the audit period, Empire's fuel costs for customers, as flowed through Empire's FAC, decreased with each FAC adjustment. Exs. 112-116; Tr. Vol 2, pp. 127-129.

Empire hedges, because Empire, upon considering and evaluating all pertinent information, including the guidance of this Commission, believes hedging is prudent and in the best interests of its customers. It has never been, nor should it be, the goal of Empire's hedging policy, as defined in Empire's Risk Management Policy ("RMP"), to ensure the lowest possible price for fuel, a price no one can predict. Instead, the RMP is designed to identify and mitigate risks, including the impact of price volatility over time. This concept has been recognized by the Commission and codified in Rule 4 CSR 240-40.018, pertaining to hedging by gas utilities ("Part of a natural gas utility's balanced portfolio may be higher than spot market price at times, and this is recognized as a possible result of prudent efforts to dampen upward volatility.").

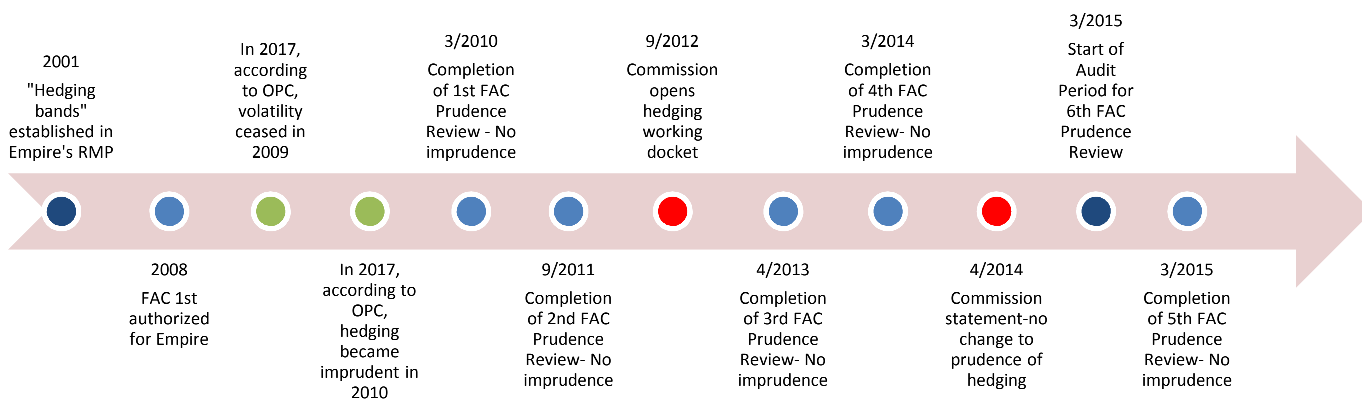
In this proceeding, both OPC and Empire have described hedging as a form of insurance against upward price movement and price volatility. Tr. Vol 2, p. 93, lines 15-24; *Id.*, p. 207, lines 1-2. In the event an adverse occurrence does not transpire, the value of insurance does not decrease, as the exposure to the identified risk was mitigated. Empire stands behind its hedging program, as defined in its RMP, and would have grave concerns regarding the cessation of its hedging program, as suggested by OPC, and the exposure Empire's customers would then face.

Empire's FAC and FAC Prudence Reviews and OPC's Collateral Attack

The Commission, pursuant to RSMo. 386.266 and Commission Rule 4 CSR 240-20.090, first authorized a FAC for Empire in Case No. ER-2008-0093. The Commission approved continuation of Empire's FAC, with certain modifications, in Case Numbers ER-2010-0130, ER-2011-0004, ER-2012-0345, ER-2014-0351, and ER-2016-0023. In each of these six rate cases, it was determined what cost categories would be included in Empire's FAC. In other words, in each case, it was determined exactly which costs and revenues Empire would be obligated to flow through its FAC. As a result of each rate case, Empire was authorized to flow hedging gains and losses through its FAC. Tr. Vol 2, pp. 80-84. In addition to rate cases, prudence reviews of costs flowed through the FAC are required every 18 months.

In this case, Empire's sixth FAC prudence review, the costs flowed through Empire's FAC from March 1, 2015 through August 31, 2016 (the 14th, 15th, and 16th six-month FAC accumulation periods) are subject to review. Five prior prudence reviews have occurred, Case Nos. EO-2010-0084, EO-2011-0285, EO-2013-0114, EO-2014-0057, and EO-2015-0214, all with no findings of imprudence on the part of Empire, and all with no disallowance of Empire's hedging losses incurred pursuant to Empire's hedging policy as defined in its RMP. Tr. Vol 2, pp. 84-90. "(T)he FAC rule does not allow recovery of imprudently-incurred costs." Tr. Vol 2, p. 148, lines 5-6 (Hyneman).

As in the prior five reviews, the Staff of the Commission ("Staff") found no imprudence on the part of Empire in this sixth prudence review. OPC, on the other hand, takes issue, in this sixth prudence review, with (1) "Empire's financial hedging decisions which appear to utilize inflexible natural gas hedge purchasing policies" and (2) "Empire's natural gas physical hedging activities as reflected by the above-market prices of its long-term natural gas supply purchases." Motion for Evidentiary Hearing, p. 2. A depiction of the timing of some of the events relevant to this proceeding is set forth below.



The "hedging bands," with which OPC takes issue in this proceeding, have been in Empire's RMP since 2001. According to OPC, Empire's hedging policy became imprudent in 2010. Tr. Vol 2, p. 92, lines 1-6. In the seven years since 2010, OPC participated in all referenced rate cases in which Empire was authorized to flow hedging costs through its FAC, and OPC was authorized and permitted to participate in all referenced FAC prudence reviews in which no imprudence was found. This, however, is the first FAC prudence review in which OPC has chosen to be involved, according to OPC witness Hyneman. Tr. Vol 2, p. 86, lines 18-19.

OPC's attempt to remove all hedging losses from Empire's FAC calculations is a prohibited collateral attack on Empire's FAC tariffs and the Commission's rate case orders and prior FAC prudence review determinations. *See* RSMo. 386.550. Disallowance of Empire's fuel costs as suggested by OPC would also constitute an unlawful taking, as Empire would be left with no avenue to recover these costs authorized by the Commission and incurred to provide service to Empire's customers.

<u>OPC's Limited Review</u>

This proceeding is to review and determine the prudence of Empire's FAC costs. Total net fuel and purchased costs for the review period were $217,448,739, with total energy costs of $193,631,266 flowed through the FAC for the review period. OPC witness Chuck Hyneman, however, testified that OPC "performed a prudence review and cost audit of Empire's hedging policy and hedging losses for the audit period." Tr. Vol 2, p. 70, lines 4-6. OPC "did not perform a prudence review or cost audit of any other part of Empire's fuel and purchase power costs." *Id.* at lines 6-8. Mr. Hyneman continued by explaining that "OPC's focus and scope in this case was primarily on Empire's natural gas fuel hedging policy." *Id.* at lines 14-16.

The Prudence Standard

The Commission's FAC rule defines fuel and purchased power costs as "prudently incurred and used fuel and purchased power costs, including transportation" and states that "(p)rudently incurred costs do not include any increased costs resulting from negligent or wrongful acts or omissions by the utility." Rule 4 CSR 240-20.090(1)(B). To evaluate prudence, Staff reviews "whether a reasonable person would find both the information the decision-maker relied on and the process the decision-maker employed when making the decision under review was reasonable based on the circumstances at the time the decision was made, i.e. without the benefit of hindsight." *See* Ex. 200, Staff's Sixth Prudence Audit Report, February 28, 2017, Staff Report, p. 1. "If either the information relied upon or the decision-making process employed was imprudent, then Staff examines whether the imprudent decision caused any harm to ratepayers. Only if an imprudent decision resulted in harm to ratepayers will Staff recommend a refund." *Id.*

Staff's prudence audit procedure is in line with the prudence standard advanced by the courts. A utility's conduct "should be judged by asking whether the conduct was reasonable at the time, under all the circumstances, considering that the company had to solve its problem prospectively rather than in reliance on hindsight. In effect, our responsibility is to determine how reasonable people would have performed the tasks that confronted the company." *State ex rel. Associated Natural Gas Co. v. Public Service Commission*, 954 S.W.2d 520, 529 (Mo.App. W.D. 1997) (internal citations omitted) (emphasis added).

Issues Presented

Issue 1: Was Empire's natural gas hedging policy that caused costs to be incurred for the period of March 1, 2015 through August 31, 2016 imprudent? No. Empire's hedging policy, and all costs flowed through Empire's FAC for the audit period, were prudent.

"As natural gas markets move through periods of high and low prices, results of hedging programs will also move through cyclic periods of gains and losses." Ex. 100, Doll Direct, p. 5. Empire witness Aaron Doll continued by explaining that hedging yields a reduction in price volatility, by keeping prices stable and predictable when evaluated over time. *Id.*, p. 6. Empire's fuel hedging program, as set forth in its RMP, provides Empire's customers a balanced approach to managing the various risks of price volatility, price mitigation, and credit exposure, while also providing protection against upward price trends. *Id.*, p. 5.

In its analysis, OPC disregards risks associated with attempts to purchase large volumes on the spot market, such as volume availability, credit limits, adverse price movement, and credit exposure. OPC points to hedging "losses," while apparently not understanding that "losses" and "gains" are relative terms used in comparison to a settled market price and are not proper tools for evaluating a hedging program. OPC also appears to misunderstand the fact that one may maintain a consistent overall hedging program or plan, while making particular hedge transaction decisions based on the current market conditions and the information then available.

Empire employs a balanced approach to managing the risks associated with supplying fuel to its natural gas generators, a task requiring consideration of many factors. With regard to the audit period, and all other times, Empire has employed, and maintained compliance with, a prudent Risk Management Policy. Ex. 105, Mertens Surrebuttal, p. 1. Empire's RMP allows the Company to address various areas of risk including, but not limited to, price volatility, credit exposure, and volume. Empire's RMP was designed to (1) provide structure and guidance, (2) allow flexibility and offer a variety of approved tools and strategies to accommodate various market conditions, and (3) effectively managing all risks, rather than singularly focus on price risks. *Id.*, p. 2. As noted by Empire witness Aaron Doll at the evidentiary hearing in this matter:

> Empire has continued to hedge from 2001 to current day. We have made adjustments within our strategy that is allotted for within the risk management

> policy, but at this time the only way we see to protect our customers from upward price risk is to hedge.

Tr. Vol 2, p. 186, lines 3-8. Mr. Doll also explained that the hedging minimums are not set in stone.

> I have a voting seat on RMOC, as well as a common presenter to the committee, as well as some of my analysts and managers as well. So, we could advocate to the risk management oversight committee for changes to the risk management policy if we felt it were prudent.

Tr. Vol 2, p. 204, lines 20-25. Empire witness Rob Sager explained that Empire is "constantly" looking at its hedging policies "to see if we feel it fits our current needs." Tr. Vol 2, p. 219, lines 22-24. The gas position reports for the time period, a portion of which are included in Exhibit 16, demonstrate the breadth of the materials being reviewed by Empire; and the meeting minutes for Empire's Risk Management Oversight Committee, contained in Exhibit 110C, demonstrate that Empire understands and respects its obligation to its customers to be informed and act prudently.

OPC has failed to provide evidence of imprudence on the part of Empire with regard to its FAC costs, including those related to its hedging program. Instead of reviewing Empire's hedging decisions based on the information available at the time hedges were placed, OPC evaluates Empire's hedging program based on "perfect information."

> Never once do they provide evidence of the natural gas forward curves at the times the hedges were executed. Rather, Mr. Riley and Mr. Hyneman rely on macro storage volumes, a current table of NYMEX prices which provide "perfect information" of how the natural gas market settled, and misidentification of current spot prices as a reasonable indicator of future prices.

Ex. 104, Mertens Rebuttal, p. 6. Mr. Mertens continues by explaining that since the OPC witnesses failed to review the forward curves from the time the hedges were executed, OPC was "unable to determine what would be considered reasonable at the time." *Id.*, p. 7. Further explanation regarding OPC's unfair and retrospective assessment of Empire's hedging activity is found on pages 10 and 11 of Mr. Mertens' Rebuttal Testimony, attached hereto.

Empire witness Doll explained that one cannot review the prudence of a hedging policy by simply comparing "mark to market," as is being done by OPC in this case.

> We certainly consider what the portfolio is showing as far as prices, but the reality is Empire is trying to hedge from adverse price movement, and to take what the current forward curves show and try to forecast yourself exactly what the price is going to be does not provide you that adverse price protection. At that point you'd be only trying to guess the market.

Tr. Vol 2, p. 206, lines 12-24. Mr. Doll continued by explaining that Empire evaluates the value of hedging "by providing that what I've heard termed as insurance." *Id.*, p. 207, lines 1-2. OPC witness Hyneman testified in this proceeding that hedging is akin to insurance. *Id.*, p. 93, lines 15-24.

As a "should have known" argument, OPC points to a decision from the Kansas Corporation Commission ("KCC") which directed that Empire not pass hedging gains or losses on to Kansas customers. The order was issued in 2008. OPC witness Hyneman testified that volatility in the gas market stopped in 2009. Tr. Vol. 2, pp. 90-91. In 2008, when the KCC decision was issued, the gas market displayed extreme volatility. Tr. Vol. 2, p. 208, lines 4-7. Also, Empire experienced substantial hedging gains in 2006, 2007, and 2008. *Id.*, p. 209, lines 1-7. The KCC hedging decision relied on by OPC appears to have no relevance to this proceeding, and it certainly cannot be used as evidence that Empire should have known to stop hedging in 2010.

OPC also points to settlements with other companies that resulted in those companies suspending hedging activities. The decisions made by these other companies also are not relevant to the case at hand. As explained by Staff witness Dana Eaves, there is no cookie-cutter approach to hedging, and Empire's particular generation mix makes hedging more important. Tr. Vol. 2, p. 296, lines 12-19. In recent years, Empire moved to a dual season peaking system, further increasing the necessity to hedge natural gas in winter months, when natural gas supplies are in higher demand due to heating loads or natural gas retail customers. Ex. 100, Doll Direct, p. 6. Mr. Eaves also explained, “(s)ince we don’t know what the fuel prices are going to be in the future and fuel is a critical component to produce energy that they sell to their customers, it’s important to have a stable supply of gas.” Tr. Vol. 2, p. 297, lines 11-15. “(T)hat’s goal number one in my mind as a regulator, you got to keep the lights on.” *Id.*, p. 308, lines 14-16.

Empire hedges, because Empire, upon considering and evaluating all pertinent information, believes hedging is prudent and in the best interests of its customers. Staff witness Dana Eaves testified that there is no incentive for a utility to utilize a hedging practice that might be judged to be imprudent. Tr. Vol 2, pp. 297-298. Empire witness Doll also explained that Empire’s merit incentives for employees are tied to low fuel and purchase power costs. Tr. Vol 2, p. 198, lines 10-18. The hedging policy set forth in Empire’s RMP was used to protect Empire from price volatility and other natural gas risks prior to the implementation of its FAC and has been kept in place to protect Empire’s customers from the potential of large unpredicted price swings. As acknowledged by OPC, gas prices change every hour, every day, every week, and every month. Gas prices and the availability of gas are constantly changing. Tr. Vol 2, p. 121, line 18 – p. 122, line 2. “The future gas prices cannot be predicted with certainty.” *Id.*, p. 126, lines 23-24.

The oversimplification of the review process by OPC dismisses the value and purpose of the hedge, which is to protect against exposure to risk. Mr. Sager explained the other purposes of a hedge and the purpose behind Empire’s RMP.

> (T)he purpose behind our risk management policy is basically to define an approach that we’ll utilize to manage our power and natural gas commodity risk overall. So, the hedging is definitely a key component to that. Whereas, your – we do numerous different types of transactions to all for what, which is already afforded in our policy. So, specifically it may not just be a future, but also a physical forward. We have to make sure that the units we have, some of the most efficient units in the SPP are available to run. <u>That’s one of the things we do to keep our costs low for the customers, and we have to be able to have those units available and if the gas is not available, then those units won’t run.</u>

Tr. Vol. 2, p. 242, lines 6-20. While a dollar to dollar comparison may result in the recording of a loss or gain for financial hedges, Empire's customers continue to benefit from Empire's RMP, which effectively manages risks and provides price stability.

Empire witness Blake Mertens recalled for the Commission that experts stated in 2004 and 2005 that gas prices would not go above $4 to $5, but that the prices were in the teens approximately one year later. Tr. Vol. 2, pp. 212-213. He continued by explaining the greater risk for a price increase than a price decrease at this time. “Obviously, much greater risk that they would go higher. . . . (T)here’s much more risk on the upside.” Tr. Vol. 2, p. 213, lines 17-25.

As explained by Empire witness Doll, citing various experts in the field, the natural gas market remains dynamic. There is no universal opinion that gas prices will remain low. Gas prices “typically act in cycles and . . . the cycles occur for a reason. So, low natural gas prices presage increase demand, which then raises the price.” Tr. Vol 2, pp. 201-204. For the audit period, as well as the preceding years, Empire has maintained compliance with its RMP and has effectively managed its natural gas risks through various market conditions, resulting in prudent FAC costs.

Issue 2a: If the Commission finds that Empire’s hedging policy was imprudent, should the Commission order a refund to Empire’s customers? No. Empire’s hedging policy, and all costs flowed through Empire’s FAC for the period of March 1, 2015 through August 31, 2006, were prudent.

In the event the Commission determines that Empire’s hedging policy was imprudent, a refund to customers would still not be warranted. No specific instances of imprudence on the part of Empire regarding its FAC costs have been identified or quantified by OPC in this proceeding. Rather, OPC has deemed Empire’s entire RMP to be imprudent due to an allegedly inflexible hedging policy. This is despite general support of Empire’s hedging policy from Staff and the

Commission, and the lack of objection from OPC, in previous proceedings, as discussed in detail above.

One cannot review the prudence of a hedging policy by simply comparing "mark to market," as is being done by OPC in this case for all financial hedges. OPC also seeks a refund related to physical hedges, but as explained by Staff witness Eaves, "physical hedges are just strictly gas costs." Tr. Vol. 2, p. 295, ln 20. "So, as a point there is no physical gains and losses from those transactions that flow through the FAC." *Id.*, lines 23-24.

Additionally, OPC has also failed to demonstrate, or even address, the overall impact of Empire's hedging program and/or the overall fuel costs flowed through to Empire's customers through the FAC. As previously noted, total net fuel and purchased costs for the review period were $217,448,739, with total energy costs of $193,631,266 flowed through the FAC. Starting with the FAC period immediately prior to the audit period for this case and continuing through the audit period, Empire's fuel costs for customers, as flowed through Empire's FAC, decreased with each FAC adjustment. Exs. 112-116; Tr. Vol 2, pp. 127-129 (Hyneman).

Issue 2b: What should be the amount of a refund, if any? As stated above, there is no basis for the Commission to order a refund. Additionally, OPC has failed to offer testimony which would demonstrate the proper amount for any refund. OPC has looked only at hedging "losses," and has failed to account for the overall impact of Empire's hedging program on the costs flowed through Empire's FAC for the audit period.

Issue 3: Should Empire change its hedging policy (as set forth in its Risk Management Policy)? If so, what changes should be made? Should Empire cease all hedging activities at this time? If Empire is directed to cease hedging at this time, under what circumstances should Empire resume hedging activities?

These questions do not need to be answered in this proceeding, in order for the Commission to reject OPC's allegations and determine that Empire's FAC costs were prudent. Additionally, Empire's management decisions are just that – decisions of Empire's management, and they should not be taken away from the company and placed in the hands of the Commission or OPC. That being said, however, direction from the Commission on these points could benefit Empire's customers, as is discussed in more detail below. Empire would also welcome direction or guidance from the Commission with regard to the Commission's current policy on the prudence of hedging.

Empire stands behind its hedging program, as defined in the RMP, and would have grave concerns regarding the cessation of its hedging program, as suggested by OPC, and the exposure Empire's customers would then face. Empire, though, is always willing to listen to alternative policy suggestions, including those regarding hedging and the mitigation of various risks.

Issue 4: Should a mechanism be put in place to allow stakeholders and/or the Commission to review and approve a utility's hedging plan prior to implementation? Again, this question does not need to be answered in this proceeding, for the Commission to reject OPC's allegations and determine that Empire's FAC costs were prudent.

RSMo. 386.550 prohibits collateral attacks on Commission orders, and advanced approval of hedging parameters could further discourage disputes like the one currently before the Commission. As noted above, the Commission first authorized a FAC for Empire in Case No. ER-2008-0093, and the Commission approved continuation of Empire's FAC, with hedging costs specifically delineated, in Case Nos. ER-2010-0130, ER-2011-0004, ER-2012-0345, ER-2014-0351, and ER-2016-0023. Empire's RMP, which is now being attacked by OPC on the basis of its allegedly inflexible structure, was in place during all of those rate case proceedings, as well as the first five FAC prudence reviews where no imprudence on the part of Empire was found.

The Commission was faced with a somewhat similar situation approximately five years ago. In that KCP&L Greater Missouri Operations Company ("GMO") prudence review, File No. EO-2011-0390, Staff alleged that GMO imprudently relied on an "overly rigid, market-insensitive cross hedging strategy" and should return nearly $15 million to customers.

The Commission found in favor of GMO and did not order any disallowances. The Commission found that "(y)ou cannot determine the success or failure of a hedging program by looking only at the futures market transaction" and that "(h)edging losses cannot be known until "after the fact," or in hindsight." Report and Order issued September 4, 2012, effective September 14, 2012, pp. 23, 28. The Commission concluded as follows: "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 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 that GMO was imprudent with its hedging practices during the prudence review period . . .

Id., pp. 47, 65. The same is true here for OPC and Empire, and Empire encourages the Commission to issue similar findings in this case.

Stemming from the GMO prudence review, the Commission opened an investigatory docket, File No. EW-2013-0101, "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." This docket was opened on September 5, 2012. As noted above, OPC now contends that Empire's hedging policy and all hedging losses incurred as a result of that policy have been imprudent since 2010.

With the conclusion of the hedging working docket, the Commission did not establish a pre-approval process for hedging programs, but the Commission, addressing a concern that "the words Staff used in the recommendation section of its report might signal a change in the Commission's views about hedging practices and the prudence of hedging decisions," assured the utilities that it was not changing its policy on the prudence of hedging. This statement by the Commission was issued on April 16, 2014 – approximately five years after volatility in the gas market ceased to exist, according to OPC's current statements, and only one year prior to the start of the audit period in this case.

WHEREFORE, Empire respectfully submits this Initial Post-Hearing Brief and requests that the Commission reject OPC's allegations and accept Staff's prudence review report. Empire requests such additional relief as is prudent under the circumstances.

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By:
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CERTIFICATE OF SERVICE

I hereby certify that the above and foregoing document was filed in EFIS on this 5th day of October, 2017, with notice of the same being sent to all counsel of record.

/s/ Diana C. Carter_________