Q. Please state your name, business address, and present position with PacifiCorp dba Rocky Mountain Power ("the Company").

A. My name is Stefan A. Bird. My business address is 825 NE Multnomah St., Suite 600, Portland, Oregon 97232. I am Senior Vice President, Commercial and Trading, for PacifiCorp Energy, a division of PacifiCorp.

Q. Please describe your education and business background.

A. I hold a B.S. in mechanical engineering from Kansas State University. I joined PacifiCorp Energy and assumed my current position in January 2007. From 2003 to 2006, I served as president of CalEnergy Generation U.S., an owner and operator of Qualifying Facility and merchant generation assets, including geothermal and natural gas-fired cogeneration projects across the United States. From 1999 to 2003, I was vice president of acquisitions and development for MidAmerican Energy Holdings Company ("MEHC"). From 1989 to 1997, I held various positions at Koch Industries, Inc., including energy marketing, financial services, corporate acquisitions, project engineering and maintenance planning in the Americas and Europe.

In my current position I oversee the Company's Commercial and Trading organization which is responsible for dispatch of the Company's owned and contracted generation resources, procurement of new generation resources, and natural gas and electricity wholesale purchases and sales to balance the Company's load and resources. I am also responsible for PacifiCorp's load and revenue forecast, integrated resource plan ("IRP") and net power costs modeling. Most relevant to this testimony, I oversee PacifiCorp's hedging program.

Q. Have you previously testified for the Company in regard to hedging?

A. Yes. I filed testimony on hedging before the Public Service Commission of Utah in Docket Nos. 09-035-15, 10-035-124 and 11-035-200.

Q. What is the purpose of your rebuttal testimony?

A. My rebuttal testimony responds to the testimony of Dr. J. Robert Malko for the Utah Industrial Energy Consumers ("UIEC") on hedging.

Q. How is your testimony organized?

A. I will first provide an overview of the Company's response to Dr. Malko's testimony. I will then address Dr. Malko's criticisms of the Company's hedging program. I will then explain why Dr. Malko's claim is inconsistent with his prior positions and other prior analyses of the Company's hedging program. Finally, I will address the proper scope of NPC at issue in this proceeding.

Q. Is the Company providing additional testimony to respond to the UIEC's hedging adjustment?

A. Yes. Mr. Frank C. Graves from The Brattle Group has prepared independent expert testimony in this case addressing the consistency of the Company's hedging policies with good industry practices, why liquidation of hedges would not have created an expected benefit for customers, why cost minimization should not be a central part of the Company's hedging goals, how the Company's hedging program was appropriately diversified, why it does not make sense to hedge natural gas and power separately, and why various analogies to other hedging and investment situations mentioned by UIEC do not demonstrate a flaw in the Company's approach. Mr. Brian S. Dickman has prepared testimony showing that Mr. Richard S. Hahn's concern about information regarding power purchases and sales, which is another basis for UIEC's proposed disallowance, has been resolved.

Overview

Q. Do you have a general reaction to Dr. Malko's claim?

A. Yes. Dr. Malko's claim is vague and undefined, but nonetheless results in an extraordinary recommendation to disallow 100 percent of the natural gas swap losses incurred during the fourth quarter of 2011. He claims that the Company was imprudent for not liquidating natural gas swaps, but fails to identify which or how many swaps the Company should have liquidated, how it should have liquidated them, when it should have liquidated them or whether it should have hedged again at lower prices upon liquidating them. He provides no evidence that liquidating the swaps would have created an expected reduction in net power costs ("NPC") or what impact the liquidation would have had on compliance with the Company's risk management policies or practices. Despite these specious claims, he recommends that 100 percent of the losses incurred on natural gas swaps that settled during the fourth quarter of 2011 be disallowed. This is the same as saying the Company should have predicted the fall in natural gas prices and should not have hedged any portion of its forecast natural gas requirements for the Energy Balancing Account ("EBA") period, leaving customers entirely at risk for the full amount of its natural gas requirements.

Dr. Malko's claim lacks any basis in sound risk management theory and is based on an improper view of the purpose of hedging. His view that cost minimization should be a goal of hedging would require that hedging be undertaken based on speculation about the future price of natural gas. An underlying premise of his position is the hindsight knowledge that natural gas prices have declined over the period from 2008 to the present. While he pays lip service to the concept that prudence cannot be determined based on hindsight, he fails to review what was known when the Company entered into the hedges and what was known at each time the Company might have considered liquidating the swaps had it been willing to adopt his unique and unorthodox approach to risk management. He completely ignores the fact that forward market prices for natural gas were always rising during this period, third party experts forecast the risk of much higher prices than then current forward prices throughout this period and his strategy would have resulted in much greater NPC had natural gas prices increased. Thus, his underlying premise is entirely based on hindsight.

Finally, Dr. Malko's suggestion that the Company should have seen the signs and acted on them is clear evidence that he believes the Company should speculate in the market. He attempts to analogize actions that might be taken with respect to investments with actions that he believes should have been taken in hedging. Beyond the fact that his examples are incorrectly stated or inapplicable, they would have involved speculation if undertaken as he suggests they were. The Company does not speculate about the future prices of natural gas or electricity for the purpose of attempting to make trading profits. Doing so would be patently imprudent. The sole purpose of the Company's hedging program is to reduce customer risk exposure to volatility that is inherent in its supply portfolio.

Q. Are there other problems with Dr. Malko's claim?

A. Yes. As I will explain in greater detail later in this testimony, in addition to the fact that all of his claims are unsupported by any evidence or sound risk management theory, his claims and recommendation to disallow 100 percent of all natural gas swap losses is inconsistent with the EBA statute and tariff and goes well beyond the change in natural gas swap value from base rates to actuals, violates stipulations entered into by UIEC and is inconsistent with his own prior testimony and positions on hedging..

Q. In summary, what do you conclude regarding Dr. Malko's claim based on this overview?

A. Dr. Malko's claim is inconsistent with sound risk management practice, is not supported by any evidence and is inconsistent with his own prior positions and recommendations of independent experts in this case and prior general rate cases. It should be rejected entirely by the Commission.

Response to the UIEC's Proposed Hedging Adjustment

Q. What does Dr. Malko suggest with regard to the Company's hedges in this case?

A. He suggests that the Company's hedging program should have included a cost minimization component, that the Company did not adequately diversify its hedge products, and that the Company was not sufficiently flexible in the execution of its hedge program. Although his claims are vague, he apparently believes the Company was not flexible because it did not liquidate natural gas swaps when they were out of the money. He also claims that the Company did not follow its own risk management policies and should hedge natural gas independently from power. He also claims that the Company's failure to liquidate out-of-the-money gas swaps is inconsistent with conduct of others that he alleges was taken in response to falling gas prices. Based on these supposed flaws in the Company's hedging program, he ultimately concludes that 100 percent of the $23.8 million of the Company's natural gas swap hedge losses incurred during the fourth quarter of 2011 and the entire variance in short term power purchases and sales should be disallowed from the EBA.

Q. Should the Company's hedge program be designed to minimize NPC?

A. No.

Q. What is the purpose of hedging?

A. The purpose is to reduce NPC volatility to the Company's customers. The purpose is not to reduce or minimize NPC. The Company cannot predict the direction or sustainability of changes in forward prices. Therefore, the Company hedges, in the forward market, to reduce the volatility of NPC consistent with good industry practice as documented in the Company's risk management policy.

Q. How does the Company minimize NPC?

A. First, we engage in integrated resource planning to plan resource acquisitions that are anticipated to provide the lowest cost resources to our customers in the long-run. In addition, in acquiring specific major resources, we participate in competitive requests for proposals to assure that the resources we acquire are the lowest cost resources available on a risk adjusted basis.

In operations, we maintain and operate a portfolio of assets that diversify customer exposure to fuel, power market and emissions risk and utilize an extensive transmission network that provides access to markets across the western United States. Independent of any natural gas and electric price hedging activity, to provide reliable supply and minimize net power costs for customers we commit generation units daily and dispatch in real time all economic generation resources and all must-take contract resources, serve retail load and then sell any excess generation to generate wholesale revenue to reduce NPC for customers. We also purchase power when it is less expensive to purchase power than to generate power from our owned and contracted resources.

Q. How does Dr. Malko suggest the Company should minimize costs in its hedging program?

A. He does not indicate or suggest how cost minimization can be incorporated into a hedge strategy. However he states "Not considering cost minimization as an important objective in a hedging strategy violates principles of economic regulation and related efficiency concerns." (Malko Direct ll. 189-191)

Q. Does Dr. Malko claim that the Division of Public Utilities ("Division") believes cost minimization should be part of a hedge strategy?

A. Yes. Dr. Malko refers to testimony of a Division witness filed in Docket No. 10-035-124 in May of 2011 that criticized the Company's hedging program because it did not appear to consider cost minimization. (Malko Direct ll. 193-217)

Q. Does the Division continue to suggest cost minimization should be included as part of the Company's hedge strategy?

A. No. Following the extensive collaborative process that resulted from a stipulation in Docket No. 10-035-124 and other cases ("2011 Stipulation"), the Division's report acknowledges "the purpose of price hedging and its associated metrics (including TEVaR) is to reduce price volatility rather than to achieve cost minimization."[1]

Q. Does Mr. Graves' testimony address whether cost minimization should be part of a hedge strategy?

A. Yes. He explains that cost minimization has nothing to do with risk management and that the Company's risk policies, analytic methods, and controls are sophisticated, well-developed, and aptly suited to monitoring and managing natural gas and power cost risks over time. He adds that properly understood and practiced, risk management is about controlling the potential width (and shape) but not about improving (reducing) the mean of the distribution of future costs (or increasing revenues) and, conversely, you cannot expect to reduce your future costs by not hedging.

Q. What does Dr. Malko suggest regarding diversifying hedge products?

A. He states "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." (Malko Direct ll. 453-455)

[1] Collaborative Process to Discuss Appropriate Changes to PacifiCorp's Hedging Practices, Report to the Utah Public Service Commission, Submitted by Utah Division of Public Utilities, Docket No. 10-035-124 (Utah PSC March 30, 2012) ("Division Report") at 8.

Q. Does Dr. Malko make clear what he means by diversification?

A. Again, Dr. Malko is vague. However, he apparently believes the Company should have used options instead of swaps in anticipation of declining natural gas prices.

Q. Why did the Company not use options instead of swaps?

A. As the Company explained in several prior dockets and in the collaborative workshops, options are not as readily available in the market and are generally more expensive means of hedging than swaps due to this limited liquidity. While the Company is willing to consider the use of options in hedging, there needs to be some consensus on how their costs will be treated if they are not exercised. For example, as Mr. Graves explains in his testimony, had the Company been able to prior to the Stipulation and did purchase call options for natural gas to be settled in 2011, they would have not have been exercised due to the subsequent decrease in prices and the Company would still have incurred the cost associated with obtaining the options.

Prior to the Stipulation, when the Company entered into the swaps that settled in a loss position in the fourth quarter of 2011, the Company's risk management practice did not generally include use of options. Notwithstanding this fact, the Company's policy and practices were found to be sound and compliant with industry standards. In 2009, the Division retained an outside consultant, Blue Ridge Consulting Services, Inc. ("Blue Ridge"), to review the Company's NPC, including its risk management program. In its report in Docket No. 09-035-23, the Company's 2009 general rate case, Blue Ridge stated:

> . . . Division Staff requested that we provide an assessment of how the Company's hedging policies compare to those employed in other states

> or jurisdictions where Blue Ridge has had experience reviewing such policies or where we are aware of the decisions made by other jurisdictions concerning the use of hedging and the impacts on an energy cost recovery mechanism.
>
> . . . .
>
> Overall, Blue Ridge found that the Company's commercial trading and risk management programs (and the related hedging programs) are well-documented and controlled and adhere to generally accepted standards found elsewhere in the industry. The Company has well-stated goals and strategy that is aimed at mitigating price volatility. In addition, our review of the Company's internal documents showed that the Company is self-monitoring compliance with accepted commercial trading and risk management procedures through its own internal audit function.[2]

Q. What does Dr. Malko state with regard to his criticism that the Company's hedge program was not sufficiently flexible?

A. He states, "Central or critical to the investment management process is selecting what to purchase and when to purchase, and deciding what to sell and when to sell." (Malko Direct ll. 289-291)

Q. Does Dr. Malko point the Commission to any specific hedges that should have been liquidated, or ever describe what "portion" of the Company's positions should have been liquidated?

A. No.

Q. Does Dr. Malko identify for the Commission examples of other large utilities that liquidated natural gas positions during the decline in natural gas prices?

A. No.

[2] Independent Third-Party Evaluation of Net Power Cost Evaluation Rocky Mountain Power 2009 General Rate Case, Prepared forUtah Division of Public Utilities, Prepared by Blue Ridge Consulting Services, Inc, Docket No. 09-035-23 (Utah PSC October 7, 2009) at 2.

Q. Does Dr. Malko say exactly when the Company should have liquidated "a portion" of its portfolio?

A. No. He states "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." (Malko Direct ll. 300-303)

Q. Does Dr. Malko ever define what he believes constitutes "some kind of action" in hedging practice?

A. Not specifically, but apparently he is referring to liquidation of hedges that are out of the money.

Q. Do you know whether it is standard utility practice to liquidate a hedged position once a forward price curve places the hedged position out of the money?

A. As discussed by Mr. Graves, it is actually *contrary* to standard practice to do so and would create increased risk if a utility followed this policy. Therefore, Dr. Malko's suggestion that we should sell hedges when they fall out of the money violates his own definition of good utility practice and prudence because it would be contrary to standard utility practice.

Q. With regard to Dr. Malko's criticism that the Company does not follow its own risk management policies, does the Company have a policy on hedging that it follows or are hedging decisions made on an ad hoc basis?

A. The Company has a formal policy. The goals of the Company's risk management policy and hedging 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 and hedging program were designed to follow electric industry best practices and are periodically reviewed and updated as necessary.

Q. How is the Company's hedging program structured?

A. Since 2003, the Company's hedge program has employed a portfolio approach of dollar cost averaging to progressively reduce net power cost risk exposure over a defined time horizon while adhering to best practice risk management governance and guidelines.

Q. What is "dollar cost averaging"?

A. This is the term used to describe gradually hedging over a period of time rather than all at once.

Q. How does Dr. Malko claim the Company violated its hedging policy in this case?

A. Dr. Malko bases this claim on misconstruing the Company's policies. For example, he cites a statement in Risk Management Oversight Committee minutes regarding flexibility, and then proceeds to assume that failure to liquidate out-of-the-market hedges failed to comply with that statement. When read properly in context, the statement in the minutes suggested that the Company should be willing to consider revision of strategy or risk management policy, such as changes in the length of hedges and the percentage of anticipated supply hedged. In fact, these were the types of changes to policy that were made as a result of the hedging collaborative workshop that took place during the EBA period and concluded in the first quarter of 2012. The statement clearly did not imply that the Company should be flexible through undertaking unsound risk management practices such as liquidation of out of the money hedges to lock in losses and expose customers to further price volatility.

Dr. Malko also misinterprets a statement from the Company's semi-annual hedging report regarding balancing risk management with low cost. The statement refers to using dollar cost averaging, not to attempting to minimize net power costs through hedging. As Dr. Malko is well aware, the Company has consistently maintained that hedging cannot be used to minimize net power costs.

Finally, Dr. Malko suggests that the Company may have failed to follow its own policies when it failed to diversify its hedging portfolio. He notes that he is not providing an opinion on whether the hedging portfolio was comprised too much of financial products relative to fixed price physical transactions. (Malko Direct ll. 531-533) Such a claim would be clearly barred by the 2011 Stipulation to which UIEC agreed and which I will discuss further below. So instead, he refers to the fact that the risk management policies permit hedging with options and other financial products. However, he points to no aspect of the Company's risk management policies and practices that would have required the Company to employ greater use of options or other financial products with their resulting greater hedging costs. Therefore, again he has not provided any evidence that the Company did not act in accordance with its risk management policies.

Q. Did the Company comply with its risk management policies?

A. Yes, and Dr. Malko has not cited any action of the Company that was not in compliance with its risk management policies.

Q. Please describe the collaborative and 2011 Stipulation you referenced above.

A. Consistent with an order issued by the Commission on September 13, 2011 in Docket No. 10-035-124 approving a stipulation in several cases, the Company and interested parties engaged in a hedging collaborative which included several meetings over several months after which the Company agreed to modify its hedging program going forward.

In addition, the 2011 Stipulation stated:

> The Company represents that its current natural gas hedged position as a percent of the Company's forecast gas requirement for the period of August 2012 through July 2013 using instruments comparable to the hedge transactions reviewed in the General Rate Case is the percent disclosed on a highly confidential basis to the Parties during a settlement meeting on July 27, 2011. The Parties agree, based on such representation and in consideration of the Company's compromises reached in this Stipulation, 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.

Q. Were the natural gas swaps that settled for a loss during the fourth quarter of 2011 entered into prior to July 28, 2011?

A. Yes. The vast majority of the natural gas swap losses were related to transactions done prior to July 28, 2011.

Q. Did the Company enter into any new natural gas hedges settling in the fourth quarter of 2011 subsequent to July 28, 2011?

A. Yes. [redacted]. These [redacted] swaps settled for [redacted] on a Utah-allocated basis during the EBA period.

Q. Did the Company [redacted] any natural gas swaps that settled during the EBA period that it entered into subsequent to July 28, 2011?

A. Yes. [redacted] on a Utah-allocated basis.

Q. Did the Company [redacted] any natural gas swaps during the EBA period that it entered into prior to July 28, 2011?

A. Yes. The Company [redacted] on a Utah-allocated basis.

Q. Did the Company [redacted] the natural gas swaps as a result of [redacted]?

A. No. The [redacted] were a direct result of a change in the Company's forecast needs for natural gas to fuel its generating plants. These requirements were [redacted] resulting in the Company [redacted]. Therefore, the Company [redacted] these natural gas swaps.

Q. What, in simple terms, is your understanding of Dr. Malko's suggestion regarding management of the Company's hedges?

A. He essentially asks us to have liquidated some undisclosed portion of our positions so we could then speculate on when the market would bottom out and (presumably) re-hedge at that point or some later yet undefined point in time. He disregards the fact that any liquidated hedge would lock in a loss and further, given his recommendation to disallow 100 percent of all natural gas hedge losses, he apparently expects that any subsequent hedge entered into by the Company would be made with such prescient knowledge of future prices such that they would never incur a loss.

Q. Is speculating on the bottom of the market good risk management practice?

A. No.

Q. Does Dr. Malko explain his statement that the Company should have "taken note of the signs" of changing market conditions impacting prices and reacted?

A. No.

Q. Were there signs that the Company should have taken note that would support the actions recommended by Dr. Malko?

A. No. The Company's actions were based on knowledge it had *at the time* it made hedging decisions. Mr. Frank Graves' testimony also discusses information available to the Company and concludes there was no market indication or sentiment remotely confirming Dr. Malko's view that there were signs of a likely decline of the experienced magnitude. The knowledge the Company based its decisions on were the *then current* natural gas forward market prices as well as spot price forecasts and risk assessments based on fundamentals provided by well-known and respected third party services. The Company did not and does not have the prescient ability to forecast future wholesale natural gas market settlement prices. Selling hedges as recommended by Dr. Malko based on speculation that prices would continue to decline would have resulted in locking in a loss for customers, increasing transaction costs, and increasing customer exposure well outside of the allowed range in the then current hedging policy, and increasing customer exposure well outside the allowed range in the collaborative guidelines that were subsequently developed during the EBA period through the first quarter of 2012.

Q. Does Dr. Malko address the inability of a utility to predict future markets?

A. No.

Q. Dr. Malko attempts to separate natural gas hedges from electricity hedges. He claims that if an investor has one stock performing well in a portfolio that has no impact on a decision to sell a poor-performing stock. Does his analogy apply to the Company's natural gas-electricity hedge dynamic?

A. No. That analogy is not applicable to the NPC exposure that the Company manages on behalf of its customers. Natural gas and power show strong correlation in wholesale prices. This is not only demonstrated by the data, it is intuitive. Natural gas generation continues to occupy an increasingly greater share of U.S. electricity supply and is often the generation resource on the margin, thereby directly influencing the wholesale market price for power. Consistent with current best practices, the Company's robust risk management process incorporates daily updates from third party sources for natural gas and power correlations and volatility as well as updates to forward market prices and produces daily updates of forecast requirements, hedge positions and risk metrics.

Q. Have the Company's customers benefited from offsetting power and natural gas positions?

A. Yes. The Company has a short natural gas position and on average a long electric power position. As I just mentioned, power and natural gas prices are closely related because natural gas is often the fuel on the margin in efficient dispatch, as is practiced throughout the western U.S. This means power sales tend to be more valuable in periods when natural gas is high cost, producing revenues that are a credit or offset to the high cost fuel. If spot natural gas prices depart from prior forward prices, power prices will tend to do so in the same direction, thereby naturally hedging some of the unexpected cost variance.

Confidential Figure SAB-1 below is a graph of the net value of PacifiCorp's hedge losses and gains for natural gas and power by month over the past few years. There is an obvious and strong pattern of the two moving opposite to each other, whether natural gas costs are high or low. As a result, the net hedge losses and gains of the two commodities has been lower than and is less volatile than the loss or gain in either individual commodity.

[redacted]

The same pattern is evident from a chart of the cumulative net value of PacifiCorp's hedge gains and losses for natural gas and power, where it becomes clear that the cumulative net energy hedge loss / gain is much less than either the natural gas or power losses and gains. This is shown in Confidential Figure SAB - 2 below.

[redacted]

Q. Dr. Malko also claims that the Company's decision to convert Naughton 3 to a natural gas fired unit demonstrates the Company's certainty that natural gas prices will remain low for the indefinite future. Was the decision to convert Naughton 3 to natural gas based on the Company's view of indefinitely low natural gas prices?

A. Natural gas price forecasts are one of *many* factors that went into the Naughton 3 decision. The decision was based on a robust risk assessment of the forward natural gas and wholesale electricity markets including then current forward price curves for natural gas and electricity, long-term third party forecasts of a range of potential future natural gas prices, potential carbon prices, the useful life of the asset, the cost of the environmental retrofit versus cost of conversion to burning natural gas, and the cost of replacement energy among other items. Therefore, Dr. Malko's comments are incomplete, at best.

Q. Does the Company's hedge program rely on a long power position?

A. No. However, the Company's hedge program takes into account the Company's full portfolio and utilizes continuously updated correlations of natural gas and power prices and thereby takes advantage of offsetting natural gas and power positions in circumstances when prices are correlated and a forecast long power position offsets a forecast short natural gas position. This has the effect of reducing the amount of natural gas hedging that the Company would otherwise pursue. Ignoring this correlation as Dr. Malko suggests would instead result in the need for more natural gas hedges to achieve the same level of customer risk reduction.

Q. Dr. Malko also claims that an approximate $1 billion write down by Berkshire Hathaway is evidence that "others took action" during the time he claims the Company should have liquidated a "portion" of its hedges. Is his analogy applicable?

A. No. Dr. Malko's use of the writedown is misplaced. The fact that a company like Berkshire Hathaway took an accounting write-down in its books but *did not liquidate* that position is hardly relevant to the suggestion that a utility should liquidate a portion of its hedges. The example Dr. Malko provides is in reference to a Berkshire Hathaway bond investment, which is not relevant to compare to the hedging activity the Company pursues on behalf of its customers. The Company's hedges do not represent an investment decision for profit. Speculative commodity trading would be an investment decision, but the Company does not engage in speculative commodity trading. The sole purpose of Company hedges is to provide price stability and protect against wildly fluctuating rates. Dr. Malko has not provided any relevant examples to support his recommendation to liquidate hedges in his testimony.

Q. How do you respond to Dr. Malko's comment "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"? (Malko Direct ll. 419-423)

A. As noted above, the Company does not engage in speculative commodity trading, commonly referred to as proprietary trading. In other words, the Company does not buy or sell natural gas or electricity speculatively as a means of making a profit. The Company only transacts to hedge its forecast requirements to mitigate net power cost volatility to customers.

Q. In summary, does Dr. Malko's recommendation that the Commission disallow $23.8 million, or 100 percent of costs related to natural gas hedge losses have merit?

A. No. He offers no explanation as to why the Company should be penalized for losses on natural gas hedges that were prudent and in compliance with the Company's risk management policy when entered into. Second, he also fails to understand that the purpose of hedging is to provide our customers with a more stable price point. It is not intended to be an investment strategy. Third, he fails to understand the link between natural gas and power hedges and omits from his analysis the benefits derived from those hedges. Fourth, he does not address the risk our customers would face if we liquidated firm positions and became more dependent on spot market purchases. Fifth, he provides no specific instances of imprudence because he cannot say (as no one could) exactly what the Company should have liquidated, when it should have done so, and to whom it could have sold these positions and for what price. His opinion is simply after-the-fact analysis that was not available at the time any hedging decisions were made.

Q. Dr. Malko states he concurs 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, Were adequate explanations provided to Mr. Hahn regarding the purpose and nature of these transactions?

A. Yes. As discussed by Mr. Dickman, the Company conducted several conference calls with Mr. Hahn and at the conclusion of the last conference call Mr. Hahn stated he had a sufficient understanding of the transactions.

Q. Dr. Malko goes on to state that 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. Do you agree?

A. No. The short term firm and system balancing purchases and sales were all done as part of the routine Company operation to reliably serve its customers.

Q. Were most of the transactions associated with "day trading"?

A. No. None of the transactions were associated with speculative trading activity. As stated previously, the Company does not engage in this type of activity.

Inconsistency of Dr. Malko's Position

Q. Has Dr. Malko had a consistent view regarding hedging strategy and natural gas swaps in other cases before the Commission?

A. No. In Docket No. 10-035-124, Dr. Malko testified both in his prefiled direct testimony and again in his surrebuttal testimony that a "prudent" strategy would have been for the Company to have one-third (33%) of its portfolio exposed to the market, i.e., that 33% of the Company's natural gas requirements should be purchased at market.[3] In other words, Dr. Malko believed it prudent that 67% of the Company's natural gas requirements should remain hedged.

Q. What was UIEC's ensuing recommendation to the Commission in that case?

A. Dr. Malko concluded that, as a result of the Company's lack of exposure to the market to the extent of 33 percent, there should be a disallowance of 33 percent of

[3] Direct Testimony of J. Robert Malko, Docket No. 10-035-124 (Utah PSC May 26, 2011) page 31, line 656; Surrebuttal Testimony of J. Robert Malko, Docket No. 10-035-124 (Utah PSC July 19, 2011) page 6, lines 19-21,.

the Company's NPC related to the Company's natural gas swaps.[4]

Q. What was UIEC's recommendation regarding this same issue in Docket No. 11-035-200?

A. In Docket No. 11-035-200, Dr. Malko recommended that the Commission disallow approximately fifty percent (50%) of the Company's NPC attributed to natural gas swap losses.[5]

Q. What is UIEC's recommendation regarding this same issue in this docket?

A. Here Dr. Malko is recommending that the Commission disallow one hundred percent (100%) of NPC attributed to natural gas swap losses.

Q. Is there an objective basis for UIEC's fluctuating positions and recommendations on the same issue over the course of three cases?

A. No. It is clear to me, based on the foregoing history, that UIEC's arguments are arbitrary and subjective opinions that cannot be and have not been individually quantitatively or qualitatively supported by any objective standard. It is also worth noting that no other party in this case has embraced UIEC's position. Dr. Malko does not explain the ever-changing positions he's taken on the same issue in the last three cases.

Q. Did UIEC have an opportunity to address the possible liquidation of natural gas swaps for a forward period before the Company filed its application in this docket?

A. Yes. As part of the 2011 Stipulation, the Company agreed to participate in hedging collaborative workshops to address a list of issues related to the

[4] *Id.*

[5] Direct Testimony of J. Robert Malko, Docket No. 11-035-200 (Utah PSC June 11, 2012) p. 23, lines 511-513.

Company's hedging strategy. Incidentally, the list of issues was compiled, in large part, by UIEC during the 2011 Stipulation negotiations. Several meetings were held related to changes to the Company's hedging strategy to take into account Utah stakeholder risk preferences. UIEC was an active participant in these meetings and never brought up any recommendation for the Company to liquidate any of its natural gas swaps.

Q. Has the Company's hedging program, which governed the time during which the swaps UIEC is contesting were executed, been reviewed in a previous rate case before this Commission?

A. Yes. In Docket No. 09-035-23, the Division requested that Blue Ridge review the Company's hedging program. Blue Ridge concluded that the Company's hedging program was well-documented and controlled and adhered to generally accepted standards in the industry.

Q. Has the prudence of NPC including projected losses of the natural gas swaps in this EBA, been previously scrutinized in a general rate cases before the Commission?

A. Yes. All but six of the swap transactions in the EBA were included in the NPC approved in Docket No. 10-035-124.

Response to Claim Regarding Appropriate Scope of Costs At Issue In this Case

Q. Dr. Malko takes issue with the testimony of Mr. Hahn in which Mr. Hahn states that the amount at issue in this proceeding is limited to the difference between the base and actual energy balancing account costs ("EBAC"). Do you agree with Dr. Malko?

A. No. Dr. Malko is incorrect for two reasons. *First*, his testimony is inconsistent with the 2011 Stipulation. *Second*, while I am not an attorney and do not purport to offer a legal opinion, it seems to me that his testimony is inconsistent with the EBA statute, the Commission's order approving the EBA,[6] UIEC's position in that proceeding and approved Tariff Schedule 94. UIEC's position also indicates that UIEC will likely take the position in the future that is inconsistent with the Settlement Stipulation in Docket Nos. 11-035-200, 12-035-79 and 12-035-80 dated August 7, 2012 ("2012 Stipulation").

Q. How is Dr. Malko's testimony inconsistent with the 2011 Stipulation?

A. In the 2011 Stipulation, UIEC (and other parties) agreed that the base NPC for the test period from July 1, 2011 through June 30, 2012, on a Utah-allocated basis, would be $629.1 million for purposes of the EBA.[7] NPC was a disputed issue in that case, and UIEC and the other parties to the case agreed to the amount of NPC that would be used in setting just and reasonable rates and in establishing base NPC. The deferral period under review in the current docket is part of the rate-effective period for the 2011 General Rate Case that was settled by the 2011

[6] *In the Matter of the Application of Rocky Mountain Power for Approval of its Proposed Energy Cost Adjustment Mechanism*, Docket No. 09-035-15, Report and Order, March 2, 2011 ("EBA Order").
[7] *See* 2011 Stipulation at ¶ 45.

Stipulation. Now, through Dr. Malko's testimony, UIEC is attempting to alter the base NPC it agreed and the Commission determined were just and reasonable.

Q. Is Dr. Malko challenging base NPC or just addressing the EBA?

A. Dr. Malko is challenging base NPC. As shown in Schedule 94 of the Company's Tariff, the EBA is defined as the Actual Energy Balancing Account Costs (the actual net costs incurred by the Company in providing power) *minus* the Base Energy Balancing Account Costs (the net costs "approved by the Commission in the most recent Utah general rate case . . . .").[8] Through Dr. Malko's testimony, UIEC challenges the prudence of costs associated with the Company's hedging transactions. These hedging transactions have already been approved by the Commission in "the most recent Utah general rate case," in accordance with the 2011 Stipulation. By challenging the prudence of the Company's hedging positions, Dr. Malko is inappropriately trying to re-set base NPC. The only proper subject before the Commission in this EBA case is whether the difference between actual and base costs for fuel, purchasing power, and wheeling, i.e., the balance in the EBA, was properly incurred during the EBA period. Any arguments related to and affecting base NPC should have been made during the general rate case.

Q. Are there any other ways in which Dr. Malko's testimony is inconsistent with the 2011 Stipulation?

A. Yes. The Company's hedging practices, and particularly its use of gas swaps, was a significant disputed issue in Docket Nos. 09-035-15 and 10-035-124. The 2011 Stipulation resolved the issue. As discussed above, in the 2011 Stipulation, the

[8] *See* P.S.C.U. No. 49, Original Sheet Nos. 94.2 and 94.7.

parties agreed that they would not challenge hedging transactions entered into before July 28, 2011 on the grounds that they "[r]esult in over-hedging of natural gas or power positions; [w]ere entered into for a period of time beyond a reasonable horizon for hedging transactions; or [w]ere comprised of too great a portion of financial products relative to fixed price physical transactions."[9]

With respect to natural gas swaps, the parties further agreed "not to challenge the prudence of existing financial hedge transactions, including swaps, entered into before July 28, 2011" for the same reasons.[10] As explained above, Dr. Malko's testimony challenges the prudence of the Company's natural gas swaps entered into prior to July 28, 2011.

Q. In Dr. Malko's testimony, he acknowledges the limitations imposed by the 2011 Stipulation and characterizes his challenges as being different.[11] What is your response to that testimony?

A. Dr. Malko is simply trying to avoid the 2011 Stipulation through semantics. The challenges he lists in his testimony are that the Company hedged without sufficiently considering cost minimization, held its swaps too long such that it incurred unneeded losses, invested too heavily in swaps, and maintained its swaps despite a misconstrued representation of the Company's risk oversight committee minutes to remain "flexible."[12] However, in discussing each of these grounds, Dr. Malko always ends with the same conclusion: the Company was allegedly imprudent because it hedged too heavily through use of gas swaps for too long a

[9] 2011 Stipulation at ¶ 54.
[10] *Id.* at ¶ 56.
[11] *See* Malko Direct at ll. 153-177.
[12] *See* Malko Direct at ll. 173-74.

period. This is the argument that UIEC agreed it would not make in the 2011 Stipulation.[13] Thus, the challenge UIEC is making through Dr. Malko's testimony is inconsistent with the 2011 Stipulation.

Q. Has UIEC and its witness Dr. Malko filed testimony in other rate cases that is inconsistent with the 2011 Stipulation?

A. Yes. In the 2012 General Rate Case, UIEC filed testimony in which Dr. Malko made essentially the same claims he has made in this case, however with an inconsistent disallowance recommendation, arguing that the Company's NPC were imprudent because of losses associated with gas swaps. In his testimony in that case he argued that the Company was imprudent for failing to liquidate swaps when the market price of natural gas declined. However, following the filing of rebuttal testimony by the Company similar to the Company's rebuttal testimony in this case, UIEC entered into the 2012 Stipulation resolving this and all other issues in the case. Despite base rates being approved by the Commission as a result of the 2012 General Rate Case, given UIEC's record of behavior, it is reasonable to expect that UIEC will similarly disregard the 2011 Stipulation and the 2012 Stipulation and seek to re-litigate these same issues in the 2012 EBA and therein create unnecessary regulatory burdens. It is therefore all the more necessary for the Commission to reject Dr. Malko's testimony in this EBA in its entirety.

[13] *See* 2011 Stipulation at ¶ 54 ("The Parties agree . . . that hedging transactions . . . will not be challenged for prudence on the grounds that they . . . [r]esult in over-hedging of natural gas or power positions, were entered into for a period of time beyond a reasonable horizon for hedging transactions; or were comprised of too great a portion of financial products relative to fixed price physical transactions..").

In sum, UIEC has challenged the prudency of the same type of hedging transactions at issue here in Dr. Malko's testimony, in the past two general rate cases. UIEC stipulated twice that it would not challenge their prudency as a party to the 2011 Stipulation and the 2012 Stipulation. Yet, it is challenging the prudency of hedging transactions a third time in this case with the same arguments. Nothing within the Company's control has changed between the past two general rate cases and now. All that has changed is that the mark-to-market value of the hedging transactions changed from the value at the time base rates were set in the 2011 General Rate Case to the value at the time the hedging transactions actually settled. Clearly, the issue is lacking in merit as it has been decided and resolved not once but twice already.

Q. You also said that you believed the UIEC's challenge was contrary to the EBA Statute, the Commission's EBA Order, UIEC's position in the EBA docket and Tariff Schedule 94. Will you explain what you mean?

A. Yes. The Company filed the application that initiated this docket in accordance with the Commission's EBA Order for "an annual reconciliation of the deferred account balance."[14] Under the EBA Statute, the Commission may only establish an EBA if it finds that the EBA is "for prudently-incurred costs; and implemented at the conclusion of a general rate case."[15] In addition, the statute provides that the Company "shall file a reconciliation of the energy balancing account . . . with actual costs and revenues incurred . . . ."[16]

[14] Corrected Report and Order, Docket No. 09-035-15 (Utah PSC March 3, 2011) ("EBA Order") at 77.
[15] Utah Code § 54-7-13.5(2)(b).
[16] Utah Code Ann. § 54-7-13.5(2)(c).

Given this statutory language, UIEC argued before the Commission in Docket No. 09-035-15 that the *propriety* of hedging was more appropriately addressed in general rate cases where (as UIEC's argument was characterized by the Commission), "all necessary information is available for analysis."[17] The Commission, in part, agreed with UIEC and dismissed all attempts to argue about the Company's hedging during the EBA proceeding. Responding to parties' recommendations as to the proper design of the EBA—specifically, that the Commission establish predefined or pre-approved levels of hedging, market purchases, energy efficiency programs, etc., the Commission held that such concerns should have been raised in the general rate case:

> [N]o party contested the inclusion in rates of these costs in the Company's most recent general rate case, again, an appropriate venue for raising issues of prudence and cost disallowance. We conclude the Company's current portfolio of resources, including the reliance on markets, use of hedging instruments and wind and natural gas resources to the degree currently employed, has been examined in former proceedings and therefore is not the issue in this case.[18]

Later, when addressing the proper components of the EBA, the Commission reiterated its position that concerns regarding swaps should be addressed in a general rate case:

> We conclude that these [swap] transactions must be reviewed and approved in each general rate case, which is an appropriate proceeding for determining the prudence of Company decisions.[19]

[17] EBA Order at 48.
[18] EBA Order at 68.
[19] *Id.* at 72.

Thus, UIEC's attempt to raise the prudence of the Company's hedging included in base EBAC in this EBA proceeding is improper. This is especially true given that UIEC raised its concerns regarding hedging in the general rate case that established base NPC, and chose to resolve those matters through stipulation.

Q. Didn't the Commission reverse itself on this particular point when it allowed swap transactions to be included as a component of the EBA when it approved the 2011 Stipulation?

A. No. For the Commission to have reversed itself it would have had to take consideration of the prudence of swap transactions out of general rate cases and it did not do that. What the Commission did is allow the Company to include swap transactions as a component in the EBA.

Q. How do you respond to Dr. Malko's suggestion that failure to adopt his position would allow the Company to recover imprudent costs?

A. His suggestions ignores the fact that the prudence and reasonableness of base NPC has been and will continue to be reviewed in general rate cases and the prudence of any difference between base and actual NPC will be reviewed in EBA dockets such as this one. Thus, by limiting its review in EBA dockets to the prudence of any actions that resulted in the difference between base and actual NPC, the Commission will not allow the Company to recover imprudent costs.

Furthermore, acceptance of Dr. Malko's position would render the determination of prudent and just and reasonable base NPC in a general rate case meaningless. Rather than attempting to arrive at a just and reasonable projection of prudent NPC during the rate-effective period, the parties could simply pick any number out of the air because the full amount of NPC incurred would be subject to prudence analysis regardless of its relationship with the base amount. This would lead to all sorts of gamesmanship in positions taken and settlements reached during a general rate case.

The purpose of the EBA is to track the difference between base NPC that have already been reviewed and approved for recovery through base rates by this Commission as prudent, just and reasonable, with actual NPC. That difference is what is deferred in the EBA, and what is appropriately reviewable in this case—whether the factors that led to the deviation of actual NPC from base NPC were caused by any imprudence on the Company's part. If so, it is appropriate to disallow recovery of a portion of the difference. If not, the Company should be allowed to recover the full amount of the difference consistent with the purpose of the EBA.

Q. Please describe the EBA for the natural gas swaps.

A. All but the six natural gas swaps described above were included and approved in the 2011 general rate case. The general rate case concluded prior to the EBA deferral period so the final settlement value of the approved swaps was not yet known. For those, the EBA captures the change in value from the mark-to-market value of the forward transaction at the time of the general rate case to the actual settled price.

Q. Does any market information, such as prices, that becomes known to the Company after the general rate case settlement have any bearing on the

prudence of natural gas swaps in the general rate case that established base forecast NPC?

A. No.

Q. Why not?

A. None of this market information is known at the time of the natural gas swaps were transacted that were within the general rate case test period and, therefore, cannot be used to determine prudence based on what is known or should be known at the time of the transactions.

Q. Has the Company's hedging program and hedging transactions been reviewed by regulators in others states and, if so, what has been the result?

A. Yes. The Company's hedging program and hedge transactions have received a high degree of scrutiny in multiple state jurisdictions. None of the Company's hedge transactions have been disallowed by any of the Company's six state commissions at any time. However, similar to Utah, the Company agreed to hold hedging collaborative workshops with interested parties in other states and in each case agreed to the same policy changes that the Company agreed to make in Utah to best reflect customer-expressed risk tolerances on a going forward basis.

Q. What did the Oregon Public Utility Commission say about the Company's hedging program?

A. The OPUC praised the Company's hedging program in its November 4, 2011 Order 11-435:

> The company's Risk Management Policy includes sound hedging goals, methodologies, and targets. Its policies and procedures were well articulated, and its specific hedging targets were made clear in advance to the company and its traders. Moreover, the company's hedging program

> appears to be robustly designed and well documented. The company provided ample contemporaneous documentation of the policies and procedures in effect at the time the hedges were executed, including its method of identifying, measuring, and managing risk, its hedging targets, its credit policies and procedures, and its approved portfolio structures, as well as detailed procedures governing company enforcement of these policies.

Q. Does this conclude your testimony?

A. Yes.