BEFORE THE

PUBLIC SERVICE COMMISSION OF UTAH

In the Matter of the Application of Rocky Mountain Power to Increase Rates by $29.3 Million or 1.7 Percent Through the Energy Balancing Account	)))))))	**Docket No. 12-035-67**

NON-CONFIDENTIAL
Prefiled Direct Testimony of

J. Robert Malko

on the Division of Public Utilities' Audit Report

On behalf of

Utah Industrial Energy Consumers

December 13, 2012

BEFORE THE

PUBLIC SERVICE COMMISSION OF UTAH

In the Matter of the Application of Rocky Mountain Power to Increase Rates by $29.3 Million or 1.7 Percent Through the Energy Balancing Account	**Docket No. 11-035-200**

CONFIDENTIAL

DIRECT TESTIMONY OF J. ROBERT MALKO

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 What is your occupation?

A I am a Professor of Finance in the Huntsman School of Business at Utah State University located in Logan, Utah.

Q On whose behalf are you appearing in this proceeding?

A I am appearing on behalf of the Utah Industrial Energy Consumers ("UIEC"). Members of UIEC purchase substantial quantities of electricity from Rocky Mountain Power ("RMP" or the "Company") in Utah, and therefore are interested in the outcome of this proceeding.

Q Please describe your educational background and experience.

A This information is included in Appendix A to my testimony.

Q What is the primary purpose of your direct testimony in this proceeding?

A The primary purpose of my direct testimony is to address Rocky Mountain Power's natural gas hedging management practices as they relate to the Company's fixed for variable swaps that have resulted in losses for the time period, October 1, 2011, through December 31, 2011 the ("EBA Period") relating to the Energy Balancing Account ("EBA").

Q What do you conclude?

A I agree with Mr. Hahn's conclusion that the Company has not provided sufficient information to determine whether the costs it seeks to recover were prudently incurred.

In addition, and apart from any conclusions in the Division's Report, I conclude that the Company has been imprudent in pursuing a hedging strategy that fails to consider cost minimization. The Company has not been prudent in implementing a hedging program without adequately diversifying its financial products. The Company has failed to remain flexible to changing market conditions. Most significantly, the Company has not been prudent to engage in a hedging program that has incurred hundreds of millions of dollars in losses without reasonably considering the cost to ratepayers or without weighing the benefit or effectiveness of the objective of price volatility against the objective of cost minimization.

Q What do you recommend based on these conclusions?

A Based on the failure of the Company to provide adequate documentation and explanation, and for the other reasons explained in my testimony below, I recommend the disallowance of the Company's approximately $[redacted] in Utah jurisdiction natural gas swap losses incurred during the time period under review here. Based on the failure of the Company to provide adequate documentation and explanation, I also recommend disallowance of the claimed variance in short-term firm power purchases and sales.

Q In general, how would you describe the Company's performance in hedging natural gas supplies with financial fixed for variable swap products?

Q That depends on the Company's objective for hedging its natural gas supply. RMP states that the purpose of its hedging program is to stabilize prices. Because the Company hedged a substantial portion of its natural gas supply during the EBA Period, it would appear that the program, as it relates to natural gas, has helped control price volatility.

Q **What has been the cost of using fixed for variable natural gas swaps to control natural gas price volatility?**

A Over the past few years, the Company has lost [redacted] of dollars on its natural gas swaps and, by all indications, it will continue to incur substantial losses from gas swaps in the future. From September, 2005 through December 31, 2011, the Company incurred approximately [redacted] in natural gas swap losses. UIEC Exhibit ___ (JRM- 1) (Response to UIEC DR 8.1). In addition, as of March 20, 2012, the Company reported [redacted] Division Report of Collaborative Process to discuss Appropriate Change to PacifiCorp's Hedging Practices, Docket No. 10-035-124 (March 30, 2011) at 10.

Q **What is the amount of natural gas swap losses during the EBA Period?**

A It appears the Company projected substantial losses from its natural gas fixed for variable swap strategy for every month during the twelve months ending June 2012, the test period in the 10-035-124 rate case. Exhibit RMP ___ (BSD-3) (Workpaper 4.3). For the 4th quarter, 2011, the period under review in the current EBA docket, the Company's data show losses from natural gas swaps to be [redacted] on system-wide basis. UIEC Exhibit ___ (JRM-2) (totaling gas swap losses from Rev. FR1-1) ; DPU Report at 25, Table 5. The

Utah share of that amount (assuming a 43.5% Utah allocator) is approximately [redacted]

Q What does Mr. Hahn say about the amount of losses from gas swaps that contribute to the variance between actual and base EBA costs in this case?

A Mr. Hahn states in his direct testimony:

> The EBA base costs included a forecasted net loss in account 547 from gas swaps of [redacted], meaning that the Company's actual loss exceeded its forecasted loss by $[redacted]. Utah's share of this variance is about $[redacted].

Hahn Direct at ll. 586-588.

Q Do you agree with Mr. Hahn's assessment of the amount of gas swap losses that are at issue in this case?

A No. The swap losses incurred during the EBA Period have never been examined to determine whether they were prudently incurred. The base rates in effect during that time were a result of a Stipulation among the parties in Docket No. 12-035-124. The parties agreed to total amount of net power costs and a price per MWh based in part on a forecasted amount of hedging losses. But, those forecasted hedging losses have never been determined to be prudently incurred. They are simply a starting point for the Commission to determine the difference between actual prudently incurred costs and the prudently incurred costs collected in base rates during EBA period.

Q Please explain.

A Suppose during a general rate case the Company were to forecast annual coal costs at $500 million, and that amount is approved by the Commission and collected through base rates,   And suppose it turns out later that because of declining load and generation outages (or any other reason), the actual cost of coal during the year under review in an EBA proceeding was $475 million. In that case, the $25 million difference between the actual coal costs and the amount collected in base rates would be refundable to ratepayers. Or, suppose that the price of coal is in base rates at $35 per ton but the Company has the opportunity to buy it at $28, but does not. Should the rate payers be required to pay $35 just because that is the price in base rates? Forecasting $35 does not mean that it is prudent for the Company to pay $35, and to shift $7 in imprudently incurred costs to ratepayers.

I am not an attorney, but I understand that, because the EBA represents an exception to the rule against retroactive ratemaking, fuel and purchased power costs included in base rates are always subject to adjustment, based on what actually occurred during the EBA Period – what the costs actually were and how the Company actually behaved. The fact that the Company may have collected a certain amount for gas swap losses does not presuppose that the losses were prudently incurred or that the amount collected should not be refunded if the losses were not prudently incurred. Now that there is an EBA in place and ratepayers are at risk, it is necessary to review the entire claimed $[redacted] in swap losses for prudence in the EBA proceeding.

Q Do you mean to say that the Company may have over-collected for swap losses from base rates during the EBA Period?

A Of course. The purpose of the EBA is to reconcile the amount of prudently incurred costs in base rates with the amount of actual prudently incurred costs. Mr. Hahn is mistaken to presume that costs are prudently incurred simply because they are in base rates. The entire amount of swap losses must be disallowed if the Company cannot demonstrate prudence.

Q Does the Division's Report recommend recovery of any of the Company's natural gas hedging losses?

A No. The Division's Report states that its auditors "could not determine the prudence of the transactions from the documentation provided." DPU Report at 29. As I understand the Report, the Division was not able to recommend that any amount of natural gas swap losses should be recovered.

Q Do you agree with that conclusion?

A Yes.

Q Why is it important that the Commission determine the prudence of the natural gas swap transactions resulting in these losses?

A With the implementation of the EBA, a significant portion of the risk of losses from hedging shifted from the Company and its shareholders to the ratepayers, who have no say in the management of the Company. At the same time, the EBA has removed a substantial portion of the Company's incentive to dispose of bad investments or mitigate their losses, which makes it imperative for the Commission to now step in to protect ratepayers by examining the prudence of the Company in incurring and passing unjust and unreasonable costs on to ratepayers.

Q Does the 70/30 sharing mechanism in the EBA provide an incentive to the Company to avoid those losses?

A The 70/30 sharing mechanism gives the Company some incentive to act prudently. But, the Company has far less incentive than it did when it was 100% accountable for its imprudence. If found to be prudent, ratepayers now must absorb 70% of the losses from natural gas swaps. Although the sharing mechanism ameliorates slightly the magnitude of the losses, it remains more important than ever for this Commission to scrutinize the costs the Company attempts to pass onto ratepayers and make a prudence determination before allowing these swap losses to be recovered through the EBA.

Q Doesn't the Stipulation entered into in Docket Nos. 11-035-124, 09-035-15, 10-035-14, 11-035-46 and 11-035-47 prevent the UIEC from challenging the prudence of swaps entered into prior to July 28, 2011?

A The Stipulation states:

> The Parties agree … that hedging transactions entered into before July 28, 2011 will not be challenged for prudence on the grounds that they:
>
> a. Do not comply with the policy changes implemented through the Collaborative Process, Commission order or as a result of this Stipulation;
>
> b. Result in over-hedging of natural gas or power positions;
>
> c. Were entered into for a period of time beyond a reasonable horizon for hedging transactions; or
>
> d. Were comprised of too great a portion of financial products relative to fixed price physical transactions.

Settlement Stipulation, Docket Nos. 10-035-124, 09-035-15, 10-035-14, 11-035-46 and 11-035-47 (July 28, 2011) at 15-16. These four situations are the only limitations on a prudence challenge.

Q On what basis do you contend that the swap losses were imprudently incurred?

A There are several. First, the Company's hedging strategy failed to consider the role of cost minimization in its hedging strategy. Second, after acquiring gas swaps, the Company failed to prudently manage them to avoid taking greater losses than it needed to take. Third, the Company failed to adequately diversify its use of financial products available for hedging. Fourth, even though its risk management policy was flawed in that respect, the Company failed to follow its own policies.

Q Why is cost minimization an essential element of a hedging strategy?

A Since PacifiCorp is a monopoly, economic regulation must be considered in the determination of a reasonable revenue requirement and associated prices. The role of economic regulation of an energy monopoly is to produce results, in a reasonable manner, of a workably competitive market concerning costs, prices, and earnings. Regulatory ratemaking is certainly not a cost reimbursement scheme and clearly should not insulate the regulated energy utility from risks of conducting business. Economic regulation of a monopoly utility is focused on encouraging efficient behavior and efficient outcomes relating to costs and prices. Not considering cost minimization as an important objective in a hedging strategy violates principles of economic regulation and related efficiency concerns.

Q Was the Company aware of the ratepayers' desire for cost minimization?

A Yes, of course. In the general rate case, Docket No. 10-035-124, nearly every party provided testimony opposing the Company's ability to recover for all its extremely high natural gas[1] hedging losses. In that case, Mr. Douglas D. Wheelwright testified on behalf of the Division of Public Utilities ("Division"):

[1] The complaints were against natural gas hedging and did not appear to include complaints against electric power hedging.

> The Company has not been able to demonstrate that the current hedging policies and practices provide the appropriate balance of risk to both the Company and ratepayers. The existing hedging strategy has been designed for price stability and ***does not adequately consider the potential cost impact***. . . . The program creates price stability for rate making purposes but reduces the incentive for the Company to look for possible cost savings opportunities. . . . ***Cost minimization does not appear to be a consideration in the current program***. . . . In the Questar Gas pass-through docket the Commission indicated that Questar should consider cost, reliability and price stability as the three factors that should influence a gas purchase strategy. . . . [T]he Division is concerned that the Company's current hedging program and practices do not provide an appropriate degree of flexibility to adapt to changing conditions ***and are weighted too heavily toward price stability at the expense of cost minimization***.

UIEC Exhibit ___ (JRM-3) (Pre-filed Direct Test. D. Wheelwright, Docket No. 10-035-124 (May 26, 2011), at 2:27-3:36, 7:137-138, 14:312-314, 16:350-353 (emphasis added)).

The Company has been aware of the ratepayers' intolerance to these losses but has done very little in response. In fact, in the highly confidential May 11, 2010, PacifiCorp Risk Oversight Committee Meeting minutes it was noted that [redacted]. The Company, however, ignored its own mandate that it [redacted] Risk Management Oversight Committee Meeting Minutes, August 6, 2007.

Q Did the Company undertake a hedging strategy that included the objective of cost minimization?

No. Despite what is stated in the recently issued Semi-Annual Hedging Report,[2] the Company has completely disregarded cost minimization as a goal and failed to actively manage its natural gas fixed for variable swaps to include that goal. The Company's statement in the Semi-Annual Report appears meant to appease the complaints from intervenors and regulators, but no action supports the statement. In fact, the Company's Commercial and Trading Front Office Procedures and Practices states, [redacted] UIEC Exhibit ___ (JRM-5). It has made essentially the same statement in its testimony in past rate cases,. The Company clearly has not engaged in a strategy of balancing price stability with cost minimization.

Q Wasn't a collaborative process convened to address the parties' concerns with the Company's hedging practice?

A Yes, it was. In the general rate case, Docket No. 10-035-124, the Division, Office of Consumer Services ("Office"), UAE, and UIEC all proposed disallowances to the Company's requested revenue requirement due to imprudent natural gas hedging purchasing strategies. The recommended disallowances ranged from approximately $13 million to $25 million. As a

[2] The Company states in that report: [redacted] Executive Summary, PacifiCorp Semi-Annual Hedging Report (March 29, 2012) at 4. UIEC Exhibit __ (JRM- 4).

result, at least in part, the Company agreed in the settlement of that case to "convene a collaborative process ("Collaborative Process") to discuss appropriate changes to the Company's hedging practices to better reflect *customer risk tolerances* and preferences." Docket Nos. 10-035-124, 09-035-15, 10-035-14, 11-035-46, 11-035 47, ¶ 53 (July 28, 2011) ("Settlement Stipulation") (emphasis added).

Q What was the outcome of the Hedging Collaborative?

A At the conclusion of the collaborative meetings, the Division filed a Report to the Utah Public Service Commission of the Collaborative Process to Discuss Appropriate Changes to PacifiCorp's Hedging Practices. Docket No. 10-035-124 (March 30, 2011). Some parties, including the UIEC, submitted comments to that report. I have read the Division's report and the UIEC's comments. It appears there were some areas of agreement among the participants in the collaborative, but no comprehensive agreement was reached among them. As the UIEC's comments to the Collaborative Report pointed out, the Division's report does not address the need for cost minimization at all. There is no mention or discussion of prudent management of fixed for variable swaps or prudent management of any of the Company's hedging programs so that they address and balance the objectives of price stability and cost minimization.

Q How does the Company explain that?

A. The Company states that during the hedging collaborative, it explained "and understood that the stakeholders agreed that hedging price risk does not minimize net power costs due to gains or losses resulting from the hedge activity." UIEC Exhibit ___ (JRM-12) (RMP Response to DPYU DR 13.5). As support, the Company cites the statement in the Division's Report that "the purpose of price hedging and its associated metrics (including TEVaR) is to reduce price volatility rather than to achieve cost minimization." I can only conclude that the Company's objective in hedging natural gas is to reduce volatility without regard to the cost to ratepayers.

In your view, is it imprudent for the Company to engage in a hedging program without regard to the cost to ratepayers?

A Yes. And any losses incurred under such a program should be disallowed. Not considering costs to ratepayers associated with a hedging program violates principles of economic regulation and related efficiency concerns and produces unreasonably high levels of revenue requirement for ratepayers. The level of costs is an important consideration in any program conducted by a regulated energy utility, including hedging.

Q Does the Company have an obligation to prudently monitor and manage its hedges?

A Yes. Central or critical to the investment management process is selecting what to purchase and when to purchase, <u>and</u> deciding what to sell and when to sell. A hedging strategy is not a simple motor whereby you set some dials and push some buttons and then let it run unattended. It needs to be actively watched and monitored in conjunction with what is going on in the market place, what others are doing, and what risk ratepayers are willing to bear. Prudence is not only measured by the Company's slavish adherence to a set policy but how it reacts to business risk changes.

Q. Has the Company been an active manager concerning its natural gas hedging program?

A The Company managers have been passive about the management of its natural gas hedging program. A prudent manager should have actively monitored the situation, taken note of the signs, and taken some kind of action in order to address and balance the objectives of price stability and cost minimization. I am not suggesting this through hindsight, which would be inappropriate in a prudence review.[3] But there were numerous signs that spoke for action, and others took action. Nevertheless, the Company held to its original plan despite the fact that the Risk Management Committee advised it [redacted]." (PacifiCorp Risk Oversight Committee Meeting Minutes, August 6, 2007).

[3] J. Robert Malko, Vicki M. Baldwin, "Prudence Review and Traditional Revenue Requirement Regulation: Some Thoughts," The Electricity Journal, Vol. 24, No. 8, pg. 88-91, October 2011. See UIEC Exhibit __ JRM-6.

Q What types of signs would have required the Company to take action?

A Well, in addition to nearly every party telling the Company that its natural gas fixed for variable swap losses were intolerable to ratepayers in several prior proceedings, the numbers themselves should have been a warning. As I mentioned above, the Company expects ratepayers to cover approximately [redacted] million in swap losses during the period under review, after experiencing millions in losses every month since [redacted].

Q Would evolving market conditions have required the Company to more actively manage its swaps?

A There is a distinctively noticeable and steady decline in the price of natural gas since June 2011. The September 2011 quarter-end was 9% below the June 2011 quarter-end; the December 2011 quarter-end, which is the current EBA recovery period, was 21% below the September 2011 quarter-end. This demonstrates a significant loss for the current EBA recovery period of the quarter ending December 31, 2011.

Q Are there indications that the Company recognized changing market conditions?

A The Company itself finally recognized the decline and sustainability in natural gas prices when it made its decision not to retrofit the environmental controls on Naughton 3 but to instead convert the facility to natural gas. The

Company's witness Mr. Teply testified in a Wyoming case considering this matter:

> The most important factor in the Company's alternative decision is the assumption of forecast natural gas prices. Since the Company's original Application filing, actual forward natural gas market prices have continued to decline and longer term natural gas price forecasts provided by third party experts have followed. WY Docket No. 20000-400-EA-11, Reb. C. Teply, 2:17-21 (April 2012)

UIEC Exhibit ___ (JRM-7).

These are just a few of the indicators of which a prudent Company would have taken notice and then should have taken some action. Now, with the risk having been shifted to ratepayers due to the approval of including swap losses in the EBA, it is incumbent upon the Commission to conduct a strict and thorough prudence review.

Q. You mention that others took action. What are you referring to?

A. For example, Berkshire Hathaway Inc. ("Berkshire") is a holding company owning a number of subsidiaries with diverse business activities. One of these subsidiaries is MidAmerican Energy Holding Company ("MEHC"), which is the parent company to PacifiCorp d/b/a Rocky Mountain Power. Berkshire's Form 10-K for the fiscal year ended December 31, 2010, noted:

> During the fourth quarter of 2010, we recorded other-than-temporary impairment charges of $1,020 million with respect to certain fixed maturity securities where we concluded that we were unlikely to receive all remaining contractual principal and interest amounts when due. These securities

> had been in an unrealized loss position for more than two years.

Berkshire 2010 Form 10-K at note (3) of Notes to Consolidated Financial Statements, UIEC Exhibit ___ (JRM-8).

More telling is the Note to Shareholders included in Berkshire's 2011 10-K. In there, Berkshire states:

> A few years back, I spent about $2 billion buying several bond issues of Energy Future Holdings an electric utility operation serving portions of Texas. . . . In large measure, the company's prospects were tied to the price of natural gas, *which tanked shortly after our purchase and remains depressed*. . . . *We wrote down our investment by $1 billion in 2010* [the referenced write down in the 2010 10-K] *and by an additional $390 million last year* [2011].

Berkshire 2011 Form 10-K Note to Shareholders at 4 (emphasis added). UIEC Exhibit ___ (JRM-9). Thus, after only two years of *un*realized losses, Berkshire was willing to take some action and write-down $1 billion. Berkshire took additional action the following year and wrote-down an additional $390 million. The Company on the other hand, holds to its original position racking up hundreds of millions in losses regardless of what is happening around it, which arguably will never be completely realized by PacifiCorp because of the EBA. Therefore, with swap losses in the EBA, the Company has much less reason to act.

Q Doesn't the Company say that it also has electric swaps and that there have been gains to off-set the natural gas fixed for variable swap losses?

A Yes, but having gains in electric does not mean you need natural gas losses, which is the effect of the Company's hedging structure. There are often different goals for each and they react to different stimuli.

Q Please explain.

A If your 401K had one stock that performed abysmally for over three years, you would not just hold on and accept those losses because you happened to have another stock in your 401K that performed well. Central or critical to the investment management process is selecting what to purchase and when to purchase it, <u>and</u> deciding what to sell and when to sell it. A hedging strategy is not a simple motor whereby you set some dials and push some buttons and then let it run unattended. It needs to be actively watched and monitored in conjunction with what is going on in the market place, what others are doing, and what risk ratepayers are willing to bear. Prudence is not only measured by the Company's slavish adherence to a set policy but how it reacts to business risk changes.

Q Do the natural gas fixed for variable swaps and electric power fixed for variable swaps need to be considered together?

A No. First of all, my understanding is that RMP did not start purchasing fixed for variable electric swaps until approximately 2008. From what I have been able to determine, it started some type of natural gas hedging as early as 2005. If they had some real connection in an overall program, the purchasing start would have coincided. In addition, the highly confidential May 11, 2010, PacifiCorp Risk Oversight Committee Meeting Minutes state: [redacted]. Thus, at least the feasibility of developing independent hedging programs for natural gas and electricity were recognized by the Company at that time. Plus, as early as October 8, 2009, Mr. Douglas D. Wheelwright testified for the Division about the problems of combining natural gas and electric swaps together. UIEC Exhibit __ (JRM-10) (Prefiled D. Test. D. Wheelwright, Docket No. 09-035-23, 1:22-24, 9:227-10:254 (Oct. 8, 2009)).

Q Are there other reasons that natural gas and electric hedging should be considered separately?

A Yes. There are distinctively different goals to be achieved by engaging in the electric power fixed for variable swap market. Electric power fixed for variable swaps are primarily to protect against a price fall. The Company wants to keep a floor under its electric power prices to avoid a significant loss. Without the electric power swaps, the Company could not capture its gains on the resale of electricity from its own resources in a declining price market, like what exists today. At least one would hope that the Company's practice of trading in electric swaps is limited to the disposition of surplus owned-capacity and does not reflect trading in electricity; especially given the fact that with the advent of the EBA, customers have assumed a much greater share of this risk.

Natural gas hedges, on the other hand, protect against price increases in natural gas, a phenomenon not recently experienced and, according to most observers, not likely to be experienced by meaningful increases for quite some time

Q Are there any other reasons that they should be considered separately?

A The Company's sale of power swaps assumes that it has excess capacity to arbitrage on the market. Its purchase of natural gas swaps assumes that gas prices will continually increase. Neither assumption is sound or prudent. Although the Company's load has been essentially flat or declining since the economic recession set in, the Company's load is certain to increase in the future. Likewise, natural gas prices, as we have seen, have fallen and may continue to fall, so that in the future, power swaps and natural gas swaps will likely not offset each other as they have during the past few years. It is not prudent, in my view, to embark on a strategy that depends on the recession occurring, or the Company's load declining, or on gas prices always rising. The only practical and prudent long-term strategy is to consider them separately and address effectively changing business risks.

Q Does linking natural gas and electric power hedging present any disadvantage to the Company's hedging strategy?

A Yes. Linking the two programs together assumes that the price of natural gas and the price of electricity will always move in tandem, which may not occur after significant events such as Hurricane Katrina or the Western Energy Crisis. It also assumes the company will remain in a long position with excess power and that the correlation between electricity pricing and natural gas pricing will remain unchanged. But, the Company will not remain in a long position indefinitely. The expiration of long term contracts, which the Company has pointed to in recent general rate cases, along with increasing loads, will significantly change the dynamic between the Company's natural gas and electricity positions.

By not developing a separate or internal diversification strategy for natural gas hedging, the Company managers have not actively changed strategies in response to significant business risk changes such as substantial falling natural gas prices. The result of this failure is price stability at unreasonably high costs and ignoring cost minimization. The financial goal of any prudent natural gas hedging program should not be obtaining a level of price stability at unreasonably high cost.

Q Do you have additional criticism of the Company's management of its natural gas fixed for variable swaps?

A In Docket No. 10-035-124, I testified:

> PacifiCorp should have followed the conclusions of its EROC and actually implemented changes to be more flexible and address concerns raised by natural gas price reductions and cost minimization considerations. PacifiCorp risk managers should have been clearly aware of the established financial concept of diversification when developing strategies to address and mitigate risk. Therefore, in addition to using longer-term year financial swaps, PacifiCorp risk managers should have had the intelligence and foresight to have a diversified portfolio approach in the Company's hedging program for natural gas, but they failed to take any action. Buying over time is a smart strategy, but it is not sufficient on its own. It cannot be the only strategy... [A] diversified approach would provide far more flexibility in the hedging program in order to reduce costs and increase benefits to ratepayers. Diversification is a crucial concept for effective risk management: "Don't put all your eggs in one basket."

Docket No. 10-035-124, D. Test. J.R. Malko, 19:395-20:406 (May 26, 2011). The Company's reliance on natural gas swaps as the only financial product used to hedge natural gas demonstrates a failure to diversify its natural gas hedging program.

Q Are you asking the Commission to prescribe hedging policy for the Company?

A I am not suggesting that the Commission tell the Company how to hedge or how to diversify its hedging. Because RMP is a multijurisdictional utility, it is impractical for one regulatory jurisdiction to prescribe portfolio standards or specific practices for the Company to follow. Instead, if the Company chooses to engage in fixed for variable swap activity, it must be wise and attentive to how it conducts such activity. So, here I am saying that the natural gas fixed for variable swap strategy should have been prudently managed with an awareness of the influential externalities and the ratepayers' desire for cost minimization. The Company has to be an active manager, not a passive manager.

Q What are you suggesting should have been done?

A The Company should have been more attentive to the market signs and at some point cut its losses and liquidated at least a significant portion of its natural gas hedged position. Discovery shows that the Company did sell several swaps in 2011, so we know it is possible to liquidate swaps. UIEC Confidential Exhibit __ (JRM-13) (Response to UIEC DR 1.5). But, these were too few to avoid the substantial losses in the 4th quarter. The Commission should consider whether the Company took adequate steps to avoid the losses that have now fallen to the ratepayers.

Q. You say that buying gas swaps over time is a smart strategy, but hasn't it been the Company's policy to buy over time?

A Buying over time is a smart strategy as part of a diversification plan, but is insufficient on its own. Company witness, Stefan A. Bird testified in Docket No. 11-035-200 that PacifiCorp engages in dollar cost averaging, where it buys swaps by investing a certain dollar amount regularly over time. In response to UIEC data request asking about the role of dollar cost averaging in the Company's hedging policies and practices, the Company denied that it has any written policy to use dollar cost averaging. UIEC Exhibit ___ (JRM-11) (Response to UIEC DR 7.2). Yet, its C&T Front Offices Procedures and Practices states that [redacted] UIEC Exhibit ___ (JRM-5). Even though it appears to be a Company policy, the Company denies that it follows any definite method of dollar cost averaging, and evidently does not follow it.

Q Are there other Company risk management policies that the Company failed to follow?

A Yes. As discussed above, the Risk Management Committee advised that the Company [redacted]. PacifiCorp Risk Oversight Committee Meeting Minutes, August 6, 2007. The Company held to its original hedging plan despite the fact that its hedging policy had resulted in enormous losses and despite the fact that market conditions were rapidly changing beginning in late 2010.

Q Did the Company ignore its own policies when it failed to diversify its hedging portfolio?

A I am not offering an opinion on whether the Company's gas hedging portfolio was comprised of too great a portion of financial products relative to fixed price physical transactions. But, the Risk Management policy authorizes its mangers [redacted] which would have allowed the Company to mitigate some of the losses it experienced due to falling gas prices. There is no indication that the Company used any [redacted] to hedge its gas supply during the fourth quarter 2011.

Q Has the Company followed its own policy on [redacted]?

A As I stated above, any such policy must have been only recently adopted. The Company has repeatedly stated that its objective in natural gas hedging is to control price volatility. To the extent its policy is to balance risk management and cost minimization, it has failed to follow that policy. And, for the reasons already discussed, if its policy was to control volatility without regard to cost minimization, its entire strategy was imprudent. Either way, the Company has not engaged in a prudent strategy of [redacted].

Q Do you have comments on any other part of the Division's Report?

A First, I question the failure of the Report to address the need for the Company to consider and balance the goals of price stability and cost minimization in its hedging program.

Second, I concur with Mr. Hahn that the substantial variance between forecasted net power costs and actual net power costs concerning short-term firm and system balance purchases and sales have not been adequately explained and therefore, have not been shown to be prudently incurred. Absent an adequate explanation, it is possible that some or most of the substantial variance stated in Figure 4 of Mr. Hahn's testimony is associated with day trading and, therefore, should not be recovered through the EBA. Mr. Hahn states on page 23, line 379 to page 24, line 383 the following:

> The explanation provided in the Company's direct testimony regarding the variance in net power costs does not adequately explain the reasons for actual net power costs being higher than forecast. Based upon the status of my review to date, I cannot agree that these costs were prudently incurred. The Company should provide greater in-depth analysis of this variance that addresses the issues raised in my testimony.

Finally, it is disappointing to see that the Company has failed to provide sufficient relevant information on a timely basis to the Division and other parties to support its Application. Eight months after filing for EBA cost recovery, and after having responded to dozens of data requests from the DPU and other parties, the Company still has not provided information sufficient for the Division to make a recommendation of whether the costs it seeks to recover were prudently incurred.

Q What are your conclusions and recommendations based on your prudence review of PacifiCorp's natural gas hedging practices and related costs within the EBA framework during the time period, October 1, 2011, through December 31, 2011?

A I agree with Mr. Hahn's conclusion that the Company has not provided sufficient information to determine whether any of the costs it seeks to recover were prudently incurred. Having failed to provide sufficient information to show the prudence of any of its natural gas swap losses, and for the reasons I have explained in this testimony, I recommend the disallowance of 100% of the Company's approximately $[redacted] in Utah jurisdiction natural gas swap losses during the EBA period. The Company has not been prudent in its pursuit of a hedging strategy that fails to consider cost minimization. It has not been prudent in implementing a hedging program without adequately diversifying its portfolio of financial products. It has not followed its own policy of diversification, or its policy to remain flexible to market conditions. Most importantly, It was not prudent for the Company to engage in a program that incurred hundreds of millions of dollars in losses without considering the cost to ratepayers or weighing the benefit of price volatility against the cost to ratepayers.

Q Does this conclude your testimony?

A Yes.

APPENDIX A

QUALIFICATIONS OF J. ROBERT MALKO

Q. PLEASE STATE YOUR NAME, ADDRESS AND OCCUPATION.

A. My name is J. Robert Malko. I am a Professor of Finance in the Huntsman School of Business at Utah State University located in Logan, Utah. My business consulting address is 245 North Alta Street, Salt Lake City, Utah 84103.

Q. PLEASE SUMMARIZE YOUR EDUCATIONAL BACKGROUND AND ACADEMIC POSITIONS.

A. I received my Bachelor's degree, cum laude, in economics and mathematics from Loyola College in Baltimore, Maryland. I received my Master's and Doctorate degrees in economics from the Krannert Graduate School of Management at Purdue University in West Lafayette, Indiana. I have also taken graduate courses in corporate finance and investment theory at the University of Wisconsin at Madison. I was a Visiting Scholar in industrial engineering at Stanford University in Palo Alto, California. At Utah State University, I teach undergraduate level and graduate level courses in Corporate Finance and Applied Microeconomics.

Q. PLEASE DESCRIBE SOME OF YOUR PRIOR WORK EXPERIENCE.

A. I served during the periods 1975-1977 and 1981-1986 as the Chief Economist for the Public Service Commission of Wisconsin. During this time, I also served as Chair and Vice-Chair of the National Association of Regulatory Utility Commissioners ("NARUC") Staff Subcommittee on Economics and Finance. From 1977-1981, I was Project Manager, and then Program Manager, for <u>The Electric Utility Rate Design Study</u>. This study was housed at the Electric Power Research Institute ("EPRI") in Palo Alto, California and prepared for NARUC. In 1981-1982, I was the Senior Staff Advisor to the NARUC Ad Hoc Committee on Utility Diversification. I assisted the Committee in the preparation and publication of their Final Report in 1983. I served on the Board of Directors at the National Regulatory Research Institute ("NRRI"), located at the Ohio State University, between 1997 and 2003. I have served on the Board of Directors of the Society of Utility and Regulatory Financial Analysts (SURFA) between 1988 and 1996 and 2002 to 2010. I am also a Certified Rate of Return Analyst which is certified by SURFA. I currently serve on the Advisory Council for the Center of Public Utilities at New Mexico State University.

Q. HAVE YOU PREVIOUSLY TESTIFIED IN REGULATORY PROCEEDINGS?

A. Yes. I have testified on behalf of state regulatory commissions, state offices of consumer counsel, energy utilities and customer groups. I have presented testimony before the Arizona Corporation Commission, the Connecticut Public Utilities Control Authority, District of Columbia Public Service Commission, the Federal Energy Regulatory Commission, the Hawaii Public Utilities Commission, the Illinois Commerce Commission, the Maryland Public Service Commission, the Minnesota Public Utilities Commission, the New Hampshire Public Utilities Commission, the New Jersey Board of Public Utilities, the Nevada Public Service Commission, the New York Public Service Commission, the Pennsylvania Public Utility Commission, the Public Service Commission of Wisconsin, the Public Service Commission of Utah, Utah State Tax Commission, and the Virginia State Corporation Commission.

Q. PLEASE SUMMARIZE YOUR PUBLICATIONS CONCERNING REGULATION AND PUBLIC UTILITY ISSUES.

A. I have written (co-authored) approximately 170 articles on public utility economics and finance that have been published in books and journals including, Forum For Applied Research and Public Policy; Journal of Business Administration; Journal of Energy Law and Policy; The Journal of Energy and Development; Energy: The International Journal; and Wisconsin Law Review. I am co-editor of Electric Utilities Moving Into The 21st Century published by PUR in 1994, Reinventing Electric Utility Regulation published by PUR in 1995, and

Customer Choice: Finding Value in Retail Electricity Markets published by PUR in 1999.

CERTIFICATE OF SERVICE

Docket No. 12-035-67

I hereby certify that on this 13th day of December 2012, I caused to be emailed, a true and correct copy of the foregoing **NON-CONFIDENTIAL** Prefiled Direct Testimony of J. Robert Malko on the Division of Public Utilities' Audit Report to:

Patricia Schmid
Wesley D. Felix
ASSISTANT ATTORNEYS GENERAL
500 Heber Wells Building
160 East 300 South
Salt Lake City, UT 84111
pschmid@utah.gov
wfelix@utah.gov

Michele Beck
Cheryl Murray
Dan Gimble
Executive Director
COMMITTEE OF CONSUMER SERVICES
500 Heber Wells Building
160 East 300 South, 2nd Floor
Salt Lake City, UT 84111
mbeck@utah.gov
cmurray@utah.gov
dgimble@utah.gov

David L. Taylor
Mark Moench
Yvonne R. Hogle
Daniel Solander
ROCKY MOUNTAIN POWER
201 South Main Street, Suite 2300
Salt Lake City, UT 84111
Dave.Taylor@PacifiCorp.com
Mark.moench@pacificorp.com
yvonne.hogle@pacificorp.com
Daniel.solander@pacificorp.com
datarequest@pacificorp.com

Chris Parker
William Powell
Dennis Miller
DIVISION OF PUBLIC UTILITIES
500 Heber Wells Building
160 East 300 South, 4th Floor
Salt Lake City, UT 84111
chrisparker@utah.gov
wpowell@utah.gov
dennismiller@utah.gov

Paul Proctor
ASSISTANT ATTORNEYS GENERAL
500 Heber Wells Building
160 East 300 South
Salt Lake City, UT 84111
pproctor@utah.gov

Gary Dodge
Hatch James & Dodge
10 West Broadway, Suite 400
Salt Lake City, UT 84101
gdodge@hjdlaw.com

Peter J. Mattheis
Eric J. Lacey
Brickfield, Bruchette, Ritts & Stone, P.C.
1025 Thomas Jefferson St., N.W.
800 West Tower
Washington, D.C. 2007
pjm@bbrslaw.com
elacey@bbrslaw.com

Nancy Kelly
Penny Anderson
Western Resource Advocates
9463 N. Swallow Rd.
Pocatello, ID 83201
nkelly@westernresources.org
penny@westernresources.org

Holly Rachel Smith
Holly Rachel Smith, PLLC
Hitt Business Center
3803 Rectortown Road
Marshall, VA 20115
holly@raysmithlaw.com

Kevin Higgins
Neal Townsend
ENERGY STRATEGIES
39 Market Street, Suite 200
Salt Lake City, UT 84101
khiggins@energystrat.com
ntownsend@energystrat.com

Arthur F. Sandack
8 East Broadway, Ste 411
Salt Lake City, Utah 84111
asandack@msn.com

Steven S. Michel
Western Resource Advocates
227 East Palace Ave., Suite M
Santa Fe, NM 87501
smichel@westernresources.org

Sarah Wright
Kevin Emerson
Brandy Smith
Utah Clean Energy
1014 2nd Avenue
Salt Lake City, UT 84103
sarah@utahcleanenergy.org
Kevin@utahcleanenergy.org
brandy@utahcleanenergy.org

Gerald H. Kinghorn
Jeremy R. Cook
Parsons Kinghorn Harris, P.C.
111 East Broadway, 11th Flr.
Salt Lake City, Utah 84111
ghk@pkhlawyers.com
jrc@pkhlawyers.com

Ryan L. Kelly
Kelly & Bramwell, P.C.
11576 South State St., Bldg. 203
Draper, UT 84020
ryan@kellybramwell.com

Betsy Wolf
Salt Lake Community Action Program
764 South 200 West
Salt Lake City, Utah 84101
bwolf@slcap.org

Steve W. Chriss
Wal-Mart Stores, Inc.
2001 SE 10th Street
Bentonville, AR 72716-0550
stephen.chriss@wal-mart.com

GREGORY B. MONSON
STOEL RIVES LLP
201 SOUTH MAIN STREET, SUITE 110
SALT LAKE CITY, UT 84111
GBMONSON@STOEL.COM

Michael L. Kurtz
Kurt J. Boehm
BOEHM, KURTZ & LOWRY
36 East Seventh Street, Ste 1510
Cincinnati, Ohio 45202
mkurtz@BKLlawfirm.com
kboehm@BKLlawfirm.com

/s/ Colette V. Dubois