

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

AG PROCESSING INC A COOPERATIVE,)	
Complainant,)	
)	
vs.)	HC-2010-0235
)	
KCP&L GREATER MISSOURI OPERATIONS)	
COMPANY,)	
Respondent.)	

AG PROCESSING INC A COOPERATIVE
PROPOSED FINDINGS OF FACT AND CONCLUSIONS OF LAW
ON REMAND

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COOPERATIVE

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I. PROPOSED FINDINGS OF FACT.

A. Introduction.

These Proposed Findings are prepared essentially following the *original* listing of issues. Those issues have somewhat been modified as a result of the remand from the Court of Appeals, but we will still follow the original outline.

B. Identified Issues.

1. Given that the Quarterly Cost Adjustment ("QCA") mechanism contained in the Stipulation approved in Case No. HR-2005-0450 included a price volatility mitigation mechanism, was Aquila/GMO imprudent in implementing a natural gas steam hedging program in order to mitigate price volatility?

As a result of the settlement of an earlier steam rate case,^{1/} the parties to this proceeding had developed an automatic adjustment mechanism, termed a "Quarterly Cost Adjustment" or "QCA" by which Aquila was permitted to adjust its steam rates on a quarterly basis through the means of a rate filing. Although there are dissimilarities, the process is similar to that employed by the Commission in the natural gas distribution company context through the purchased gas adjustment or "PGA," and, more recently, pursuant to statutory changes, through an electric rate adjustment mechanism/fuel adjustment clause or "FAC." In both those cases, the utility is permitted to adjust its rates up or down based on periodic computations of the variations in fuel costs. The variations are computed for defined cost accumulation periods and compare actual fuel costs for the period to a base level of fuel costs. In such cases the utility is permitted to collect these adjustment amounts, *subject to refund, and later prudence review.*

In this remanded case, the QCA mechanism included a 3 month cost accumulation period, a 12 month period to spread the cost variation and mitigate price volatility, a coal performance standard or minimum to incent management towards good performance and to protect consumers from substandard performance, and a cost tracking mechanism by which 80% of these changed costs (increases or decreases) were passed through to customers by the mechanism. These costs are recovered subject to refund and the arrangement

^{1/} HR-2005-0450.

is clear that they are subject to a later prudence review. This is that review.

At issue, however, are certain costs that Aquila incurred to hedge its natural gas costs. The Commission finds that, while Aquila was encouraged to engage in hedging, it was not authorized under the QCA mechanism to engage in imprudent hedging practices.

AGP's evidence is, and the Commission so finds, that the QCA mechanism, while not a hedging program per se, resulted in a spreading of increasing costs or cost spikes so that those costs would be smoothed. The impact is dramatic as illustrated in Chart 2 contained in Mr. Johnstone's Direct Testimony.^{2/}

AGP has shown and GMO admits that Aquila engaged in a mechanical hedging method, which it terms a "1/3 strategy," without consideration of the mitigational effects on customers of the QCA mechanism. Although Aquila argues in its brief that it expected natural gas prices to rise, and that its hedging strategy was intended to mitigate price volatility, AGP has shown by a preponderance of the competent and substantial evidence on the whole record that Aquila acted imprudently in failing to consider the effect of the QCA mechanism.

Aquila offered testimony from five witnesses. None of these witnesses offered any explanation of the rationale of the design of Aquila's hedging program or strategy and only one of the witnesses, Mr. Clemens, was involved in the development of

^{2/} Exhibit 1, Johnstone Direct, p. 6.

the QCA mechanism. However, he was unable to testify to any involvement in any corporate analysis, review or evaluation of the decision to implement this strategy that considered the implications of the QCA mechanism.

The Commission finds that AGP has met its burden of showing by a preponderance of the competent and substantial evidence on the whole record that the corporate decision to implement this hedging strategy did not consider the QCA at all and, in fact, only made brief reference to the 80/20 cost tracking mechanism. In fact, in a brief exchange of e-mails,^{3/} the QCA and its mitigating effects were never mentioned at all and one member of management recommended that the hedge program proceed as though there were no QCA. While this was apparently intended to suggest that the QCA should not introduce a bias one way or another into the decision to pursue a hedge program, it is no substitute for a lack of analysis of relevant facts about the impact of the QCA on retail rates.

- 2. Given that a price volatility mitigation mechanism was established in the Stipulation approved in Case No. HR-2005-0450, was Aquila/GMO imprudent in failing to take into appropriate consideration that mitigation mechanism before proceeding to implement a financial hedging program for natural gas fuel that was used to raise steam?**

^{3/} Exhibit 4.

The discussion of this issue is fully comprehended by the earlier discussion and no independent finding of fact is deemed necessary.

3. **Given that a price mitigation mechanism was approved by the Commission in the Stipulation in Case No. HR-2005-0450 and that there were only six steam customers, was Aquila/GMO imprudent in failing to discuss its proposed steam hedging program with its customers before implementing such a program?**

The fundamental question here is whether it was imprudent to proceed to a hedge program without first discussing the program with customers. There is factual disagreement regarding the extent to which AGP or other steam customers became aware or were even made aware of Aquila's intention to implement a hedging program. The transcript from the on-the-record presentation of the Stipulation and Agreement in HR-2005-0450^{4/} certainly reveals the existence of the program. However, there is dispute about the level of discussion. GMO points to discussions of the natural gas hedge program for the electric business and posits that AGP does not have clean hands as a result. AGP simply notes that there were only six steam customers and Aquila could have easily discussed the matter with them. Aquila argues that AGP knew in advance about its intentions regarding the steam hedging program by virtue of the electric hedge program.

^{4/} Exhibit 108.

Aquila's evidence included the testimony and extensive exhibits of Mr. Fangman, a long-time Light & Power (and later Aquila) customer representative. Mr. Fangman testified that he maintained continuing contact with the steam customers regarding their anticipated needs, and kept them informed about Aquila's activities. However, Mr. Fangman did not testify that he had advised the customers or AGP about the hedging program. Indeed, Mr. Fangman admitted that he did not even know that Aquila was engaging in a hedging program until a representative of AGP complained to him about the costs associated with the program. Mr. Fangman's testimony constitutes competent and substantial evidence to support a finding by this Commission that AGP and other steam customers were not informed by him of the existence of the steam hedging program. Moreover, even Mr. Fangman's evidence did not show that the customers or AGP was advised before the program or strategy was implemented.

Aquila also offered the testimony of Gary Clemens. Mr. Clemens was an Aquila employee and was involved in the discussions that resulted in the Stipulation and Agreement and QCA mechanism. Mr. Clemens' testimony, however, certainly supports the idea that the Stipulation and Agreement and QCA left room for a hedging strategy but falls short of supporting a finding that AGP ratified this particular hedging strategy.

Aquila also admitted Exhibit 108, that being a transcript of the February 27, 2006 presentation before the Commission regarding the Stipulation and Agreement. Mr. Clemens

testified at that session. However, his testimony is again not clearly directed to a particular strategy to be used for the steam system and, indeed, as AGP pointed out in brief, did no more than confirm that Aquila understood what the hedging program was to be. At no point did Mr. Clemens support a particular hedging strategy as Aquila now asserts.

Other Aquila witnesses were either not involved in the discussions or were not even Aquila employees at the time (Mr. Blunk), disclaimed any contact with the steam customers themselves (Mr. Gottsch), or did not testify to any customer knowledge, having left Aquila employ several years prior (Mr. Rush). No Aquila witness testified to any direct communication that was communicated to AGP or to other steam customers that a particular hedging strategy was to be used or that explained AGP's showing of imprudence in implementation. Indeed, even Mr. Clemens acknowledged that the Aquila electric program, which was implemented in the context of an Interim Energy Charge or IEC, differed in numerous particulars, including monitoring, proportionate purchases and continuing corporate review, from the program that Aquila now argues had been adopted for the steam system.

In order to conclude that there were relevant discussions as contended by Aquila the record would have to show 1) that the electric and steam natural gas programs were identical, and 2) that the customers were informed of this fact. The record shows that there were, in fact, numerous differences between the

two programs. Therefore, the customers could not possibly have been informed of the steam program from any discussions of the electric case.

The record further shows that not even Mr. Fangman, the Aquila customer liaison was aware of the steam hedge program, and therefore could have conveyed nothing of its substance to customers.

The Commission finds by a preponderance of the competent and substantial evidence on the whole record that customers including AGP were not informed of the steam hedge program or consulted as to its form in any constructive or meaningful way.

- 4. Given that natural gas is used as a "swing" fuel for raising steam and that analysis is required to establish the amount of natural gas to be hedged, was Aquila/GMO imprudent in adopting a steam hedging program design without analyzing the nature of its natural gas usage and quantifying the amount of natural gas fuel that should have been subject to any steam hedging program?**

Exhibit 108 makes clear that the Stipulation and Agreement was not limited to natural gas, but, rather to all fuel sources used by Aquila in generating steam. The quoted portion of the Exhibit 108^{5/} shows that coal as a base load fuel was included in the Stipulation and Agreement and QCA and the Stipulation and Agreement included the coal performance standard as a

^{5/} Exhibit 108, pp. 77-78.

means of creating an incentive for Aquila to continue to maintain the coal operation at a minimum level.

AGP's point is simple. It argues that Aquila was imprudent in designing and implementing the steam hedging program that it did because Aquila failed to analyze the nature of the load and appeared to focus solely on natural gas.

The Commission agrees and finds that AGP has proved imprudence on the part of Aquila by a preponderance of the competent and substantial evidence on the whole record. There is no evidence from Aquila that there was any analysis of the nature of the fuel load and the recognition that the nature of the natural gas load involved in the generation of steam was, by its nature, a swing load that could not be predicted with certainty on a forward-going basis. Thus, even if Aquila's "1/3 strategy" had been properly used, most if not all of the natural gas load would have been left to float on the market.

Aquila witness Blunk testified that the most important consideration in designing a hedging program was this analysis and the identification of the goals to be achieved through the hedging strategy. Although so testifying, Mr. Blunk did not testify that Aquila had made such an analysis nor that any goals had been identified during the design of the program. Indeed, in Exhibit 12HC, a portion of Mr. Blunk's testimony for KCPL in another case,^{6/} he testified that the program he had designed for KCPL was substantially dissimilar. This excerpt does not

^{6/} Case No. ER-2010-0355.

appear to support what Aquila implemented nor does his testimony filed herein provide that support.

No Aquila witness testified regarding any analysis that Aquila performed about its steam load or the nature of the fuel sources that were to be used to support that load. In the view of the Commission, it appears that Aquila simply took its "1/3 strategy" that was being used in its electric system and applied that same strategy to the gas purchasing that it was doing for the steam system. This Commission finds that Aquila's actions in so doing were imprudent. AGP has provided competent and substantial evidence that Aquila did not engage in this analysis or make these considerations.

AGP has proved by a preponderance of the competent and substantial evidence on the whole record that Aquila's actions in this regard were imprudent.

5. **Given that analysis is required to establish the amount of natural gas to be hedged for use as a "swing" fuel, did Aquila/GMO act imprudently in failing to analyze the nature of natural gas usage and the quantity to be hedged and in failing to properly use information purportedly obtained from consultations with its customers regarding their projected steam usage resulting in forecasts that were over twice the actual usage in many months?**

The essence of this issue is whether Aquila prudently relied upon information from its steam customer regarding their anticipated usage and demands in formulating its steam hedging program.

AGP produced evidence in the form of several exhibits that Aquila's forecasts were significantly excessive compared to actual burns. Aquila witness Gottsch testified that he had made no independent analysis of actual hedging needs, but simply did what he was told with regard to how much to hedge. Mr. Fangman testified that he gathered this information but did not perform the forecasts himself, rather he forwarded this information to a higher level within Aquila where a Mr. Nelson (who was not offered as a witness) did the actual forecast. Mr. Fangman was unable to describe that process and Mr. Nelson was not offered as a witness to describe the process. Mr. Fangman received information from Mr. Nelson and reviewed that information for what he characterized as "reasonableness."

Aquila witness Rush had been involved for several years with St. Joseph Light & Power and testified that he had been involved in the forecasting process for a part of the time that he was so employed. However, he confirmed that forecasts were typically and commonly at variance with actual usage. This information alone, if not known, certainly should have been known and should have given Aquila foreknowledge that there was a high degree of uncertainty involved in the steam usage forecasting operation.

AGP offered Exhibit 9, obtained as part of a data request from Aquila, indicating that, as far back as 2005 the annual budgeted amounts for gas were at significant variance with the customers' actual usage and that in 2005, 2006 and 2007, the

latter two years being involved here, the budgeted amounts were substantially higher than customers actual usage. These discrepancies were identified as significant by Aquila witnesses, and although Mr. Gottsch indicated that he could have made adjustments, there were only two reviews done during the periods in issue and neither resulted in a modification to the budget.

In addition, it was shown that Mr. Gottsch purchased all the 2006 hedge positions at once, making commitments for Aquila to purchase these volumes that could not be unwound without financial consequence. In addition, very much the same thing was done for 2007. Although Aquila's electric hedging strategy suggested that monthly and quarterly reviews of the positions were to be held, there was no similar program in place for the steam hedging program.

For Aquila, this created a substantially overhedged position that should have been promptly noticed and rectified assuming monitoring consistent with the electric hedge program held out GMO to have been the template. However, Aquila, instead, found itself having to or financially settle these hedged positions when gas costs had substantially declined. Accordingly, the stated intent of the "1/3 strategy" was frustrated and the customers, subject to this prudence review, have made up the difference. AGP has met its burden of proof to show by a preponderance of the competent and substantial evidence on the whole record that Aquila substantially overhedged its positions and do so imprudently.

At the same time, Aquila has sought to make the case that the customers provided it with bad information on which it based the erroneous forecasts. Aquila fails to explain how individual customer data, although willingly provided in good faith, was used in preparation of the forecast of system load. Moreover, this is but the first step in the process in that Mr. Nelson had to then prepare a forecast of both base load coal and natural gas requirements. These fuel forecasts are at least two steps removed from good faith projections of the customers. There is also no defense of the disregard for uncertainty in load as explained by Mr. Rush. On top of all of this there was the unacknowledged (by Aquila) uncertainty because of the swing fuel status.

Although Aquila asserted customer culpability, this was not shown by Aquila's evidence. Particularly, Aquila failed to show the method by which the forecasts were developed or that there was any serious consideration given by Aquila management to addressing excessive hedges. Rather it appears that Aquila's instructions to Mr. Gottsch were mechanical and detached from reality. Significantly, the evidence showed, and the Commission finds, that Aquila had responsibility for the proper forecasting of usage levels and the base and swing fuel (natural gas) requirements. Correspondingly, Aquila must accept responsibility for being significantly incorrect.

The Stipulation and Agreement provided a "safe harbor" of 10% to address inaccuracies. AGP was only entitled to lodge a

prudence complaint if the amount charged exceeded 10% of the total. Aquila did not contend that AGP was not entitled to bring this complaint on that ground.

AGP has shown by a preponderance of the competent and substantial evidence on the whole record that these excessive hedges were purchased by Aquila, that they were significantly in excess of what was needed, and that 80% of the costs of the financial settlement of these excessive hedges were passed on to the customers. Imprudent costs should not be the responsibility of customers and the Commission so finds.

- 6. Given that Aquila/GMO claimed to be seeking to mitigate price volatility through its hedging program, did Aquila/GMO act imprudently in making a forecast of natural gas usage requirements that was two or more times actual usage thereby creating volatility in fuel costs and price spikes that moved prices up in a market when they should have been going down?**

Aquila claimed that its program was intended to mitigate price volatility and sought to distinguish from the QCA mechanism with the latter being designed to mitigate only the impact on the customers of price spikes. However, by purchasing all the 2006 hedges at one time shortly after the Commission approved the Stipulation and Agreement, and mechanistically continuing to purchase additional hedges without apparent attention to the accumulating discrepancies between hedges and actual customer usage, Aquila locked itself into a situation from which it could not unwind the hedges without substantial costs being

passed on to the customers. Additionally, the descriptions of the "1/3 Strategy" purportedly contemplated that only 2/3 of the natural gas needs would be hedged while the remaining 1/3 would be purchased at spot prices.

However, because of Aquila's inaccurate forecast coupled with its hedge purchases made by Mr. Gottsch, Aquila's hedged positions exceeded the actual burn and Aquila simply bet wrong on the market. Exhibit 109, which was offered by Aquila, shows that the hedged positions instead of meeting the 2/3 design criteria, exceeded the actual burn by nearly 1/3. This does not accord with even the description of the strategy that was given to the Commission. Had this been correct, the hedged positions would have been only 2/3 of the total burn and the customers would have been exposed (and benefitted from) to the declining prices of the market according to representations made to the Commission.

As a result (including the lack of monitoring addressed earlier), Aquila was unable to capture the declining market for the customers and, instead, had to settle its futures hedge positions at higher-than-market rates. These additional costs were passed through to the customers and, in the Commission's opinion, should not have been.

AGP showed by a preponderance of the competent and substantial evidence on the whole record that the result of Aquila's incorrect forecast created a perverse situation where natural gas prices were in decline, yet steam customers received

higher costs because of the settlement of these excessive hedges. This was only exacerbated by the imprudent decision to sell protection to others for potential profit. The effect was to introduce price volatility through an Aquila-adopted mechanism that was initially intended to avoid that result. Aquila did not provide any evidence to justify this perverse result nor did it provide any explanation of how these excessive positions created a benefit for the customers.

7. **Given that Aquila/GMO claimed to be seeking to mitigate price volatility through its hedging program, did Aquila/GMO act imprudently by implementing a hedge program that sold puts for profit thereby contributing to costs of a steam hedging program that caused a spike in the October 2006 cost of natural gas and that was counterproductive to the stated volatility mitigation purpose of the hedge program?**

Mr. Blunk explained that the sale of puts can be part of a hedging strategy known as a collar. This was not disputed. Mr. Johnstone explained that an analysis of the risks of such a program was in order. Indeed, he pointed out that the Commission's natural gas hedge rule requires analysis and states that to adopt such a strategy with no analysis contributes to his opinion of imprudence. The fact that any particular hedge strategy has a name for reference certainly has no bearing on whether or not it is appropriate for Aquila's use in this situation. Again, Aquila fails to offer any analysis to show that the risky sale of puts might have been appropriate for the program. AGP, having the

burden on persuasion on this issue, has met that burden by a preponderance of the competent and substantial evidence on the whole record.

8. **Given that a forecast of natural gas usage was shown by actual consumption to have been excessive, did Aquila/GMO act imprudently in not adjusting its natural gas usage forecast and its hedging program in response to actual consumption data?**

AGP showed that the steam fuel hedging program was not aligned with actual experience as manifested by Exhibit 9. In fact, the year 2007 was more significantly divergent than 2006 which was far more divergent than 2005. The 2005 data from Aquila should have forewarned Aquila that its forecasting left something to be desired and this situation appeared to continue without explanation into the 2007 year.

Although this circumstance was raised by AGP witness Johnstone in his direct testimony,^{7/} Aquila did not provide a witness that could explain these discrepancies.

Exhibit 9 showed the discrepancy between actual and budgeted usage. Exhibit 9 included the 2005 year and that year's results indicated the discrepancy shown. However, with this information, Aquila did not show that it took any action to adjust its forecast customer usage consistent with this information nor did Aquila provide any evidence to explain why the results for 2006 (one of the years to which this complaint is

^{7/} Exhibit 1.

addressed). Indeed there is evidence of a monthly monitoring requirement in the electric program that is held out as the standard. There is no evidence of frequent monitoring of the steam hedging program. There is no evidence that it was prudent to continue excessive hedges as the market prices were falling. Mr. Gottsch testified that he could have easily unwound the positions had he been instructed to do so. He also indicated that he would have done so promptly to mitigate the risk. There was no evidence presented to support the infrequent monitoring and lack of adjustment as prudent. Aquila failed to meet its burden.

Aquila also maintained through its witness Gottsch that it had the capability to adjust its hedge positions to accommodate reality, but neither Mr. Gottsch nor any other Aquila witness testified that they had done so or why they had not. It appears to this Commission that Aquila activated its "1/3 strategy" and directed Mr. Gottsch to make purchases in accordance with that strategy, then did not review the results or compare them to actual. The Commission is concerned that this does not manifest the level of management attention that this program deserved.

Customers, even industrial steam customers, are entitled to more. Aquila showed that quarterly filings disclosing hedging activity were circulated to AGP counsel, but Mr. Clemens' testimony indicated that AGP had sought to discuss the matter with Aquila personnel during this period. After some time and some discussions, the Aquila entity was acquired by Great Plains

Energy and now operates (after a change of name) as KCP&L Greater Missouri Operations Company (GMO) the respondent in this case. Following that, AGP submitted its prudence challenge to this Commission. AGP, having the burden of persuasion on this issue, has met it.

9. **Given that divergence between actual steam sales and the Aquila/GMO budget first became manifest in 2006 and continued to be manifest in 2007, was Aquila/GMO imprudent in not adjusting its natural gas steam fuel hedging program to be more aligned with actual experience?**

The discussion of this issue is fully comprehended by the earlier discussion and no independent finding of fact is deemed necessary.

10. **What Is The Amount That Was Refunded To Customers Through The QCA With Respect To The 2006 Accumulation Period.**

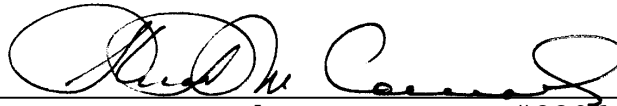
Based on testimony from the stand, Mr. Rush confirmed the accuracy of Mr. Johnstone's figure that the amount that was subject to refund to steam customers for the 2006 year as a result of Aquila's imprudence is \$931,968. The Commission finds that pursuant to the original Commission Report and Order in this matter, this amount has been refunded to customers through the operation of the QCA. Given that AGP has met its burden of showing imprudence on the part of Aquila, the Commission confirms its earlier Report and Order.

**11. What Is The Amount That Was Refund-
ed To Customers Through The QCA
With Respect To The 2007 Accumula-
tion Period.**

Based on testimony from the stand, Mr. Rush confirmed the accuracy of Mr. Johnstone's figure that the amount that is subject to refund to steam customers for the 2007 year as a result of Aquila's imprudence is \$1,953,488. The Commission finds that pursuant to the original Commission Report and Order in this matter, this amount has been refunded to customers through the operation of the QCA. Given that AGP has met its burden of showing imprudence on the part of Aquila, the Commission confirms its earlier Report and Order.

Respectfully submitted,

FINNEGAN, CONRAD & PETERSON, L.C.

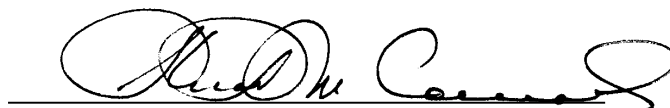


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ATTORNEYS FOR AG PROCESSING INC.

SERVICE CERTIFICATE

I certify that I have served a copy of the foregoing pleading upon identified representatives of the parties hereto per the EFIS listing maintained by the Secretary of the Commission by electronic means as an attachment to e-mail, all on the date shown below.



Stuart W. Conrad, an attorney for
Ag Processing Inc a Cooperative

January 7, 2013