BEFORE THE

PUBLIC SERVICE COMMISSION OF UTAH

In the Matter of the Application of Rocky Mountain Power for Authority to Increase its Retail Electric Utility Service Rates in Utah and for Approval of its Proposed Electric Service Schedules and Electric Service Regulations	**)))))))))**	**Docket No. 10-035-124**

Surrebuttal Testimony of

J. Robert Malko

on Revenue Requirement

On behalf of

Utah Industrial Energy Consumers

July 19, 2011

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<u>SURREBUTTAL TESTIMONY OF J. ROBERT MALKO</u>

Q PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A J. Robert Malko. My business consulting address is 245 North Alta Street, Salt Lake City, Utah 84103.

Q ARE YOU THE SAME J. ROBERT MALKO WHO FILED DIRECT TESTIMONY ON BEHALF OF UTAH INDUSTRIAL ENERGY CONSUMERS (“UIEC”) IN THIS PROCEEDING?

A Yes.

Q WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY IN THIS PROCEEDING?

A My surrebuttal testimony responds to Rocky Mountain Power (“RMP” or the “Company”) witnesses, Frank C. Graves and Stefan A. Bird, concerning natural gas hedging strategies employed by the Company.[1]

[1] In footnote 1 of Mr. Apperson’s testimony, he indicates that Mr. Widmer and I differ on the amount the Company has lost due to natural gas swaps. I am revising my number of $715 million to agree with Mr. Widmer’s figure of $707 million for the period January 1, 2006, through June 2012.

Q HAS THE COMPANY REASONABLY REPRESENTED YOUR POSITION ON HEDGING FOR NATURAL GAS?

A The Company either fails to understand my position or is deliberately trying to confuse the issue. I support hedging. Hedging should be done. However, hedging should also include diversification with some percentage exposed to market. My problem is not with the fact that the Company hedges, but with the fact that it's hedging program for natural gas has no market exposure element.

Q DO WITNESSES GRAVES AND BIRD APPROPRIATELY CONSIDER THE ROLE OF DIVERSIFICATION IN THE COMPANY'S HEDGING PROGRAM FOR NATURAL GAS?

A No. Mr. Bird states on page 16, lines 335 to 341 of his Rebuttal Testimony:

> The Company has a large short position in natural gas because of its ownership of gas-fired electric generation, requiring it to purchase large quantities of natural gas to generate power for its customers. The risk policy requires the Company to purchase natural gas well in advance of when it is required to reduce the size of this short position. Likewise, on the power side, the Company either purchases or sells power in advance of anticipated open short or long positions to manage price volatility on behalf of customers.

Mr. Bird goes on to state on page 16, lines 351 to 353:

> The Company hedges its net energy (combined natural gas and power) position to take full advantage of any natural offsets between its long power and short natural gas positions.

Mr. Bird fails to address the value of some diversification within the natural gas hedging program—of buying a portion of the portfolio at market price in order to address the risk of falling natural gas prices and the benefits of reducing costs to ratepayers. Mr. Bird also fails to clarify that the Company is purchasing financials, not physical gas, well in advance of required needs.

Mr. Graves states on page 4, lines 73 to 77 of his Rebuttal Testimony:

> There is no intrinsically "best" horizon for hedging, nor any "best" mix of hedging instruments to use. Long term forward contracts or financial hedges will dampen exposure to correspondingly long shifts in energy costs, but that benefit comes with the inevitable possibility of hedges ending up out of the money (more expensive than having been unhedged).

Although there may not be the "best" or optimal mix of hedging tools for use, Mr. Graves fails to address the value of some diversification within the natural gas hedging program that includes buying a portion of the portfolio at market prices in order to address the risk of falling natural gas prices and the benefits of reduced costs to ratepayers. In fact, because hedging is a tool to protect against forward risks, and it is equally probable that prices could move in either direction, up or down, a risk management strategy that fails to cover the move downward is not prudent. Therefore, it is imprudent for the Company to have no portion of its natural gas hedging program exposed to market within a diversified framework.

Q DO WITNESSES GRAVES AND BIRD APPROPRIATELY CONSIDER THE ROLE OF REACTING ON A TIMELY BASIS TO CHANGES IN MARKET CONDITIONS IN THE COMPANY'S HEDGING PROGRAM FOR NATURAL GAS?

A No. Mr. Graves states on page 14, lines 259 to 264 of his Rebuttal Testimony:

> Then the financial crisis and resulting recession, combined with the shale gas revolution, pushed prices back down to much lower, more

> comfortable levels today. This low cost pattern may last for a few years, but it is certainly plausible that there will be resurgence to high fuel and power prices once the economy picks up steam, tighter environmental regulations take effect, and perhaps inflation sets in.

Mr. Graves acknowledges that starting in 2009 the downward pressure on the price of natural gas attributable to the serious recession and the significant increase in the supply of shale gas were occurring. However, Mr. Graves fails to discuss the value for the Company to actually buy a portion of the natural gas portfolio at market prices in order to capture the benefits of falling natural gas prices.

Mr. Bird states on page 16, line 373, to page 17, line 384, of his Rebuttal Testimony:

> Q. Has the Company's risk management policy and hedge program changed in response to the development of shale gas and the decreasing price of natural gas?
>
> A. Yes, the Company's risk management program has been actively reviewed by its internal risk oversight committee and updated every year for several years running to reflect best practices and respond to changing market conditions. In addition, as mentioned above, the hedge program was modified in May 2010 with the institution of the TEVaR metric. The result of these changes has been a decrease in the Company's longer-dated hedge activity, i.e., four years forward on a rolling basis, has decreased from a peak forward hedge percentage of approximately 50 percent in 2008 (a period reflecting high volatility) to approximately 25 percent in 2011 (a period reflecting lower volatility).

Mr. Bird clearly acknowledges the importance of the development of shale gas and the related decrease in the price of natural gas. However, the Company's continued lack of participation at market prices indicates that the Company has failed and continues to fail to be in a position to reap the benefits of this significant business risk development.

Q DO WITNESSES GRAVES AND BIRD REASONABLY CONSIDER THE ROLE OF COST MINIMIZATION IN THE COMPANY'S HEDGING PROGRAM FOR NATURAL GAS?

A No. Mr. Bird states on page 15, lines 322 to 326 of his Rebuttal Testimony the following:

> The goals of the Company's risk management program are to: (1) ensure that reliable power is available to serve customers; (2) reduce net power cost volatility; and (3) protect customers from significant risks. The Company's risk management policy was designed to follow electric industry best practices and is periodically reviewed and updated as necessary.

Mr. Bird acknowledges that an important goal of a risk management program is to protect customers from significant risks. The hundreds of millions dollars in losses associated with the Company's natural gas swaps since 2006 represent a significant risk to ratepayers. In order to reduce risk and associated costs to the customers, the Company could have a portion of its hedging portfolio at market price. As I discussed in my prefiled direct testimony and I continue to believe currently, a prudent strategy would be to have one-third (33%) of its portfolio exposed to market prices.

Mr. Graves states on page 3, lines 57 to 59 of his Rebuttal Testimony:

> The purpose of hedging is not to find the lowest after-the-fact approach to procurement. To the contrary, hedging is designed only to limit the *a priori* <u>range</u> of potential future costs. It is inevitable that

non-speculative hedges will sometimes (about half the time) end up out of the money.

Mr. Graves acknowledges that a hedging program is designed to limit *a priori* range of potential future costs. However, in order to reduce this range of potential future costs and address falling natural gas prices, the Company clearly should have a portion of its hedging portfolio at market prices.

Q WHAT IS YOUR OPINION CONCERNING THE "MOVING FORWARD" APPROACH PROPOSED BY MR. GRAVES CONCERNING THE FORMATION OF A WORKING GROUP ON RISK-LIMITING GOALS FOR THE FUTURE AND RELATED ACTIVITES?

A Mr. Graves' moving forward approach implicitly recognizes the need for changes in the Company's hedging program. However, Mr. Graves' moving forward approach should only be considered <u>after</u> the Commission finds that the Company's past practices concerning natural gas hedging have been imprudent. The Commission ordered on page 72 of its Corrected Report and Order, Docket No. 09-035-15, issued March 3, 2011, that the prudence of swap transactions should be reviewed in each general rate case. That is what we suggest be done. Mr. Graves' proposed approach is not a substitute for a finding of imprudence.

Q DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?

A Yes

CERTIFICATE OF SERVICE

(Docket No. 10-035-124)

I hereby certify that on this 19th day of July 2011, I caused to be emailed, a true and correct copy of the foregoing **SURREBUTTAL TESTIMONY OF J. ROBERT MALKO ON REVENUE REQUIREMENT ON BEHALF OF UIEC** to:

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