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
Surrebuttal Testimony of

J. Robert Malko

On behalf of

Utah Industrial Energy Consumers

January 17, 2013

Q Please state your name and business address.

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

Q Are you the same J. Robert Malko who filed direct testimony and rebuttal testimony on behalf of Utah Industrial Energy Consumers ("UIEC") in this proceeding?

A Yes.

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

A The purpose of my surrebuttal testimony is to respond to the rebuttal testimony of Stefan A. Bird, Frank C. Graves and Brian S. Dickman filed on behalf of Rocky Mountain Power ("RMP" or "Company") and the rebuttal testimony of Richard S. Hahn for the Division of Public Utilities ("Division" or "DPU").

Q Mr. Bird responds to your testimony by claiming that cost minimization should not be a part of hedging strategy. Please explain what you mean by "cost minimization."

A I am using "cost minimization" in a broad sense to reflect cost impacts and cost considerations. This is a common meaning of the term and is consistent with Douglas Wheelwright's use of the term in his discussion of the Company's hedging policy in the 2010 general rate case (quoted in my direct testimony at lines 197-214). He criticized the Company's hedging strategy because it "has been designed for price stability and does not adequately consider the potential cost impact." Later in his testimony, addressing the same concept, he stated that "cost minimization does not appear to be a consideration in the current program."

Q Please explain.

A I'm not saying that cost minimization is or should be the main goal of hedging. But, I agree with Mr. Wheelwright's criticism that "cost minimization" or the "potential cost impact" must be a consideration in any hedging policy.

Q Does Mr. Bird or Mr. Graves in rebuttal testimony offer any explanation of how the Company has attempted to balance the goals of price stability and cost/price minimization in its purchasing of natural gas for electricity generation?

A No.

Q Mr. Graves implies that the Company's risk management policies and methods conform to industry norms. Do other professional analysts share your concerns about considering and balancing stability and costs in pass through mechanisms, such as the EBA?

A Yes. I agree with the following quotation made by Dr. Jonathan A. Lesser and Dr. Leonardo R. Giacchino in their text, Fundamentals of Energy Regulation, 2007, pp. 186-187. In discussing pass-through mechanisms, the authors state:

> The mechanisms themselves often balance several conflicting goals. As we discussed in Chapter 2, one of the most

> important goals of regulation is to mimic the pricing that would prevail in a fully competitive market. Pass-through mechanisms make this goal easier to achieve, because prices can adjust more quickly. Another goal of regulation, however, is price stability. When retail rates change constantly, it can be more difficult for firms to operate efficiently, using the lowest cost mix of inputs. Still another goal is to ensure firms have an incentive to manage their costs. *Allowing firms to pass along every price increase without having ever considered prudent hedging measures removes that efficiency incentive*. [Emphasis added].

These authors are grappling with the conflicting goals of stability and cost impacts – a conflict that was demonstrated by the Company's hedging policy which has achieved price stability but at a huge cost. As long as the Company's goal in hedging is only price stability, regulators will need to step in and require that balance between price stability and costs. Otherwise, there is no incentive to the Company ever to manage the cost of its hedging program.

Q Please explain.

A There clearly needs to be a cost-benefit or cost-effectiveness analysis of a utility's hedging mechanisms and programs. When an analyst in a regulatory setting is applying an economic or finance theory such as marginal cost price or the capital asset pricing model, the analyst needs to use "sanity checks" or balancing considerations to avoid an absurd outcome. It is no different in applying a hedging theory and related program. The goal of price stability needs to be balanced with the "sanity check" of cost considerations. In other words, the utility must consider the cost effectiveness of achieving a certain level of price stability. As authors Lesser and Giacchino stated on page 301 of their text:

> A greater need for more sophisticated, low-cost hedging strategies has complicated the tasks of assessing the prudence of a firm's hedging activities and estimating revenue requirements – either under traditional cost-of-service or, as is becoming more common in the United States, performance-based regimes. Since there is no uniquely "correct" quantity of insurance one ought to buy, *regulators must weigh the costs and benefits for those consumers who cannot directly hedge their natural gas purchases*. (Emphasis added).

This quote was in the context of a gas company obtaining its natural gas supply, I don't see a relevant distinction between the hedging practices of a gas utility and an electric utility. In either case, there must be a balance between costs and price stability.

Q Has the Public Service Commission of Utah stated a similar position concerning considerations and objectives for an energy utility in purchasing natural gas?

A Yes, in Docket No. 00-057-08 and Docket No. 00-057-10, the Public Service Commission of Utah ("Commission") issued the following finding in a Questar Gas Company case (May 31, 2001):

> The Commission finds that the Company should consider *price stability, as well as cost and reliability*, in acquiring its natural gas supplies.

(Emphasis added).

This is in reference to Questar's gas purchasing practices. As I said, I don't see any reason that RMP should be treated any differently from Questar since RMP's hedging policy was actualized in purchasing its gas. The Commission was correct to say that all three considerations — reliability, stability and cost — have to be considered as part of a prudent policy.

Q Has any other jurisdiction determined that cost considerations and impacts are essential for natural gas hedging programs by energy utilities?

A In response to concerns regarding the cost-effectiveness of increasing financial losses associated with natural gas hedging programs of the Nevada electric utilities, the Nevada Commission suspended procurement of any additional financial natural gas hedges by Nevada Power Company and Sierra Pacific Power Company in 2010.[1] Before the suspension of the natural gas hedging program, the electric utilities in Nevada had the following portfolio: 50% in swaps, 25% in collar options, and 25% in open market. In Docket No. 10-09003, Order issued on December 8, 2010, the Public Utilities Commission of Nevada approved a Stipulation directing NPC to abandon its natural gas hedging program.

Q Please explain why that order is relevant to this case.

The Nevada Commission's orders reflect the objectives of the energy utilities' hedging programs based on their Energy Supply Plans which include: measures to minimize the cost of supply, minimize price volatility, and maximize the

[1] PUCN, Docket No. 10-09003 (Dec. 16, 2010); PUCN, Docket Nos. 09-12002, 10-07003 (Oct. 20, 2010).

reliability of energy.[2] Hedging plans concerning natural gas are addressed in the Energy Supply Plan Proceedings in Nevada.

Q At the end of Mr. Bird's rebuttal testimony, Mr. Bird quotes from Order 11-435, issued by the Oregon Public Utilities Commission on November 4, 2011, that praises the Company's risk management and hedging programs. Did various parties representing Utah ratepayers in 2011 have a similar view?

A Absolutely not. The parties to the Stipulation in the 2010 rate case expressed the opposite view. As I stated in my direct testimony at lines 243 to 253:

> In the general rate case, Docket No. 10-035-124, the Division, Office of Consumer Services ("Office"), UAE, and UIEC all proposed disallowances in year 2011 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 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).

Utah ratepayers clearly rejected the concept of price stability at a cost of hundreds of millions of dollars in the Company's purchasing of natural gas. In other words, the ratepayers were dissatisfied that the Company had failed to acknowledge and actively address the importance of price/cost minimization

[2] *See, e.g.*, Docket Nos. 09-12002, 10-07003, Test. of Otsuka and Mendl/Wennerly.

along with price stability in the purchasing of natural gas to generate electricity. That was clearly one of the primary drivers that led the Commission to establish the Hedging Collaborative.

Q What does Mr. Bird say the Hedging Collaborative concluded with respect to the purpose of hedging?

A Mr. Bird cites the Collaborative Report as acknowledging that "the purpose of price hedging and its associated metrics (including TEVaR) is to reduce price volatility rather than to achieve cost minimization."

Q Is that statement consistent with other statements in Mr. Bird's testimony?

A. Yes. Mr. Bird states that "The sole purpose of Company hedges is to provide price stability and protect against wildly fluctuating rates." Bird Reb. at ll. 461-62. Mr. Bird also points out that "Mr. Graves explains that cost minimization has nothing to do with risk management," Bird Reb. at l. 168, and criticizes my testimony for failing "to understand that the purpose of hedging is to provide our customers with a more stable price point." Bird REb. at ll .

Q How do you respond?

A Obviously, I understand that the Company's policy is to engage in hedging only for the purpose of limiting price volatility. The problem is that the Company's policy does not take into account what it costs to limit volatility. Reliability, stability *and cost* all must be considered in any program the Company undertakes. This is especially important where, as in the EBA, the ratepayers are at risk for the costs of the program.

Q Mr. Bird states that the Company does not use options in hedging natural gas because there is no consensus about how the costs will be treated if they are not exercised. How do you respond?

A Mr. Bird ignores the cost of inadequate flexibility in the Company's hedging program. It is the generally practice in traditional hedging programs to address concerns of price stability and also flexibility, which includes considerations of costs impacts. This is achieved by diversifying the portfolio of hedging investment instruments. Mr. Wheelwright recognized this principle in his Direct Testimony in Docket No. 10-035-124 (at page 2) when he stated that "The current hedging program does not provide enough flexibility and the Company has not recognized the internal and external changes in market conditions." I support that concept and agree with the following recommendations he proposed at page 18 in his testimony to address these shortcomings:

> The Commission should direct the Company to complete an analysis and review of specific investment vehicles currently available such as options, caps, collars, and their associated costs.

A prudent hedging program would implement a range of hedging instruments to balance the needs of price stability and flexibility. By having reasonable flexibility, changing market conditions can be addressed to avoid unreasonably high costs. To have a meaningful hedging program, the Company needs to consider stability and flexibility, including cost impacts.

Q Mr. Bird and Mr. Graves have said you are inconsistent in your recommendation of the amount of losses from natural gas swaps that should be disallowed. How do you respond?

A In the previous rate case, I recommended 50% disallowance "based on the concept that cost minimization should be at least equal in importance to price stability." Malko Direct (Docket No. 11-035-200) at ll 471-73. But I also stated that if different weights were assigned to these objectives, then a different sharing of losses between ratepayers and shareholders would be appropriate.

Q Is your basis for recommending disallowance in this case different?

A The basis for recommending disallowance of 100% of the hedging losses is, as I stated in both my direct and rebuttal testimony, that the Division's witness, Mr. Hahn was unable to conclude on the information available to him that the Company had demonstrated prudence of those costs.

Q But both Mr. Bird and Mr. Graves complain that you have not recommended an alternative theory of what the prudent costs would have been under the prudent policies and practices that you recommend.

A I am not proposing an alternative theory. I am pointing out areas where the Company was imprudent. Mr. Hahn, who reviewed all of the information the

Company produced, said he didn't have enough information to make the call. Assuming the Company bears the burden, and not the other way around, none of the costs should be allowed because prudence was not demonstrated. That is the basis for recommending 100% disallowance.

Q Has Mr. Bird offered any testimony to demonstrate the Company was prudent in entering incurring the natural gas swap losses for which you recommend disallowance?

A Mr. Bird explained the Company's policies and claimed that the Company followed them. He says that Company representatives talked with Mr. Hahn and Mr. Hahn understood the Company's position. But in his Supplemental Direct, Mr. Hahn still did not conclude that the losses were prudent.

Q Has Mr. Bird offered any testimony to demonstrate that the Company's losses from short-term power purchases and sales were prudent?

A I pointed out in my rebuttal testimony that there are two main reasons that the Company engages in short-term trades: one is to balance its power requirements based on changing load or other operational considerations, and the other is to make off system sales to take advantage of the margin in short-term power. Mr. Bird's testimony asserts that the Company does not engage in "speculation." Mr. Hahn confirms that the reason the Company offered for these transactions was [redacted], and that the Company provided him with additional information that was "helpful." But, because of the delay in providing the information, Mr. Hahn stated only that he would continue to analyze the material. He did not say that he could now find the transactions to be prudent, or that he had the necessary information to make a clear prudence finding concerning short term purchase and sales.

Q Mr. Bird contends that the Stipulation from Docket 10-035-124 precludes UIEC from advancing the position you are advocating. How do you respond?

A I believe this is a legal issue that neither Mr. Bird nor I can resolve. I stated in my direct testimony the bases on which I am challenging natural gas swap losses.

Q Are you challenging the prudence of natural gas swap losses on the ground that the company's hedging policy "does not comply with the policy implemented through the Collaborative Process, Commission order or other terms in the Stipulation?

A According to Mr. Bird, the Collaborative Report acknowledged that "the purpose of price hedging and its associated metrics (including TEVaR) is to reduce price volatility rather than to achieve cost minimization." I am not challenging the Company's hedging practices as inconsistent with that policy. I am saying that to follow such a policy without regard to the cost impact – which in the case of RMP is a substantial sum in this docket – is an imprudent policy.

Q Are you challenging the prudence of natural gas swap losses on the ground that the pre-July, 2011 swap transactions "were entered into for a period of time beyond a reasonable horizon for hedging transactions?"

A No.

Q Are you challenging the prudence of natural gas swap losses on the ground that the pre-July, 2011 swap transactions resulted in "over-hedging of natural gas or power positions?"

A No. In Docket No. 09-035-124, I suggested that a prudent hedging portfolio might consist of 1/3 swaps, 1/3 options and 1/3 open to market, which I still believe is the case. I have not asserted imprudence on that basis in this docket.

Q Are you challenging the prudence of natural gas swap losses on the ground that the Company's pre-July, 2011 hedging transactions "were comprised of too great a proportion of financial products relative to fixed price physical transactions?"

A No. I have offered direct testimony that the mix of financial products was inappropriate, not the proportion of financial products to physical products.

Q Mr. Dickman and Mr. Bird argue that net power costs that have been approved in base rates are not subject to a prudence review in an EBA proceeding. (Dickman Reb. at ll 480-494; Bird Reb. at lines 586-600). How do you respond?

A This is a legal issue. As a financial economist, I do not have an opinion on the legal issues raised by setting net power costs in base rates. If we are looking at the prudence of actual costs, however, as opposed to the prudence of the company's forecast, that review can only be undertaken by looking at how the Company actually behaved under the circumstances that actually occurred which caused the Company to incur the costs.

Q Do you have any comment on the other legal issues raised by Mr. Bird?

A No. I am not offering any opinion on the legal issues in this case.

Q Does this conclude your surrebuttal testimony?

A Yes.

CERTIFICATE OF SERVICE

Docket No. 12-035-67

I hereby certify that on this 17th day of January, 2013, I caused to be emailed, a true and correct copy of the foregoing NON-CONFIDENTIAL Surrebuttal Testimony of J. Robert Malko on the Division of Public Utilities' Audit Report to:

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